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Dodd-Frank Wall Street Reform and Consumer Protection Act Poised to Usher in Sweeping Reform of U.S. Financial Services Regulation

On June 29, 2010, the House-Senate conference committee finalized negotiations and filed the conference report to accompany the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act").[1] With a vote of 237-192, the House of Representatives approved the conference report on June 30, 2010. Although the Act must still be approved by the Senate and signed by President Obama before becoming law, these steps are expected to occur during the month of July. The Act is the most sweeping legislation regulating the U.S. financial services industry since the Great Depression. Some of the Act's provisions will become effective immediately upon enactment. Most provisions, however, have a delayed effectiveness and/or require rulemaking by various Federal regulators, including the Board of Governors of the Federal Reserve System (the "Fed"), the Federal Deposit Insurance Corporation (the "FDIC"), the U.S. Department of the Treasury ("Treasury"), the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC"). In addition, the scope and meaning of many of the Act's provisions are unclear. It is therefore difficult to predict with confidence the potential impact of the Act on U.S. financial institutions and markets.

In this memorandum, we summarize the provisions of the Act that we believe have the greatest potential impact on the financial markets and market participants.

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[1] The conference report is available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_reports&docid=f:hr517.111.pdf

I. EXECUTIVE SUMMARY

The following are the most significant provisions of the Act that will change the regulatory landscape of the financial services industry. Following the Executive Summary, this memorandum provides a more detailed analysis of the principal provisions of the Act organized by category.

- **Systemic Risk and Financial Stability**. The Act will create a new framework for overseeing systemic risk. A new Financial Stability Oversight Council (the "Council") will be established to identify and manage systemic risks in the financial system, and the Fed will assume the front-line responsibility for supervising and regulating systemically significant institutions. Systemically significant nonbank financial companies and large interconnected bank holding companies will be subject to heightened capital and other prudential standards. Regulators will be given additional tools to restrict the size, growth and activities of these systemically significant companies, including the power in some circumstances to order the divestiture of certain activities or operations, and the Act will restrict the ability of large bank holding companies and systemically significant nonbank financial companies to grow by acquisition. The Act will also place new restrictions on the ability of banks to engage in some types of proprietary trading or to sponsor or invest in private equity or hedge funds, and it will significantly modify the capital requirements placed on depository institution holding companies.

- **Orderly Liquidation Authority**. The Act establishes a new system for the orderly liquidation of certain systemically significant financial companies. This new insolvency regime generally applies to companies currently subject to the U.S. Bankruptcy Code (the "Bankruptcy Code"); insured banks remain subject to the insolvency regime under the Federal Deposit Insurance Act ("FDIA"). Upon a determination by the Treasury Secretary that a company is in "default or in danger of default" and that such default presents a systemic risk to U.S. financial stability, the company can be removed from the usual bankruptcy process and made subject to a special orderly liquidation process administered by the FDIC as receiver.

- **Over-the-Counter Derivatives Regulation**. The Act will create an extensive framework for the regulation of over-the-counter ("OTC") derivatives and a broad range of swap market participants and facilities. The Act will require prudential regulators, the CFTC and SEC to establish capital and margin requirements and business conduct standards for swap dealers and major swap participants and will require central clearing and trading for swaps subject to a mandatory clearing requirement by the CFTC or SEC. The Act will also impose significant limitations on the swap activities of banks and other recipients of certain forms of Federal assistance.

- **Corporate Governance; Executive Compensation**. The Act mandates additional Federal regulation of compensation paid by "covered financial institutions" (including depository institutions and their holding companies, broker-dealers, investment advisers and potentially foreign institutions) prohibiting arrangements that encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss. It also implements certain corporate governance and executive compensation disclosure reforms that would apply to all listed U.S. companies, not just financial institutions.

- **Credit Rating Agencies and Securitization**. The Act requires any person creating asset-backed securities ("ABS") to retain some of the credit risk associated with such securities, with certain exceptions. The Act does not include the Franken amendment, which would have required the initial rating on a structured finance product to be assigned by a rating agency designated by a new board established by the SEC rather than by a rating agency of the sponsor's choosing. It does, however, require the SEC to implement such a requirement, after a study, if it believes such a requirement would benefit the public interest.

- **Investor Protection**. The Act mandates the SEC to conduct a study evaluating existing standards of care with respect to brokers, dealers and investment advisers providing personalized investment advice and recommendations to retail customers about securities and grants discretionary rulemaking authority to the SEC to impose a new fiduciary standard in these circumstances. The Act also includes structural changes to the SEC including the creation of an Investor Advisory Committee, Office of the Investor Advocate and an Ombudsman to mediate between retail investors and the SEC.

- **Hedge Fund Reforms**. The Act will require a broader range of advisers to private funds to register with the SEC and maintain certain records and reports subject to SEC inspection but will exempt advisers to venture capital funds from SEC registration. Exempt private equity fund advisers will be subject to new recordkeeping and reporting requirements.

- **Consumer Protection**. An independent Bureau of Consumer Financial Protection (the "Consumer Bureau") will be created within the Fed to develop consumer protection rules for both bank and nonbank companies that offer consumer financial products and services and to enforce compliance with such rules by large banks and their affiliates as well as nonbank financial companies.

- **Insurance**. A new Federal Insurance Office (the "FIO") will be established within the Treasury to monitor the insurance industry for systemic risk purposes.

- **Applicability to Non-U.S. Institutions**. Given its broad scope, many provisions of the Act will apply to the U.S. operations of non-U.S. financial institutions and may potentially apply extraterritorially, depending on the regulatory status of an institution, the nature of its financial activities in the United States and its relationship with U.S. market participants.

- **Administration of the SEC**. The Act sets forth a number of provisions that are designed to improve the management and administration of the SEC and that require reports to Congress regarding those matters, including an annual assessment by the SEC of the effectiveness of its internal supervisory controls with respect to examination of registered entities; enforcement investigations and reviews of corporate financial securities filings, a triennial report by the U.S. Government Accountability Office ("GAO") on the quality of the SEC's personnel management; annual reports by the SEC describing and assessing the SEC's internal control structure for financial reporting, and from the Comptroller General, attesting to and reporting on the SEC's assessment of its internal control structure and procedures; a one-time report by an independent consultant on the internal operations, structures and funding of the SEC and semiannual reports by the SEC describing its implementation of such independent consultant's recommendations for the two-year period following such report; and finally a one-time report by the GAO on "revolving door" issues relating to employees who leave the SEC to work for financial institutions regulated by the SEC.

II. SYSTEMIC RISK AND FINANCIAL STABILITY

Restructuring Federal Banking Supervision: Systemic Risk and Beyond

- In many key respects, the end result of the legislative process in the areas of systemic risk supervision and the structure of Federal bank regulation resembles the Obama Administration's original proposal. Front-line responsibility for systemic risk supervision and regulation is left squarely in the hands of the Fed, and the new Council will play a largely advisory, coordinating and persuasive role.

- On the other hand, there are many new elements of the framework that will have important implications for the U.S. supervisory system and for U.S. and international financial services firms.

- Significant questions surround the future role of the Council. The Council's size grew in the legislative process, now consisting of ten voting members (the heads of the Treasury, the Fed, the Office of the Comptroller of the Currency (the "OCC"), the Consumer Bureau, the SEC, the FDIC, the CFTC, the Federal Housing Finance Agency (the "FHFA"), the National Credit Union Administration and an independent member with insurance expertise) and five nonvoting members representing other Federal and state financial regulatory interests.
    - The Council's most significant direct authority will be to designate (by a two-thirds vote) nonbank financial companies as systemically significant.
    - As Chair of the Council, the Treasury Secretary will have significant influence, including an effective veto over some of the Council's key decisions such as whether to designate a nonbank financial company as systemically significant.
    - The Council is intended to be a coordinating body to promote consistency and comprehensiveness in Federal regulation of systemic risks. However, the size, scope and composition of the Council's membership will present challenges, and a key area to watch will be how the Council approaches some of the more contentious issues that could be presented.

- Multiple new layers of congressional and other oversight authorized by the Act are expected to put significant pressure on financial services regulators to prevent systemic risk. As a result, it is reasonable to expect that institutions will be operating in a highly cautious regulatory environment in the near term.
    - For example, the Council will be required to report to Congress annually regarding significant developments and emerging threats to financial stability. Each voting member of the Council will be required to submit a signed statement to Congress stating that he or she believes that "the Council, the Government and the private sector are taking all reasonable steps to ensure financial stability and to mitigate systemic risk that would negatively affect the economy." If the voting member does not believe that all reasonable steps are being taken, then he or she will need to submit a signed statement

stating what actions need to be taken.

- Despite dramatic swings during the legislative process in the Fed's supervisory and regulatory authority, the Fed emerged in the final legislation with its existing authority intact (even expanded) and a clear new mandate as the supervisor and regulator of systemically significant institutions.

  - The Fed has retained its current supervisory authority over bank holding companies and state member banks, as well as its role as supervisor of the U.S. operations of internationally headquartered banks. Its powers to supervise the nonbank subsidiaries of holding companies will be expanded.

  - The Fed will become the holding company supervisor for thrift holding companies, although the existing legal framework for regulation of thrifts and thrift holding companies will be preserved (see below).

  - The Fed will gain supervisory authority over "securities holding companies" without bank subsidiaries that volunteer to be subject to comprehensive consolidated supervision, replacing the investment bank holding company framework adopted in the Gramm-Leach-Bliley Act of 1999 and the SEC's recently terminated "consolidated supervised entities" program.

- Although the Act preserves and expands the Fed's supervisory powers, it will limit the Fed's discretion in other areas and subject it to additional oversight and disclosure requirements.

  - The Act imposes limitations on the Fed's emergency lending authority, most notably by limiting it to programs with broad-based eligibility and by prohibiting lending to insolvent borrowers.

  - The Act imposes significant new reporting and disclosure requirements on the Fed's use of its lending authorities (including discount window advances and other credit facilities) and open market transactions, with requirements for public disclosure, reports to Congress and both backward-looking and ongoing GAO audits.

- In many areas, other Federal regulators are given concurrent or back-up authority with the Fed. Most notably, the Council will play an important role in defining how systemic risk will be regulated, conducting separate research and making recommendations for prudential standards and activity restrictions.

  - The FDIC will also gain significant overlapping authority, with new examination and backup enforcement powers pursuant to the FDIC's new orderly liquidation authority, concurrent authority with the Fed to review credit exposure reports and resolution plans required of systemically significant companies, and new authority to require additional reports from insured depository institutions without the agreement of their primary regulator.

- The OCC and FDIC will have new back-up enforcement authority over nonbank affiliates of bank and thrift holding companies that engage in bank-permissible activities such as consumer lending.

- Another area that saw wide variations during the legislative process was the regulation of thrifts and thrift holding companies. In the end, the thrift charter survived, although its Federal supervisor, the Office of Thrift Supervision (the "OTS"), will be merged into the OCC. Federal thrifts will be regulated by the OCC under a new Deputy Comptroller for thrift supervision, and thrift holding companies will be regulated by the Fed.

    - The Act expressly preserves most of the existing laws and regulations (and OTS interpretations) governing thrift and thrift holding company regulation. However, because that framework will be administered and enforced largely by the OCC and the Fed, a key issue to watch will be how the framework evolves in the hands of the newly responsible agencies.

    - Among the areas where this shift could have important practical implications is the formation of private equity structures for investing in banking organizations, including as platforms to acquire failed banks from the FDIC.

Heightened Prudential Standards for Systemically Significant Institutions

- All bank holding companies with total consolidated assets of at least $50 billion, along with nonbank financial companies designated by the Council as systemically significant, will potentially be subject to heightened prudential standards promulgated and administered by the Fed.

    - While the $50 billion threshold for bank holding companies is significant, the Fed retains important flexibility to distinguish between bank holding companies on the basis of their perceived riskiness, complexity, activities, size and other factors in designing a scale for heightened prudential standards.

- The Act generally does not set specific prudential requirements. Instead, the Act articulates the areas where the Fed may or must impose (and the Council may recommend) heightened standards, along with factors they are required to consider.

    - Required prudential standards will include heightened capital, leverage and liquidity standards, risk management requirements, concentration limits (25% of capital stock and surplus), resolution plans (so-called "living wills") and stress tests. Certain publicly traded companies supervised by the Fed will be required to establish independent risk committees.

        - The Fed will be required to impose a strict 15:1 debt-to-equity leverage ratio on any financial company that the Council determines poses a "grave threat" to financial stability.

    - The Fed will be required to create an early remediation regime (similar in concept to the prompt corrective action ("PCA") regime under the FDIA) in consultation with the Council and the FDIC.

  - The Fed will have discretion to impose other prudential standards, including contingent capital requirements, enhanced public disclosures, short-term debt limits and other requirements that the Fed deems appropriate (on its own or pursuant to a recommendation of the Council).

- The Act permits, but does not require, the Fed to require systemically significant nonbank financial companies to segregate their financial activities from their non-financial activities in an intermediate holding company, with limited enforcement authority over the ultimate parent to ensure compliance with source of strength requirements.

- The Act contains a so-called "Hotel California" provision, which will make it more difficult for certain large bank holding companies that received TARP funds under the Capital Purchase Program to "de-bank" to avoid supervision and regulation by the Fed. In effect, if such a company "de-banked" (by divesting its bank or otherwise giving up its status as a bank holding company), it would be deemed systemically significant unless the company successfully appeals to the Council (requiring a two-thirds vote and an affirmative vote of the Treasury Secretary).

- The Fed's implementing regulations are expected to address many of the significant questions facing internationally headquartered institutions under this framework. Key questions include how to apply the $50 billion threshold and other criteria for determining which institutions should be subjected to heightened prudential standards, and how to apply the heightened standards to the cross-border operations of the affected institutions.

  - In defining the standards, the Fed is directed to take into account the principle of national treatment and equality of competitive opportunity, and the extent to which an institution is subject to comparable home country standards. This has been an important element in previous banking legislation to allow the Fed to adapt new U.S. requirements to internationally headquartered institutions.

Measures Intended to End "Too Big to Fail"

- For many in Congress, the most important component of ending "too big to fail" was the development of a resolution regime for systemically significant institutions. However, the Act also provides regulators with several explicit tools to limit the size, growth and activities of systemically significant companies. The practical significance of these measures for large financial companies will depend on whether and how the agencies use them.

  - A systemically significant company can be prohibited from merging with or acquiring other companies, or required to restrict or terminate certain activities or divest assets, upon a finding by the Fed of a "grave threat" to financial stability and a two-thirds vote of the Council.

- ○ Failure to supply a credible resolution plan can lead to heightened restrictions on a company and ultimately lead to forced divestiture of assets.

- ○ The Act also permits primary financial regulators to impose heightened standards on any practice or activity, whether or not conducted by a systemically significant company, deemed to present systemic risk to the U.S. financial system upon the recommendation of the Council.

- In addition, the Act explicitly limits the largest financial companies from growth by acquisition. No financial company will be permitted to merge with another company if the total consolidated liabilities of the combined company would exceed ten percent of the total consolidated liabilities of all financial companies.

Substantive Changes Affecting All Banking Organizations

- **New Minimum Capital Requirements for Holding Companies (the Collins Amendment)**. The Act will establish a floor under the capital levels of depository institution holding companies and significant nonbank financial companies. It requires the leverage and risk-weighted capital ratios for these institutions to be no lower than the leverage and risk-based capital requirements applicable to insured depository institutions under banking regulators' generally applicable PCA regulations.

  - ○ This could prevent large banks and bank holding companies from using Basel II risk-based asset measurements and will prevent bank holding companies from relying on hybrid capital instruments such as trust preferred and cumulative preferred securities (but not REIT preferred securities) in Tier 1 capital.

  - ○ In response to significant controversy and warnings of unintended consequences, the conference committee added phase-in periods for debt and equity instruments issued before May 19, 2010, as well as grandfathering for depository institution holding companies with less than $15 billion in total consolidated assets.

  - ○ The conference committee also clarified the application of the Collins Amendment to internationally headquartered bank holding companies. The non-U.S. parents of U.S. banks will not be subject to the amendment's requirements, but their U.S. intermediate holding companies will be required to comply five years after enactment. For some international banks, this would represent a reversal of a long-standing Fed supervisory policy toward intermediate bank holding companies. The Act requires a GAO study regarding this issue.

- **The Volcker Rule**. The Act was significantly revised in the conference committee from its form as passed in the Senate. On one hand, the changes eliminated the explicit flexibility for the Council to recommend modifications to the definitions and requirements of the Volcker Rule. On the other hand, the language was revised to preserve banking organizations' ability to conduct traditional asset management activities through private equity and hedge funds. In addition, significant flexibility remains to craft regulatory exemptions from the Volcker Rule consistent with safety and soundness considerations.

- In brief, the Volcker Rule will prohibit banking entities from engaging in some types of proprietary trading and will impose limits on sponsoring or investing in hedge funds or private equity funds.

  - The "banking entities" covered by the rule include all insured depository institutions, their holding companies, internationally headquartered banking organizations with U.S. banking operations (including those without insured deposits), and the affiliates and subsidiaries (such as broker-dealers) of each.

  - While systemically significant nonbank financial companies will not be subject to the Volcker Rule's prohibitions, they will be subject to additional capital and quantitative limits on such activities promulgated by the Fed.

- The definition of proprietary trading is limited to buying and selling securities, derivatives and other financial instruments as principal for the entity's "trading account." The "trading account" is defined as any account used to take positions 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. Regulators also have discretion to adopt rules treating other accounts as the "trading account" for this purpose.

  - Permissible proprietary trading includes:

    - trading in certain expressly permitted securities, including U.S. Treasury securities and obligations of the Government National Mortgage Association, the Federal Home Loan Banks ("FHLBs"), the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC");

    - trading in connection with underwriting or market-making-related activities, to the extent designed not to exceed the reasonably expected near term demands of clients, customers and counterparties;

    - risk-mitigating hedging activities designed to reduce the specific risks to a banking entity in connection with and related to individual or aggregated positions, contracts or other holdings;

    - trading on behalf of customers;

    - trading by regulated insurance companies and their affiliates for the general account of the insurance company; and

– trading solely outside of the United States by foreign banking organizations.

- Banking entities should be able to sponsor and invest in private equity and hedge funds if they comply with specific limitations designed to preserve traditional asset management activities, or if they qualify for an exception for foreign banking organization investments in foreign funds. Although the Act defines private equity fund and hedge fund by reference to exemptions under the Investment Company Act of 1940 (the "'40 Act"), resulting in an overbroad statutory definition, legislative history clarified that the Volcker Rule was intended to regulate investments in traditional private equity and hedge funds and not other corporate structures.

  - Banking entities should be able to sponsor (i.e., act as general partner) and invest in a private equity/hedge fund if the banking entity's investment is limited in accordance with *de minimis* ownership restrictions (described below), the fund is offered only to customers of the banking entity's trust, fiduciary or investment advisory services and the banking entity complies with restrictions on transactions with and disclosures about the fund.

  - Banking entities generally will not be able to invest in private equity/hedge funds unless the banking entity organizes and offers the fund and complies with *de minimis* ownership restrictions requiring that (a) the banking entity seek unaffiliated investors, (b) the size of the banking entity's investment one year after the fund's establishment be not more than three percent of the fund, (c) the investment be "immaterial" to the banking entity and (d) in the aggregate, investments in all such funds do not exceed three percent of Tier 1 capital.

  - Investments in or sponsorship of private equity/hedge funds solely outside of the United States by foreign banking organizations should be permitted, so long as the funds are not sold to U.S. residents.

  - Banking entities will retain the ability to serve as investment manager or investment advisor to private equity/hedge funds, subject to restrictions on transactions with the fund.

- The Volcker Rule does not seem to preclude continuing merchant banking investment authority for financial holding companies, so long as the investments do not constitute proprietary trading and are not in private equity/hedge funds.

- The Volcker Rule will become effective not later than two years after enactment. Banking entities will have an additional two-year transition period to come into compliance, with the potential for up to three years of extensions (and additional time possible for investments in certain "illiquid funds"). If the Act becomes law in July as currently expected, banking entities should not face the possibility of divestitures until the third quarter of 2014 at the earliest.

Commercial Firm Parents of Insured Depository Institutions

- The Act will impose a three-year moratorium on approvals for deposit insurance and changes in control for nonbank insured depository institutions (i.e., industrial banks, credit card banks and limited purpose trust companies) that would be controlled by a commercial firm. The Act requires a GAO study evaluating the impact of abolishing the exemptions in the Bank Holding Company Act (the "BHCA") that exempt their holding companies from Fed supervision and regulation under the BHCA.

- In contrast, commercial firms that are grandfathered unitary thrift holding companies under current law will become subject to Fed supervision (like other thrift holding companies), with new authority for the Fed to require such companies to segregate their financial activities in an intermediate holding company.

III. ORDERLY LIQUIDATION AUTHORITY

Generally

- The Act creates a special insolvency regime, known as Orderly Liquidation Authority ("OLA"), to address the failure of systemically significant financial companies in cases where such an insolvency would have serious adverse effects on the U.S. economy.
  - The new regime is closely modeled on the bank receivership provisions of the FDIA.
  - FDIC-insured depository institutions remain subject to the FDIA.
  - The new regime will be effective the day after enactment.
- Under OLA, a failing financial company would be placed into a receivership administered by the FDIC, the sole purpose of which would be the liquidation of the financial company.
  - As receiver, the FDIC would have the power to enforce or repudiate contracts of the financial company and to transfer assets and liabilities of the company to either a third-party acquirer or to one or more specially chartered bridge financial companies.
  - Special provisions govern the treatment of "qualified financial contracts", i.e., certain securities, commodity and forward contracts and repurchase and swap agreements (collectively "QFCs").
- Notably, OLA does not replace existing insolvency regimes. Rather, all companies eligible for orderly liquidation remain subject to otherwise applicable insolvency law (generally, the Bankruptcy Code) unless Federal regulators determine, at the time of the financial company's failure, that the company should be liquidated under OLA.
  - Accordingly, when considering insolvency-law related matters in advance, analysis must be performed under both OLA and the otherwise applicable insolvency regime(s) for the company in question.

Financial Companies Eligible for Orderly Liquidation

- All "financial companies" are eligible for orderly liquidation. The term "financial company" is defined as any U.S. organized entity that is:
  - a bank holding company for purposes of BHCA;
  - a "nonbank financial company supervised by the [Fed]";[2]

[2] See "Heightened Prudential Standards for Systemically Significant Institutions" in Section II for a discussion of nonbank financial companies subject to heightened prudential standards promulgated and administered by the Fed.

- a company predominantly engaged in activities the Fed has determined are financial in nature; or

- a subsidiary of any company described above that is predominantly engaged in activities the Fed has determined are financial in nature, other than a subsidiary that is an insured bank or insurance company.

- For a company to be "predominantly engaged" in specified activities, the consolidated revenues from such activities must account for 85% or more of the total consolidated revenues of such company.

- Excluded from eligibility under OLA are:

  - Farm Credit institutions;

  - governmental entities;

  - "regulated entities" for purposes of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, i.e., the FHLBs, FNMA and FHLMC; and

  - FDIC-insured depository institutions.

Authorizing the Orderly Liquidation of a Financial Company

- The procedures described below must be followed before a financial company can be liquidated under OLA.

- **Recommendation of Federal Regulators**. The applicable Federal regulators must make a recommendation to the Treasury Secretary that the financial company should be liquidated under OLA.

  - For registered broker-dealers (or financial companies whose largest U.S. subsidiary is a registered broker-dealer), such recommendation must be made by the Fed and the SEC.

  - For insurance companies (or financial companies whose largest U.S. subsidiary is an insurance company), such recommendation must be made by the Fed and the Director of the FIO (in consultation with the FDIC).

  - For all other financial companies, such recommendation must be made by the Fed and the FDIC.

- **Determination of the Treasury Secretary**. Based on the recommendations of the applicable Federal regulators, the Treasury Secretary must determine, among other things, that the financial company is in "default or in danger of default", its failure under otherwise applicable insolvency law would have serious adverse effects on the U.S. economy and the financial company should be liquidated under OLA.

- A financial company is in "default or in danger of default" if:
  - a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code;
  - the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion;
  - the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or
  - the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.
- Once the Treasury Secretary has made the required determinations, the financial company is referred to as a "<u>covered financial company</u>".

- **Opportunity for Judicial Review**. The Treasury Secretary must notify the board of the covered financial company that it has made the determination described above. The board would have the opportunity to consent to the appointment of the FDIC as receiver or to seek judicial review of the Treasury Secretary's determination under an arbitrary and capricious standard.
  - If the court fails to issue a determination within 24 hours, the FDIC would be appointed receiver by operation of law.
  - Directors of the covered financial company would be shielded from liability to shareholders for consenting in good faith to the appointment of the FDIC as receiver.

<u>Powers of the Receiver</u>

- **Transfer of Assets and Liabilities**. As under the FDIA, the receiver would be able to transfer, without consent or approval, assets and liabilities of the covered financial company to one or more third-party acquirers or to one or more specially chartered bridge financial companies.
  - In certain circumstances, obligations to similarly situated creditors may be treated differently; <u>provided</u> that the creditors treated less favorably receive at least what they would have received had the covered financial company been liquidated under otherwise applicable insolvency law.
  - Special provisions govern the transfer of QFCs—see "Treatment of Derivatives and Other QFCs" below.
- **Repudiation of Contracts**. As under the FDIA, the receiver would be able to repudiate any contract of the covered financial company that it determines is "burdensome" and the

repudiation of which would "promote the orderly administration of the affairs of the covered financial company."

  - Parties to repudiated contracts would have a claim for actual direct compensatory damages, calculated as of the date of the receiver's appointment.

  - Special provisions govern the repudiation of QFCs and the calculation of resulting damages—see "Treatment of Derivatives and Other QFCs" below.

- **Enforcement of Contracts**. The receiver would be able to enforce contracts with the covered financial company (other than QFCs) notwithstanding clauses permitting the termination of such contracts based on the insolvency of the covered financial company or the appointment of a receiver.

  - Unlike under the Bankruptcy Code, pursuant to which a debtor cannot enforce, among other things, commitments to lend or to purchase securities of the debtor, the receiver can enforce such contracts under OLA.

  - If the receiver enforces a commitment to lend to the covered financial company, any claim for repayment thereunder would receive administrative priority (the highest priority of unsecured claim against the assets of the estate).

  - Certain "walkaway" clauses are made expressly unenforceable.

- **Placing Subsidiaries into Receivership**. Under certain circumstances, the receiver could place U.S. subsidiaries of the covered financial company into receivership for liquidation under OLA. Such subsidiaries would be considered "covered financial companies" for purposes of OLA.

- **Prohibiting Cross-Defaults at Subsidiaries and Affiliates**. The receiver can enforce any contract of a subsidiary or affiliate of the covered financial company that is guaranteed by the covered financial company notwithstanding any provision therein permitting the non-defaulting party to terminate such contract based on the insolvency, receivership or financial condition of the guarantor; provided that such guaranty is transferred to a solvent third party or adequate assurances are otherwise provided.

Orderly Liquidation of Broker-Dealers

- Covered financial companies that are registered brokers or dealers would be placed into liquidation proceedings governed by both OLA and the Securities Investor Protection Act ("SIPA"), with the FDIC as receiver and the Securities Investor Protection Corporation ("SIPC") appointed as trustee.

  - SIPC would generally have all the powers and duties provided by SIPA in the context of liquidating such a broker-dealer, though the FDIC as receiver may exercise powers under OLA if doing so would not impair customer property.

- Notwithstanding any provision of SIPA, the rights of QFC counterparties to such broker-dealers would be governed by the QFC provisions of OLA—see "Treatment of Derivatives and Other QFCs" below.

Treatment of Derivatives and Other QFCs

- OLA's treatment of counterparties to QFCs is substantially similar to that under the FDIA.
- The receiver would be permitted, within one business day of its appointment, to transfer all QFCs between the covered financial company and a counterparty (and its affiliates) to a third party; provided that it transfer all such contracts with the counterparty (and its affiliates).
    - Thus, while the receiver may not "cherry pick" among QFCs with a counterparty and its affiliates, it may "cherry pick" between families of counterparties.
    - Counterparties to transferred QFCs would not be permitted to exercise contractual rights to close out such QFCs based solely on their transfer or the appointment of the receiver. Such counterparties would be permitted to exercise contractual rights to close out based upon the transferee's performance default (e.g., a payment or margin default).
- At the end of the first business day following the appointment of the receiver, counterparties to QFCs not transferred would be able to exercise contractual rights to terminate, net, set off and apply collateral held with respect to the QFCs.
- The receiver would be able to exercise repudiation powers with respect to QFCs not transferred to a third party (again, on an all-or-none basis, by counterparty family). Parties to repudiated QFCs would have a claim for actual direct compensatory damages, which would include reasonable costs of cover, calculated as of the date of repudiation.

Treatment of Creditors and Parity with the Bankruptcy Code

- As a general matter, creditors in OLA proceedings are required to receive at least what they would have received had the covered financial company been liquidated under chapter 7 of the Bankruptcy Code rather than OLA—the so-called "minimum recovery" provision.
- The substantive treatment of creditors under OLA is substantially similar, but not identical, to the treatment under the Bankruptcy Code (the insolvency regime that would generally apply to a financial company, absent Federal regulators' determination to place such company into liquidation under OLA), including provisions regarding the avoidance of fraudulent transfers, preferential transfers and post-petition transfers and the defenses thereto.
- Under OLA, setoff rights are generally enforceable with respect to contracts of the covered financial company that have not been transferred, to the same extent as under the Bankruptcy Code. However, the receiver's transfers of assets and liabilities of the covered financial company can be made free from setoff rights if a transferee would, under applicable law, take free of such setoff rights.

    - The amount of any setoff claim that a creditor would have had but for such a transfer is assigned a priority senior to unsecured claims but junior to administrative claims and claims of the United States.

- The treatment under OLA of claims in respect of contingent obligations, such as guaranties, is substantially similar to the treatment under the Bankruptcy Code, but, due to the drafting of certain provisions, may not be exactly the same.

- The minimum recovery provision, providing parity with the Bankruptcy Code, could be read as being in conflict with the more specific provisions regarding the treatment of creditors, particularly those that differ from their counterparts under the Bankruptcy Code.

<u>Funding an Orderly Liquidation Proceeding</u>

- Upon its appointment as receiver, the FDIC would be permitted to borrow from the Treasury to finance the liquidation of a covered financial company. The proceeds of such borrowing, along with the proceeds from the liquidation of the covered financial company, would be placed in the Orderly Liquidation Fund.

- If the proceeds from the liquidation of a covered financial company are insufficient to repay obligations to the Treasury, the receiver would:

    - first, recover from creditors any amounts that such creditors received due to the exercise of resolution authority in excess of what they would have received in an ordinary liquidation (e.g., because an obligation was transferred in whole to a third party); and

    - then, levy assessments on all bank holding companies (including non-US bank holding companies) with $50 billion or more in consolidated assets, all “nonbank financial companies supervised by the [Fed]” and all other financial companies (as defined in Sec. 201(a)(11)) with $50 billion or more in consolidated assets.

IV. DERIVATIVES REFORMS

Overview

- The Act repeals existing restrictions on the substantive regulation of OTC derivatives under the Commodity Exchange Act ("CEA"), the Securities Exchange Act of 1934 ("Exchange Act") and the Securities Act of 1933 ("Securities Act") and instead establishes a regime of substantially parallel regulation for swaps involving single non-exempt securities, loans and narrow-based security indices—to be administered by the SEC—and swaps involving other financial interests and commodities—to be administered by the CFTC.

- Swaps and the market participants that enter into them will be subject to comprehensive regulation, in some ways more restrictive than existing regulation of the securities markets. Requirements will include: registration and capital, margin and business conduct requirements for swap dealers and major swap participants; mandatory clearing and trading requirements for potentially all standardized swaps; real-time public transaction reporting; and a provision limiting the scope of permitted swap activities that may be conducted by certain swap entities that receive Federal assistance.

- These new requirements will, for the most part, come into effect roughly one year after enactment and most agency rulemakings must also be completed within roughly one year. During this rulemaking process, regulators and market participants will need to grapple with a host of definitional, jurisdictional and other technical issues raised by the Act, which are exacerbated by the highly prescriptive terms of many of the Act's substantive requirements and the Act's significant restrictions on agency exemptive authority.

Covered Derivatives

- A broad range of the most widely traded types of OTC derivatives, such as interest rate swaps, commodity swaps, total return swaps and credit default swaps, will be subject to the new regulatory regime. Exclusions exist for certain other common types of derivatives, including: puts, calls and other options on securities; and indexed debt and depository instruments.

- Significantly, the "swap" definition and the related "security-based swap" definition are both over- and under-inclusive, thereby resulting in the following issues, among others:

    - *Insurance Products*. The swap definition includes provisions that, on their face, include (and, if given effect, will render the CFTC the exclusive regulator of) conventional insurance products, preempting any concurrent state insurance regulation.

    - *Swaps vs. Futures*. The swap definition does not include any contract of sale of a commodity for future delivery, whether or not such contract is exchange traded. Given the uncertainties surrounding the distinction between swaps and futures, market participants may therefore be uncertain as to whether futures or swaps provisions will apply to their activities, thus reintroducing significant legal uncertainty.

- *Foreign Currency*. Foreign currency products other than spot and exchange-traded contracts will be subject to regulation by the CFTC as swaps. Although the Treasury Secretary has authority to grant limited exemptions for certain physically settled foreign exchange swaps and forwards, in order to grant such an exemption, the Treasury Secretary must make a determination based on a range of enumerated factors that seem designed to preclude any finding that an exemption should be issued.

- *Physical Settlement Contracts*. The status of forward contracts that may result either in physical or cash settlement (other than conventional and digital options) is subject to some uncertainty under the swap definition.

- *Other Contracts*. A range of contracts that are plainly not swaps, such a variable rate debt, contracts with escalation clauses and the like are also captured by the definition.

- *CFTC vs. SEC Jurisdiction*.

  - Generally, any security-based swap that also contains an interest rate, currency and/or commodity component—including (if unaddressed) a total return swap that has a floating rate financing component—will be subject to joint rulemaking by the CFTC and SEC, in consultation with the Fed.

  - The narrow scope of the security-based swap definition raises questions whether loan-only credit default swaps, basket products and certain other products will be subject to regulation by the CFTC, rather than the SEC.

  - Swaps on broad-based security indices and exempted securities (other than municipal securities) will be regulated by the CFTC, resulting in dual regulation of the credit default swap and equity securities derivatives businesses.

- *Rate Lock/Caps*. As a result of the broad scope of the swap definition and a further requirement that a swap with a person other than an eligible contract participant ("ECP") be traded on an exchange, products such as interest rate locks and caps may become unavailable to homeowners/buyers and small business owners who are not ECPs.

Push-Out Requirement

- The Act includes the controversial so-called "push-out" provision, which will prohibit certain forms of Federal assistance—including broadly available and fully collateralized programs such as the Fed discount window and FDIC insurance—from being provided to swap dealers and major swap participants ("swaps entities").[3]

[3] The push-out provision also includes provisions regarding (a) exceptions from this prohibition for certain entities in conservatorship or receivership (as well as FDIC bridge banks), (b) use of taxpayer funds in the receivership or insolvency of swaps entities, (c) prudential standards for a bank or bank holding company that is or seeks to become

While not free from doubt, it appears that this prohibition will take effect roughly three years after enactment, subject to a potential extension for up to an additional three years in the case of an insured depository institution.[4]

- While the scope and effect of this prohibition will be far-ranging, it appears to be limited in three key ways:
  - First, while the push-out provision will prohibit actual Federal assistance to swaps entities, it does not prohibit swaps activities from being conducted in an entity that is eligible for, but not receiving, Federal assistance.
  - Second, the prohibition will not affect non-swap derivatives activities. As noted above, certain derivatives, such as security options and futures, will not constitute swaps.
  - Third, the push-out provision contains several exceptions for insured depository institutions.
    - Most significantly, an insured depository institution that limits its swap activities to (a) hedging and risk mitigating activity and (b) dealing in certain types of swaps (including swaps on interest rates, foreign currency, precious metals, government securities and investment grade debt securities, but not swaps on commodities, most types of equity securities or below investment grade debt)[5] will not be subject to the prohibition on Federal assistance.[6] Credit default swaps will be permitted under this exception only if cleared or if entered into as part of hedging or risk mitigating activity.
    - The prohibition will also not prevent an insured depository institution from having a swaps entity affiliate so long as (a) such insured depository institution is part of a bank or thrift holding company supervised by the Fed and (b) the swaps entity affiliate complies with Sections 23A and 23B of the Federal Reserve Act and such other requirements as the CFTC or SEC, as applicable, and the Fed may determine appropriate.

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a swaps entity and (d) authority for the Council to prohibit insured depository institutions who are swaps entities from accessing federal assistance on a case-by-case basis.

4 An ambiguous cross-reference in the push-out provision's effective date subsection could be read as setting the effective date of the prohibition roughly 2 (rather than 3) years after enactment.

5 Specifically, an insured depository institution will be permitted to enter into swaps on rates or reference assets that are permissible for investment by national banks under Section 24(7) of the National Bank Act (as further elaborated in the OCC regulations promulgated thereunder).

6 The push-out provision excludes from the definition of "swaps entity" a major swap participant that is an insured depository institution. However, in light of the combined impact of the Volcker Rule's prohibition on proprietary trading and the activities that are and are not permitted to an insured depository institution under the push-out provision, the practical impact of this exclusion seems likely to be minimal.

- The Federal banking agencies will be permitted to establish a transition period for up to 2 years (with the possibility of an extension for up to one additional year) for insured depository institutions, and the prohibition on Federal assistance will apply only to swaps entered into after the end of such transition period. While not entirely clear, it appears that this transition period will begin upon effectiveness of the push-out prohibition (i.e., roughly three years after enactment).[7]

- These exceptions for insured depository institutions do not, by their terms, apply to a noninsured U.S. branch of a foreign bank, thus giving rise to the potential unintended consequence of inequitable treatment of foreign banks.

Mandatory Clearing

- The Act gives authority to the CFTC and SEC (as applicable), either upon application by a clearinghouse to clear a swap or upon their own initiative, to require designated swaps to be cleared.[8] Under these provisions, the agencies could subject swaps that are not eligible for clearing at any clearinghouse to the mandatory clearing requirement, thereby effectively banning transactions in the affected categories of swaps and driving standardization of such swaps.

- A limited exception to this requirement applies to a defined category of end users. Specifically, this exception will be available to a person (and under specified conditions, an affiliate of a person) who (a) is not a "financial entity" (defined broadly, but excluding certain captive consumer financing entities), (b) is using swaps to hedge or mitigate commercial risk and (c) notifies the CFTC or SEC, as applicable, "how it generally meets its financial obligations associated with entering into non-cleared swaps".

    - The CFTC and SEC also must determine whether to exempt small banks, thrifts, credit unions and Farm Credit institutions.

    - End users may both require that a swap be cleared and designate the clearinghouse to which the swap is to be submitted.

- Before designating a swap as required to be cleared, the relevant agency must provide public notice and a minimum 30-day comment period and consider certain statutorily enumerated factors. These factors include liquidity, adequate pricing data, effect on mitigation of systemic risk and legal certainty in the event of the insolvency of the clearinghouse.

[7] But see note 4 above.

[8] Although most, if not all, swap clearinghouses will likely be designated by the Council as "financial market utilities" engaged in systemically important payment, clearing and settlement activities under Title VIII of the Act, Title VIII explicitly states that it does not permit either the Council or the Fed to take any action or exercise any authority in determining which swaps will be subject to the mandatory clearing requirement.

- Margin accepted for cleared swaps will be subject to segregation requirements, which are similar to those that currently apply to futures commission merchants for futures.[9] Additionally, in order to accept margin for cleared swaps (but not security-based swaps), a swap dealer will need to register with the CFTC as a futures commission merchant.
  - These requirements will apply regardless of whether the clearinghouse is registered with the CFTC and so will apply, for instance, in the case of swaps cleared through a clearinghouse exempt from CFTC registration (e.g., an SEC-registered clearing agency or a comparably regulated foreign clearinghouse).[10]
- Existing swaps will, under the Act, be grandfathered from the mandatory clearing and trading requirements (subject to the reporting requirements noted below).

Mandatory Exchange/SEF Trading

- Swaps subject to the mandatory clearing requirement will also be required to be traded on an exchange or regulated trading facility (called a "swap execution facility" or "SEF"), unless no exchange or SEF makes the swap available to trade.
  - A SEF is defined as a trading system in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the system. While this formulation does not appear to capture bilateral voice brokerage arrangements, it remains an important question whether it will be read to capture request-for-quote and other "one-to-many" or "many-to-one" execution functionalities.
  - It also remains unclear how the many exchange-like requirements that will apply to SEFs (e.g., requirements for market surveillance and disciplinary infrastructure and emergency authority to liquidate or transfer open positions) can be satisfied in the context of a platform that does not operate an integrated clearinghouse or that does not act as a central counterparty.
  - SEFs appear to be permitted to establish special rules for block-size swap transactions, but the scope of this authority is not clear.
  - The CFTC and SEC are required to prescribe rules defining the universe of swaps that "can" be executed on a SEF. The standard to be used in applying this provision is also

[9] The Act's text governing the use of margin by a clearinghouse deviates from the existing CEA provision on which it is modeled in a manner that raises the question whether a swaps clearinghouse can (as it can for futures) apply non-defaulting swap customer funds maintained at the clearinghouse to satisfy the obligations of defaulting swap customer(s) of a clearing member.

[10] In theory, the mandatory clearing requirement could be satisfied by clearing through an exempt foreign clearinghouse deemed comparably regulated by the relevant agency. In practice, however, the requirement that a firm clearing swaps be registered as a futures commission merchant could, absent exercise of agency exemptive authority, make this alternative illusory.

not clear. However, significantly, swaps falling outside this universe will be permitted "to be executed through any other available means of interstate commerce".

Ownership of Regulated Market Facilities

- The CFTC and SEC are required to adopt rules to mitigate conflicts of interest posed by the control of clearinghouses, exchanges and SEFs by swap dealers, major swap participants and a wide range of other industry participants. These rules may, but are not required to, include numerical limits on control or voting rights.

Clearinghouse Linkages/Open Access

- The Act includes a new provision in the CEA that entitles a derivatives clearing organization to decline to enter into any inter-clearinghouse arrangements involving mutual offset, cross-margining, interoperability or similar arrangements that would expose it to the credit risk of another clearing organization.

- A clearinghouse must, however, maintain open access by (a) prescribing that all swaps submitted to it with the same terms are economically equivalent and may be offset with each other within the clearinghouse and (b) providing non-discriminatory access to clearing for swaps executed bilaterally or on or through the rules of an unaffiliated exchange or SEF.

Trade Reporting and Public Disclosure

- The Act requires market participants to report publicly all swaps, whether or not cleared (or required to be cleared), as soon as technologically practicable after execution. Separate provisions require the CFTC and SEC to prescribe rules for delayed reporting of large notional swap transactions (i.e., block trades).
  - However, likely inadvertently, the provisions for reporting of block trades do not, by their terms, apply to non-cleared swaps not subject to the end user exception—thereby potentially subjecting many bespoke, wholesale transactions not merely to public reporting, but also to real-time public reporting.

- All swaps must also be reported to a registered swap data repository or the CFTC or SEC, as applicable. Existing swaps must be reported on a schedule to be established by the applicable agency by interim final rule within 90 days of enactment. Unless the agencies provide otherwise, existing swaps must be reported no later than 30 days after issuance of the interim final rule.

Margin for Non-Cleared Swaps

- The Act requires regulators to impose both initial and variation margin requirements for swap dealers and major swap participants on "all swaps that are not cleared by a registered" clearinghouse. These requirements shall be set in order to "help ensure the safety and soundness" of the swap dealer or major swap participant. Generally, Federal banking agencies will prescribe these requirements for swap dealers and major swap participants that are banks; the CFTC and SEC will prescribe them for other swap dealers and major swap participants.

- The Act deleted an explicit exception from margin requirements for swaps with end users that had appeared in earlier versions of the Act.
  - Recent correspondence between Senators Dodd and Lincoln, states that the margin requirements are not intended to be interpreted to require end user counterparties to post margin to a swap dealer or major swap participant.
  - In a subsequent House colloquy, Congressmen Peterson and Frank further noted that, while regulators will have authority over the swap dealer or major swap participant side of the transaction, they expected that the level of margin required by regulators at their discretion will be minimal, in keeping with the greater capital that swap dealers and major swap participants will be required to hold.
  - Barring subsequent technical amendments, regulators and commentators will need to consider what weight, if any, to give to this legislative history.
- Initial (but not variation or mark-to-market) margin accepted by a swap dealer or major swap participant for a non-cleared swap will be required, at the request of the counterparty, to be segregated in an account carried by an independent custodian. There is no requirement that a counterparty request to segregate margin be made at the time the swap is executed.
- Although previous versions of the Act had explicitly grandfathered outstanding swaps from the imposition of margin requirements, the Act does not. Regulators may, however, have discretion to apply margin requirements prospectively.

<u>Swap Dealer and Major Swap Participant Regulation</u>

- **Swap Dealer Definition**.
  - The swap dealer definition encompasses any person who is a dealer or market maker in swaps or who "regularly enters into swaps with counterparties as an ordinary course of business for it own account", but not someone who enters into swaps other than as part of a regular business.
  - Exceptions to this definition apply in the case of (a) an insured depository institution to the extent that it offers to enter into a swap with a customer in connection with originating a loan with that customer and (b) a person engaging in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers.
- **Major Swap Participant Definition**. There are three independent bases upon which a significant, non-dealer participant in the swaps markets could be subject to registration and regulation as a major swap participant.
    - Any non-dealer who maintains a "substantial position" in swaps will be regulated

as a major swap participant. Positions held for "hedging or mitigating commercial risk" and positions held by an ERISA plan for the "primary purpose of hedging or mitigating any risk directly associated with the operation of the plan" are both excluded for purposes of the "substantial position" determination.

- Any non-dealer whose outstanding swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets" will also be regulated as a major swap participant.

- Any non-dealer "financial entity" (not defined for this purpose) that is "highly leveraged relative to the amount of capital it holds" and maintains a "substantial position" in swaps (whether or not such swaps are held for hedging purposes) will also be regulated as a major swap participant, unless the financial entity is "subject to capital requirements" established by a Federal banking regulator.[11]

The agencies are directed under the Act to take into account a person's systemic significance when determining whether it holds a "substantial position" in swaps. In addition, the agencies are also directed to consider the person's relative position in cleared versus non-cleared swaps and are permitted to take into consideration the value and quality of collateral held against counterparty exposures.

It is important to note that the precise criteria for whether a person will be subject to registration and regulation as a major swap participant (e.g., the threshold at which a person will be deemed to hold a "substantial position" in swaps) will depend heavily on agency rulemaking and interpretation.

- **Swap Dealer/Major Swap Participant Registration**. Swap dealers and major swap participants must register with and be examined by the CFTC, the SEC or both, depending on the scope of their activities. Significantly, there are no explicit exemptions or exceptions for foreign banks or other entities subject to comparable regulation, and existing exemptions under Rule 15a-6 under the Exchange Act and Part 30 of the CFTC Regulations will not apply by their terms.

- **Capital**. Swap dealers and major swap participants will be subject to risk-based capital requirements. Generally, Federal banking agencies will prescribe these requirements for swap dealers and major swap participants that are banks;[12] the CFTC and SEC will prescribe them for other swap dealers and major swap participants.

- **Disclosure Obligations**. Swap dealers and major swap participants will be required to disclose to non-swap dealer/non-major swap participant counterparties such matters as

[11] Note also that the major swap participant definition includes an explicit exception intended to address certain captive consumer financing entities.

[12] In the case of foreign banks, it is expected that the Fed will defer to the home country regulator.

contract characteristics, "material incentives" (but not remuneration) and conflicts of interest. They will also be required to provide to such counterparties their own "daily marks" for non-cleared swaps. "Daily mark" is not defined in this context.

- **Duties to Special Entities**. Swap dealers and major swap participants that advise "special entities" (e.g., municipalities, pension plans, endowments) will have a duty to act in the "best interests" of the special entity. By contrast, swap dealers and major swap participants that act merely as counterparties to special entities will be required to have a reasonable basis to believe that the special entity counterparty has a qualified representative independent of the swap dealer or major swap participant that undertakes a duty to act in the "best interests" of the special entity counterparty and complies with certain specific business conduct requirements.[13] No alternative is provided for situations in which the special entity does not have a qualified representative.

- **Exception for Exchange-Traded Swaps**. The disclosure obligations and duties to special entities will not apply with respect to a transaction initiated by a special entity on an exchange or SEF where the swap dealer or major swap participant does not know the identity of the special entity counterparty.

Extraterritoriality

- The Act excludes from regulation extraterritorial activity, an exclusion that generally tracks the agencies' existing interpretations of their respective jurisdictions.

- It seems likely that the CFTC and SEC will interpret their jurisdictions to extend to non-U.S. entities transacting with U.S. market participants or executing or clearing swap transactions on or through a U.S. facility. Additionally, as noted above, there are no explicit exemptions or exceptions from swap dealer/major swap participant registration for foreign banks or other entities subject to comparable regulation and existing exemptions under Rule 15a-6 under the Exchange Act and Part 30 of the CFTC Regulations will not apply by their terms.

- The CFTC and SEC may each, in consultation with the Treasury Secretary, prohibit an entity domiciled in a foreign country from participating in swap activities in the United States if the relevant agency determines that regulation of swaps in the foreign country undermines the stability of the U.S. financial system.

[13] This requirement contains an ambiguous reference to a "counterparty that is an eligible contract participant within the meaning of subclauses (I) and (II) of clause (vii) of the [ECP definition]". Those subclauses refer only to governmental and multinational or supranational entities and their political subdivisions. Presumably this reference was not intended to exclude from the scope of the provision transactions with pension plans, endowments and governmental entities' instrumentalities, agencies and departments, considering that the provision goes on to refer specifically to employee benefit plans and that the legislative history unambiguously indicates that pension plans and endowments are intended to be included.

“Legal Certainty” Provision

- Under the Act, unless “specifically reserved” in the applicable swap documentation, neither the Act’s enactment nor any requirement or amendment made by it will constitute a termination event, force majeure, illegality, increased cost, regulatory change or similar event under any swap that would allow a counterparty to terminate or renegotiate the swap.[14] The meaning of the phrase “specifically reserved” is unclear in this context. This is a particularly unfortunate result given that the costs to market participants of this provision are potentially enormous.

Futures Law Issues

- **CFTC Registrant Categories**. The Act significantly expands the definitions of commodity trading advisor, futures commission merchant and commodity pool operator to include entities that, respectively, provide advice or brokerage services with respect to, or that operate funds that trade in, swaps and certain other non-futures products.

- **Position Limits for Futures**. The CFTC will be required to directly set speculative position limits on futures and options on physical commodities and economically equivalent swaps. Moreover, in order for a swap dealer to qualify for a “bona fide” hedge exemption from such position limits, it will need to demonstrate that any given futures position or OTC derivatives position hedged by futures serves as a hedge against a specific OTC derivatives transaction with a counterparty that is itself hedging a commercial risk under the narrow definition of “bona fide” hedging included in the Act.

Securities Law Issues

- **Security-Based Swaps as Securities**. The Act includes security-based swaps in the definition of “security” under both the Exchange Act and the Securities Act. As a result, regulators and market participants must now consider which references to “securities” in Federal and state statutes and regulations, investment guidelines and other materials may now incorrectly encompass swaps.

- **Beneficial Ownership**. The Act amends Section 13 of the Exchange Act so that security-based swap positions will give rise to beneficial ownership of a security for the purposes of reporting and short-swing profit disgorgement liability only to the extent that the SEC determines, by rule, that the security-based swap provides “incidents of ownership comparable to direct ownership of the equity security.” It is unclear whether the SEC will construe this new criterion more or less restrictively than its current test for beneficial ownership, which relates to the power to vote or dispose of a stock.

[14] We note that a change in this provision from the term “bilateral trading agreement” to the term “swap” during the conference process, as well as the placement of the provision in the CEA, suggests that the provision should not by its terms be applicable to SEC-regulated security-based swaps. The reason for this distinction remains one of the many mysteries presented by the Act.

- **Position Limits for Listed Securities**. The Act gives the SEC authority to impose position limits on any security-based swap and, significantly, the SEC may aggregate related stock and stock futures positions (for swaps referencing a stock) and loan positions (for swaps referencing a loan) with swap positions for purposes of administering these limits.

Preemption

- **State Gaming and Bucket Shop Laws**. Although the application of state gaming and bucket shop laws is preempted under existing law and under the Act in the case of OTC security-based swaps between ECPs, no similar preemption is included in the CEA with respect to other OTC swaps, potentially subjecting such contracts to antiquated "gaming" and "bucket shop" state statutes. This development will resurrect significant legal uncertainty that had formerly been laid to rest.

- **State Insurance Laws**. Regulation of swaps as insurance is explicitly preempted. However, the Act fails to draw a clear functional distinction between swaps, on the one hand, and insurance products that make payment or performance contingent upon incurrence of a loss, on the other hand.

Rescission

- The Act significantly carves back CEA provisions limiting the right of ECP counterparties to rescind swap transactions that violate CEA provisions applicable to swaps.

V. CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION

Excessive Compensation at Financial Institutions

- The Act requires new regulations to be implemented within nine months following enactment that will:
  - require "covered financial institutions" to disclose to their regulators the structures of all incentive-based compensation arrangements sufficient to determine whether the compensation structure either (i) provides the institution's executive officers, employees, directors or principal shareholders with "excessive compensation" or (ii) could lead to material financial loss to the institution; and
  - prohibit any compensation arrangements at a "covered financial institution" that regulators determine falls within either (i) or (ii) above.
- The Act states that the regulations on excessive compensation shall be "comparable" to the existing safety and soundness rules for excessive compensation at depository institutions; however, the Act's rules on excessive compensation apply far more broadly.
  - "Covered financial institution" is defined to include not only depository institutions and their holding companies, but also registered broker-dealers, credit unions, investment advisers, FNMA, FHLMC and any other financial institutions that Federal regulators determine should be regulated.
    - Any entity with less than $1 billion in assets is exempted.
- **Application to foreign private issuers**. The regulations appear to apply to all "covered financial institutions," including those that are not incorporated in the United States. Although recent guidance on incentive compensation practices published by the Fed, the FDIC, the OCC and the OTS gave some deference to home country regulators with respect to foreign banks' U.S. operations, it is unclear whether a similar level of deference would be accorded here given that the rules would apply at the holding company level, rather than the branch level.

Governance and Executive Compensation Provisions

- The Act contains a number of governance and executive compensation provisions that appear to apply to virtually all domestic public issuers with listed securities.[15]
  - *Say on Pay and "Say When on Pay*." All domestic public companies will be required to hold a non-binding "say on pay" vote to approve executive compensation disclosed in the proxy statement on at least a triennial basis, starting with the first annual meeting

[15] We note that the provision requiring a majority voting standard in uncontested director elections was dropped from the Act in conference committee.

occurring after the six-month anniversary of enactment. Shareholders must vote at that same meeting, and subsequently at least every six years, whether the say on pay vote is to occur on an annual, biennial or triennial basis.

- *Say on Golden Parachutes*. Domestic public companies must include a non-binding "say on golden parachutes" vote in any proxy statement seeking shareholder approval for a merger or similar corporate transaction, together with disclosure regarding any compensation arrangements that the issuer's named executive officers have relating to the corporate transaction. The vote is required at any shareholder meeting occurring after the six-month anniversary of enactment, with the SEC to issue regulations regarding the required disclosure.

- *Broker Non-Votes*. The Act makes votes on "executive compensation" non-routine matters on which brokers cannot vote unless they have received voting instructions from the shareholders for whose account they hold the shares.

- *Compensation Committee and Consultant Independence*. The Act imposes new independence requirements for compensation committee members of all issuers with listed securities (including foreign private issuers, unless they make certain disclosures to their shareholders—see "Application to foreign private issuers" below). The requirements are similar to those currently required for audit committee members (relating to fees received by the director and affiliations that the director has with the issuer). The Act also establishes independence standards for compensation consultants, legal counsel and other advisers and requires proxy disclosure regarding conflicts of interest raised by the work of compensation consultants. This provision will be implemented by national securities exchange and association listing standards no more than 360 days following enactment.

- *Clawbacks*. The Act requires issuers with listed securities (potentially including foreign private issuers – see "Application to foreign private issuers" below) to establish a clawback policy in the event of an accounting restatement that would recover incentive-based compensation received during the three-year period preceding the date of the restatement by any current or former executive officer of the issuer "in excess of what would have been paid to the executive officer under the accounting restatement." Misconduct on the part of either the issuer or the individual is not a factor in the clawback. This provision is to be implemented by national securities exchange and association listing standards, although no deadline is specified in the Act.

- *Disclosure of Hedging Policies*. The Act requires the SEC to issue rules requiring public companies to disclose in their proxy statement whether directors or employees are permitted to hedge compensatory equity grants or stock otherwise held, directly or indirectly, by them.

- *Executive Compensation Disclosure*. The Act also requires the SEC to issue regulations applicable to domestic public companies requiring:

- "pay versus performance" disclosure requiring correlation of company financial performance not just against executive compensation as disclosed in the company's proxy statement, but against amounts "actually paid" (which could include, for example, changes in equity award value), taking the focus from why compensation decisions were made to the ultimate result of those decisions; and

- disclosure in any proxy statement, annual report, registration statement, going-private transaction statement or tender offer statement describing the ratio between the median annual total compensation of all employees of the issuer (other than the CEO) and the annual total compensation of the issuer's CEO. "Total compensation" is defined by reference to the total compensation column of the summary compensation table in the proxy statement. This provision effectively requires summary compensation table calculations to be performed in respect of every employee of an issuer, rather than only highly-paid executives.

- *Proxy Access*. The Act permits (but does not require) the SEC to issue rules permitting shareholder use of an issuer's proxy solicitation materials for the purpose of nominating individuals for membership on the issuer's board of directors.

- **Application to foreign private issuers**

  - The Act's compensation committee independence requirements are applicable to foreign private issuers unless the issuer provides annual disclosure to its shareholders of the reasons that it does not have an independent compensation committee.

  - The clawback provision does not clearly exclude foreign private issuers and does not reference any proxy provisions to which foreign private issuers are not otherwise subject; therefore, it is possible that foreign private issuers will be covered by this provision.

  - All other provisions almost certainly do not apply to foreign private issuers.

VI. CREDIT RATING AGENCIES AND SECURITIZATION

Credit Risk Retention for Securitizations

- Under rules to be adopted by Federal regulators, "securitizers" will be required to retain an economic interest in the credit risk of any asset they securitize. Virtually all details of the risk retention requirement have been left up to Federal agency rulemaking.
  - "Securitizer" means an issuer of an ABS and anyone who "organizes and initiates" an ABS transaction by directly or indirectly selling or transferring assets to the ABS issuer.
    - "ABS" is defined broadly for this purpose and specifically includes collateralized debt obligations ("CDOs"), CDOs of ABS and CDOs of CDO interests (so-called "CDO-squareds"). The SEC is given authority to issue rules designating additional securities as ABS.
  - The required risk retention will be at least 5% except:
    - securitizations solely of "qualified residential mortgages" (to be defined by regulation) will not require any risk retention (but second-order securitizations of those qualifying RMBS are not exempt);
    - securitizations of other assets will require less than 5% risk retention if the originator meets underwriting standards to be prescribed by the regulators;
    - securitizations of certain Federally-guaranteed mortgage loans are exempt from risk retention requirements;
    - securitizations of other assets issued or guaranteed by the U.S. and its agencies (other than FNMA and FHLMC), and ABS issued or guaranteed by a state or political subdivision or instrumentality, may be totally or partially exempted from risk retention by the regulators;
    - the regulators may provide for allocation of the applicable risk retention requirements between securitizers and the originator(s) of the securitized assets; and
    - the regulators are given broad authority to totally or partially exempt any other securitization as they deem appropriate.
  - The retained risk may not be hedged or transferred, but the regulators may prescribe exemptions from this requirement as well.
- Designated Federal agencies are directed to jointly prescribe implementing regulations within 270 days after enactment.
  - The applicable agencies are the OCC, the Fed, the FDIC and the SEC plus, in the case of

residential mortgages, U.S. Department of Housing and Urban Development and the FHFA. The Council is to coordinate the joint rulemaking.

- ○ The regulations are to prescribe the form and minimum term of the required risk retention.

- ○ The regulations concerning securitizations of residential mortgages are to become effective 1 year after they are finalized, and regulations for all other asset classes take effect 2 years after finalization.

- ○ The regulations are to prescribe requirements by asset class.

  - ▪ The Act specifies that regulations for commercial mortgage-backed securities ("CMBS") may provide for retention of the required risk by a third-party purchaser that "specifically negotiates for the purchase of such first-loss position," holds adequate financial resources, and diligences the individual assets; this may provide a road map for alternative requirements for other classes as well.

- **Studies of Effects**. The Act requires 2 separate studies.

  - ○ The Fed, in coordination with the OCC, the OTS, the FDIC and the SEC, is directed to study the effects of the Act's risk retention requirement and FAS 166 and 167 (recently adopted modification to Generally Accepted Accounting Principles that will require securitization vehicles to remain on a securitizer's balance sheet under circumstances in which they would previously have been de-consolidated) on each individual class of ABS and report within 90 days of enactment. The report is to recommend ways to eliminate negative effects on the ABS markets and the availability of credit.

  - ○ The Council is directed to study the macroeconomic effects of the Act's risk retention requirement, emphasizing any stabilizing effect on housing prices. That report is due 180 days after enactment.

Study and Rulemaking on Assignment of NRSROs to Structured Transactions

- In a compromise on an amendment proposed by Senator Franken, the Act requires the SEC to conduct a study of:

  - ○ the credit rating process for structured finance products (defined to mean ABS and any structured product based on an ABS) and related conflicts of interest; and

  - ○ the feasibility of having a "public or private utility or a self-regulatory organization" determine structured finance credit ratings.

- The SEC is required to report the findings of this study within 24 months after enactment.

  - ○ After submitting the report, the SEC is required to establish a system for Nationally Recognized Statistical Rating Organizations ("NRSROs") to be assigned to determine and monitor initial ratings on structured finance products in a manner that prevents the issuer, sponsor or underwriter of the structured product from selecting the first NRSRO to rate that issuance.

- The SEC is required to "give thorough consideration" to the system proposed by the Franken amendment and to implement that system "unless the SEC determines that an alternative system would better serve the public interest and the protection of investors."
- The Franken amendment, which did not become part of the Act, would have created a "Credit Rating Agency Board" under the SEC to assign NRSROs to provide ratings for structured products. Issuers would have been prohibited from requesting a rating from any other NRSRO until the NRSRO assigned by the Board had issued its rating.

<u>Prohibition of Underwriter Conflicts in ABS Transactions</u>

- An underwriter or placement agent of an ABS and its affiliates may not, for one year after the ABS is issued, "engage in any transaction that would involve or result in any material conflict of interest with respect to any investor" in the ABS.
  - "<u>ABS</u>" is defined for this purpose specifically to include synthetic transactions.
  - The provision includes no definition of what types of activity would be considered to create a material conflict of interest.
- The SEC is to issue rules implementing the provision within 270 days after enactment, and the prohibition becomes effective on the effective date of those rules.
- Exceptions in the provision include only:
  - "risk-mitigating hedging activities" in connection with underwriting-related risks, and
  - market-making purchases and sales.

<u>Ratings References in Statutes and Regulations</u>

- The Act strikes references to credit rating agencies and investment grade ratings in various Federal statutes, and in many instances replaces them with references to standards of credit-worthiness to be established by the applicable regulator.
  - These changes take effect two years after enactment.
- The Act also requires each Federal agency to review the use of credit ratings in its rules and to remove those references and replace them with standards of credit-worthiness determined by the agency.
  - The review is to be completed within one year of enactment, and each agency is required

to report to Congress on the modifications made to its rules as a result.

  - The SEC currently has several proposals outstanding to make these changes to the rules they administer.

<u>De-Registration of ABS Transactions</u>

- The Act excludes ABS from the existing Exchange Act provision that automatically suspends SEC reporting obligations for issuers whose securities are held by fewer than 300 record holders.

- Instead, the SEC is given authority to provide by rule for the suspension or termination of an ABS issuer's reporting obligations on such terms as the SEC deems necessary.

<u>ABS Disclosure Requirements</u>

- The SEC is directed to adopt regulations requiring asset-level disclosure by issuers of ABS.
  - This requirement is added to a section of the Securities Act relating to registration statements and does not appear to be intended to apply to transactions not registered with the SEC. However, the SEC has proposed on its own rules requiring such disclosures in certain private placement transactions.
  - This requirement to prescribe asset-level disclosures appears to be addressed already by the extensive overhaul of Regulation AB proposed by the SEC on April 7, 2010.
- The SEC is also directed to issue rules requiring each issuer of SEC-registered ABS to review the underlying assets and disclose the nature of that review in the registration statement.
  - These rules are required within 180 days of enactment.
- The Act requires the SEC to prescribe regulations on representations and warranties in ABS transactions that:
  - require NRSROs to report on representations, warranties and enforcement mechanisms for each deal they rate and to compare them to those in similar transactions; and
  - require securitizers to disclose fulfilled and unfulfilled repurchase requests across all of that securitizer's transactions.
  - These regulations are to be prescribed within 180 days after enactment and are substantially covered by rule changes already proposed by the SEC.

<u>ABS Due Diligence</u>

- The Act requires each issuer or underwriter of an ABS to "make publicly available the findings and conclusions of any third-party due diligence report" it obtains.

- Any third-party diligence provider hired by an issuer, underwriter or NRSRO is required to provide the NRSRO with a written certification in the form established by the SEC, and the SEC is to adopt a rule requiring NRSROs to disclose the certification publicly.

<u>SEC Office of Credit Ratings</u>

- The Act establishes a separate Office of Credit Ratings within the SEC.
  - The office is required to examine each NRSRO at least annually and make publicly available "in an easily understandable format" a summary of those examinations and the NRSROs' responses.

<u>Liability of NRSROs</u>

- The Act strikes the Exchange Act provisions that preclude private rights of action based on the Exchange Act registration and reporting of NRSROs.
- In place of those provisions, the Act provides that the Exchange Act's enforcement and penalty provisions apply to statements by NRSROs "to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst."
  - The Act also provides that ratings statements are not forward-looking statements for purposes of the Private Securities Litigation Reform Act and are "commercial speech" (and by implication, not fully protected by the First Amendment).
  - The Act also establishes a pleading standard for suits against NRSROs or their controlling persons. Under this new standard (which is specific to NRSROs), the complaint must state facts showing that the NRSRO knowingly or recklessly failed to:
    - conduct a reasonable investigation of the factual elements its ratings methodology relied on; or
    - obtain reasonable verification of those factual elements from sources independent of the issuer and underwriter.
- These changes are not limited to structured finance or ABS transactions.

<u>Repeal of Rule 436(g) under the Securities Act</u>

- The Act also specifically repeals Rule 436(g) under the Securities Act, which provides that rating agencies won't be considered "experts" for registration statement purposes.
  - The effect will be to require NRSROs to file consents to be named as experts each time their ratings are used in a prospectus.

  - The SEC has an outstanding proposal to require that any ratings used to sell securities be included in the related prospectus.
  - "Expertizing" ratings disclosure will increase the NRSROs' liability for that information but will decrease somewhat the underwriters' potential liability for it.
  - It is not clear how the SEC or issuers will deal with a situation in which a rating agency refuses to consent.
- Repeal of Rule 436(g) under the Securities Act was already the subject of an SEC concept release, which will be superseded by this act.

Rating Agency Whistleblowing

- The Act requires an NRSRO to report to the authorities any information the NRSRO "receives from a third party and finds credible" that alleges a material violation of law by an issuer of rated securities.
  - This may cause concern in the context of rating agency legal diligence on operating companies especially.

Rating Agency Exemption from Regulation FD

- The Act requires the SEC to remove the specific exemption in Regulation FD for disclosures made to credit rating agencies to obtain a rating.
  - The SEC is required to do this within 90 days of enactment.
  - This change is unlikely to have any significant effect, since:
    - Rating agencies are not within the classes of persons to whom selective disclosure is prohibited in the first place by Regulation FD; and
    - in any case, like other entities receiving material non-public information, disclosure to a rating agency under a confidentiality agreement would not be prohibited by Regulation FD.

VII. INVESTOR PROTECTION

Fiduciary Standard for Brokers, Dealers and Investment Advisers

- The House bill proposed to make brokers and dealers subject to the same fiduciary standard applicable to investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act") with respect to providing personalized investment advice and recommendations to retail customers about securities. The Act does not impose such a standard.

- As a compromise, the SEC is mandated to conduct a study evaluating existing standards of care with respect to brokers, dealers and investment advisers providing such advice and is granted discretionary rulemaking authority.

- **Study**. The SEC is required to complete a study no later than six months after enactment to evaluate the effectiveness of existing legal or regulatory standards of care for brokers, dealers and investment advisers and to determine whether there are any gaps or overlap in legal or regulatory standards in the protection of retail customers relating to those standards of care.

    - For the purpose of this study, a "retail customer" is defined as a natural person or the legal representative of such natural person who receives investment advice about securities (as opposed to investments) from a broker, dealer or investment adviser.

    - The Act explicitly sets out detailed considerations the study must take into account including the potential impact of imposing on brokers and dealers the standard of care applied under the Advisers Act to investment advisers as well as the potential impact of eliminating the broker and dealer exclusion from the definition of "investment adviser" under Section 202(a)(11)(c) of the Advisers Act.

    - The latter approach would expand a broker or dealer's fiduciary duty to all clients, not just retail customers.

- **Rulemaking**.

    - *Standard of Conduct*. After considering the findings of its study, the SEC is provided discretionary rulemaking to require brokers, dealers and investment advisers providing personalized investment advice about securities to a retail customer and significantly, such other customers as the SEC may by rule provide, to act in the best interest of the customer without regard to the financial or other interests of the broker, dealer or investment adviser providing the advice.

        - This standard if enacted must be no less stringent that the standard applicable to investment advisers under Sections 206(1) and (2) of the Advisers Act.

        - If enacted, this standard would effectively create a Federal fiduciary standard. Currently, the fiduciary duty applicable to investment advisers is a state common law standard.

- This rulemaking, if undertaken, would suggest that simply subjecting a broker or dealer to the fiduciary duty applicable to an investment adviser, which is based on state law, may be insufficient to protect retail investors.

- Receipt of compensation based on commission or fees would not violate this standard if adopted.

- The SEC is also granted discretionary rulemaking authority to undertake a narrower exercise and simply to require that the standard of conduct for a broker or dealer's investment advice about securities to a retail customer (and such other customers as the SEC may by rule provide) is equivalent to the standard of conduct applicable to an investment adviser under the Advisers Act.

  – Receipt of compensation based on commission or other standard compensation for the sale of securities would not violate this standard if adopted.

  – Additionally, a broker or dealer would not be required to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities, a provision SIFMA actively pushed to be included.

  – The SEC will have to determine whether it thinks a Federal standard is necessary to supplement the state common law standard, or whether this rulemaking would be sufficient.

○ *Disclosure*. If a broker or dealer sells only proprietary or otherwise limited range of products, the SEC may by rule require it to notify each retail customer and obtain the consent or acknowledgement of the customer that the product range offered is limited.

- The SEC is mandated to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers and investment advisers, including any material conflicts of interest.

- The SEC is also mandated to examine, and where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers and investment advisers that the SEC deems contrary to the public interest and protection of investors.

  – This examination is likely to focus on the retail sales of securities underwritten by the broker or dealer.

<u>Liability Relating to Aiding and Abetting</u>

- The Act does not incorporate the Specter amendment which would have created a private civil right of action against any person that provides substantial assistance to another person in violation of the Exchange Act thereby overturning the decision in <u>Stoneridge Investment</u>

Partners, LLP v. Scientific-Atlanta, et al.

- However, it does amend existing securities laws to grant the SEC authority to bring actions against any person who knowingly or recklessly provides substantial assistance to another person in violation of that law or of any regulation issued under that law.
    - This provision clarifies that the SEC only has to show reckless conduct in an aiding and abetting case.
    - Importantly, the Act mandates the GAO (but interestingly, not the SEC) to conduct a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of existing securities laws to be completed not later than 1 year after enactment.

Extraterritorial Jurisdiction of the Antifraud Provisions of the Federal Securities Laws

- The Act grants U.S. district courts and the U.S. courts of any territory jurisdiction over actions and proceedings brought or instituted by the SEC or the United States with respect to violations of antifraud provisions in the Securities Act, the Exchange Act and the Advisers Act involving:
    - "(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States" (for the Advisers Act, the language reads "even if the violation is committed by a foreign adviser"); and "involves only foreign investors;" or
    - "(2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States."
- This is particularly significant in light of the Supreme Court's June 24, 2010 decision in the Morrison, et al., v. National Australia Bank, et al case in which the Court upheld the Second Circuit Court of Appeals decision that there was insufficient domestic conduct to establish subject matter jurisdiction under Section 10(b) of the Exchange Act (and by implication, the Securities Act) in connection with a U.S. action involving trades on a foreign exchange by foreign investors against a foreign issuer, but rejected the standard conducts and effects test developed by the Second Circuit, ruling that Section10(b) actions under the Exchange Act extend only to transactions and securities listed on domestic exchanges, not to transactions or conduct outside the United States.
    - In the government's brief to the Supreme Court, the SEC and the Solicitor General advocated that while the Second Circuit's analysis was defective, the SEC should be recognized as having authority to bring actions against defendants not only in "transnational frauds in which domestic conduct predominates" but also, "if the scheme involves significant conduct within the United States that is material to the fraud's success", a standard wider than applicable, it argued, in private rights of action because

the SEC did not have to prove reliance to bring an action.

- ○ Although the Supreme Court's decision did not address the jurisdiction of the SEC under Section 10(b), the Act codifies the SEC's position in its brief, effectively making the Court's ruling moot with respect to the SEC.

- Additionally, the Act added a new provision requiring the SEC (and not the GAO) to solicit public comment and thereafter conclude a study within 18 months of enactment to determine the extent to which the jurisdiction of U.S. courts to consider private rights of action under the antifraud provisions of the Exchange Act should be extended in the same way.

  - ○ The study must consider the scope of such a private right of action including whether it should extend to all private actors or whether it should be more limited, that is to extend just to institutional investors or some narrower set rather than all investors; implications of such a private right of action on international comity; the economic costs and benefits of extending a private right of action for transnational securities frauds; and importantly, whether a narrower extraterritorial standard should be adopted.

Structural Changes to the SEC

- The Act mandates the SEC to conduct a number of studies and reports to be submitted to Congress including an assessment of its internal supervisory controls and procedures, a triennial personnel management report, an annual audit of its internal financial controls as well as mandated compliance examinations within the agency.

- The Act also requires an independent consultant to conduct a study on the operations and structure of the SEC and provide suggestions for reorganizing and reforming the agency.

- Additionally, the Act creates an Investor Advisory Committee within the SEC to protect investor interest and confidence by consulting with the SEC on its regulatory priorities.

- The Act also creates an Office of the Investor Advocate within the SEC to assist retail investors in resolving significant issues between the investor and the SEC or other Self-Regulatory Organizations as well as identifying areas of existing regulations in which investors would benefit from change. An Ombudsman is also created to mediate between retail investors, the Investor Advocate and the SEC.

Lack of Self-Funding and Match Funding of SEC

- The Act does not provide for the self-funding of the SEC as previous iterations of the Act did, but does provide for "match funding" of the SEC including provisions that enable the SEC to collect transaction fees and assessments that are designed to recover the costs to the government of the annual appropriation to the SEC by Congress including adjustable fee rates.

- The Act also provides for significantly more resources to be allocated to the SEC but mandates that the SEC submit a budget to the President starting for fiscal year 2010.

Additionally, the Act would create the SEC Reserve Fund funded by any registration fees within certain designated limits.

Authority to Restrict Mandatory Pre-Dispute Arbitration

- Under the Act, the SEC is empowered to make rules prohibiting or imposing conditions or limitations on the use of agreements that require customers or clients of any broker, dealer or municipal securities dealer to arbitrate any future dispute between them arising under current laws if it finds that doing so is in the public interest and for the protection of investors.

Nationwide Service of Subpoenas

- The Act amends the existing securities laws to provide for nationwide service of process for actions and proceedings of the SEC.

Beneficial Ownership and Short-Swing Profit Reporting

- The SEC is empowered to shorten the 10-day reporting period under Section 13(d) of the Exchange Act from 10 days or "within such shorter time as the SEC may establish by rule" for persons who acquire more than 5% of certain classes of securities.
  - The Act also amends Section 13(d) so that security-based swap positions will give rise to beneficial ownership of a security for the purposes of reporting and short-swing profit disgorgement liability to the extent that the SEC determines, by rule, that the security-based swap provides "incidents of ownership comparable to direct ownership of the equity security".
  - The SEC is also granted the discretion to shorten the reporting period in the same way for directors, officers and principal stockholders who are beneficial owners of more than 10% of any class of any equity security (other than an exempted security) under Section 16(a) of the Exchange Act.

Study on Conflicts of Interest

- The Act requires the GAO to conduct a study within 18 months of enactment on the potential conflicts of interest between investment banking and equity and fixed income securities analysts working at the same firm and to make recommendations to Congress designed to protect investors in light of such conflicts. This study will clearly build upon and be influenced by the SEC's settlement with regard to financial analysts and limiting conflicts of interest.

Levin Amendment to Overturn Gustafson Decision Not Included

- An amendment introduced by Senator Levin that would have effectively overturned the decision in Gustafson v. Alloyd Co. Inc. by expanding the scope of Section 12(a)(2) of the Securities Act (which imposes liability on market participants for misstatements or omissions in prospectuses and oral communications in connection with the offer and sale of securities) to cover prospectuses used in private securities offerings in addition to public offerings was removed from the Act.

VIII. **HEDGE FUND REFORMS**

Generally

- The Act will require advisers to hedge funds and private equity funds that are currently exempt from registration to register as investment advisers under the Advisers Act.
  - The Act eliminates the "private adviser exemption" under the Advisers Act, which exempts from registration advisers who (i) during the course of the preceding 12 months have had fewer than 15 clients; (ii) do not hold themselves out to the public as investment advisers; and (iii) do not provide advisory services to funds registered as investment companies under the 40 Act.
  - Most private fund advisers currently rely on this exemption as a fund can be counted as a single client. However, the Act requires the SEC to provide an exemption from registration under the Advisers Act for advisers that act solely as advisers to private funds (defined as an issuer that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the '40 Act) and have aggregate assets under management ("AUM") in the United States of less than $150 million.

Exemptions from Registration

- For non-U.S. based advisers, the Advisers Act *in general* will apply only to their relationships with their U.S. clients. The Act exempts from registration any investment adviser that is a "foreign private adviser", which is defined as an adviser who:
  - has no place of business in the United States;
  - during the preceding 12 months has had (i) in total, fewer than 15 clients and investors in the United States in private funds advised by such investment adviser, and (ii) AUM attributable to clients and investors in the United States in private funds advised by such investment adviser of less than $25 million; and
  - neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to any investment company registered under the '40 Act.
- The Act also limits the newly extended reach of the Advisers Act by exempting from registration, "venture capital fund" advisers (to be defined by the SEC), advisers to any family office (to be defined by the SEC, including certain grandfathering provisions), and advisers to small business investment companies that are regulated by the Small Business Administration.
- U.S. advisers, who do not advise any registered funds, must have at least $25 million of AUM to register with the SEC. U.S. advisers with less than $25 million in AUM will be subject to regulation/registration by the state in which they have their principal place of

business.

- In addition, an investment adviser that has AUM between $25 million and $100 million and is required to be registered with the state in which it has its principal office, and as a result is subject to examination as such an investment adviser, is not permitted to register with the SEC unless the investment adviser is an adviser to an investment company registered under the '40 Act, or a company which has elected to be a business development company under the '40 Act. However, such an adviser may register with the SEC if it would otherwise be required to register with 15 or more States.

Reporting Requirements

- Regardless of whether a private fund adviser is exempt from registration as described above, the Act requires such advisers of "private funds" to maintain such records and provide the SEC annual or other reports as the SEC determines necessary or appropriate in the public interests or for the protection of investors.
  - The Act also requires registered investment advisers of private funds to report to the SEC (i) the amount of their AUM; (ii) the use of leverage (including off-balance sheet exposures); (iii) counterparty credit exposure; (iv) trading and investment positions; (v) trading practices; (vi) valuation policies and practices of the fund; (vii) types of assets held; (viii) side arrangements or side letters whereby certain investors in the fund obtain more favorable rights or entitlements than other investors and (ix) other information determined by the SEC.
  - While venture capital fund investment advisers are to be exempt from registration under the Advisers Act, the SEC is directed to require such advisers to maintain such records and to provide to the SEC such annual or other reports as the SEC deems necessary or appropriate in the public interest or for the protection of investors.

Definition of "Client"

- For purposes of the Adviser Act, fund advisers have generally been able to count each fund as a single client, rather than looking through each fund to the individual fund investors (so long as the fund receives investment advice based on its investment objectives, rather than the separate investment objectives of its investors). This has been particularly important prior to the Act to fund advisers counting the number of their clients for purposes of the *de minimis* exemption, and will now be of similar importance to the definition of foreign private advisers. However, it should be noted that the Act limits the SEC's rule making authority by prohibiting the SEC from defining the term "client" to include investors in a private fund for purposes of Sections 206(1) and (2) of the Adviser Act, which are the main anti-fraud provisions of the Advisers Act. Thus, an adviser's anti-fraud obligations should be with respect to its funds, rather than a fund's individual investors.

Custody Requirements

- The Act requires that an investment adviser registered under the Advisers Act take steps to safeguard client assets over which the adviser has custody, as the SEC may prescribe, including, without limitation, verification of such assets by an independent public accountant.

Accredited Investor/Qualified Client Standard

- Effective upon enactment, the Act would change the $1 million natural person net worth threshold for "accredited investors" under the Securities Act to $1 million excluding the value of the investor's primary residence. The SEC is also authorized to review the definition of accredited investors as it applies to natural persons and promulgate rules adjusting the definition (other than with respect to $1 million net worth prong), and is authorized to adjust the provision (including $1 million net worth prong) four years after enactment and at four-year intervals thereafter.
  - The Act also requires that all dollar amount tests used by the SEC as a factor in making determinations under the Advisers Act, such as a net asset threshold, be adjusted for inflation not later than one year after enactment and every five years thereafter. This provision would capture the definition of "qualified client" which is currently determined by using a $750,000 AUM test and a $1.5 million net worth test.

Studies/Timing

- The Act requires that a number of studies and reports be conducted, one of which is a study to be conducted by the Comptroller General of the feasibility of forming a self-regulatory organization to oversee private funds. The Comptroller General is required to submit a report to the Senate and House committees within a year of enactment.
  - With the exception of the exclusion of the value of an investor's primary residence from the definition of net worth under the definition of Accredited Investor, which will take effect immediately upon enactment, the rest of the Act will become effective one year after enactment. We note that an investment adviser may in its discretion register with the SEC under the Advisers Act during the one-year transition period subject to SEC rules and that, for many advisors who are not currently regulated, the process for becoming a registered investment adviser may involve the formulation of numerous policies and procedures that can take 6 months or longer.

IX. CONSUMER PROTECTION

Structure and Independence

- The Act creates the Consumer Bureau, an independent bureau within the Fed.
  - The Consumer Bureau will have a director that is appointed by the President, with the advice and consent of the Senate. The director will serve for a five-year term. The Consumer Bureau will have significant independence from the Fed. In particular:
    - the Fed will not be permitted to appoint, direct or remove any officer or employee of the Consumer Bureau;
    - the Fed will not be permitted to intervene in any matter or proceeding before the Consumer Bureau;
    - the Fed will not be permitted to merge or consolidate the Consumer Bureau with the Fed or any Federal Reserve Bank;
    - no rule or order of the Consumer Bureau will be subject to approval or review by the Fed; and
    - the Fed will not be able to delay or prevent the issuance of any rule or order by the Consumer Bureau.
  - Even though the Consumer Bureau will be independent of the Fed, the Council can stay any rule or regulation proposed by the Consumer Bureau if two-thirds of the members of the Council determine that the proposed rule or regulation would put the safety and soundness or the stability of the U.S. financial system at risk.
    - In addition, the Consumer Bureau is required to consider the views of other prudential regulators when proposing a rule or regulation but is not required to follow the suggestions of such regulators.

Funding

- In general, funding for the Consumer Bureau will come from the Fed. Each year the director of the Consumer Bureau will make a request to the Fed for funding sufficient to carry out the mandate of the Consumer Bureau, and the Fed is obligated to provide these funds to the Consumer Bureau subject to a cap that is a percentage (that increases annually) of the Fed's operating expenses.
  - In addition, until 2014, Congress is granted the ability to appropriate up to $200 million per year to the Consumer Bureau over and above funding provided by the Fed if requested to do so by the director.

Scope of the Consumer Bureau's Regulatory Authority

- As expected, primary regulatory authority of large number of existing Federal consumer protection laws (e.g., Truth In Lending, the Equal Credit Opportunity Act, etc.) will be transferred to the Consumer Bureau. In addition, the Consumer Bureau will have the authority generally to regulate any person that provides a consumer financial product or service.
    - Consumer financial products and services are specifically enumerated in the title but can be added to by the Consumer Bureau through rulemaking.
    - The Consumer Bureau will have regulatory authority over a wide swath of entities: national banks, state banks, Federal thrifts and non-banking entities that provided consumer financial products and services.
    - With respect to insured depository institutions and insured credit unions, the Consumer Bureau has primary regulatory authority over such entities if they have assets in excess of $10 billion. Otherwise, such entity's primary prudential regulator is charged with enforcing the consumer financial protection laws.
    - In addition, the title exempts certain categories of entities from regulation by the Consumer Bureau. The most significant of these entities are merchants, retailers and sellers of nonfinancial goods and services, automobile dealers, accountants and persons regulated by the SEC, the CFTC or a state insurance commissioner.
        - Entities regulated by the SEC and the CFTC they are exempt only in regulated capacities.
    - Even though primary enforcement authority over most current Federal consumer protection laws is transferred to the Consumer Bureau, the Federal Trade Commission (the "FTC") retains its current regulatory authority under the Federal Trade Commission Act.
        - The Consumer Bureau and the FTC are required to negotiate an agreement to efficiently coordinate consumer financial protection regulation.

Limits on State Attorney Generals

- The Act limits the ability of state attorney generals to bring suit against national banks and Federal thrifts. A state attorney general can only bring suit in his or her own state and can only bring a suit to (i) enforce a "regulation prescribed by the Consumer Bureau" (as appropriate to general violations of the title) and (ii) secure remedies under the title or remedies otherwise provided under other laws.
    - The Act limits the courts in which a state attorney general can bring suit to courts in its state that have jurisdiction over the person against whom the state attorney general is

bringing suit.

Preemption

- The Act includes Federal preemption provisions.
    - The Act introduces the 'Federal floor principal' under which states can promulgate consumer financial protection laws that are more protective of consumers than the analogous Federal standard promulgated by the Consumer Bureau.
    - Nonetheless, the OCC and the successors to the OTS can, pursuant to the standard set forth in the Barnett decision, preempt any state consumer financial protection law that "prevents or significantly interferes with the exercise" by a national bank or Federal thrift of any power granted to it under Federal law.
        - A state consumer financial protection law can be preempted even if there is no Federal standard applicable to the activities regulated by the state law. In addition, when reviewing a preemption decision a court is required to look to the strength of the Federal prudential regulators' reasoning and not review the preemption decision de novo.
        - Any Federal preemption will not apply to a subsidiary and/or affiliate of a national bank or Federal thrift if such subsidiary and/or affiliate is not itself a national bank or Federal thrift.

Restrictions with respect to Debit Cards and Credit Cards

- Under the first part of the Durbin amendment, interchange fees charged or received by issuers of debit cards must be reasonable and proportional to the costs incurred by such issuers. The Fed is tasked with defining what is reasonable and proportional.
- Under the second part of the Durbin amendment, payment card networks and issuers cannot contractually prohibit vendors from (1) giving discounts and/or in-kind incentives to consumers to use cash, checks or debit cards rather than credit cards or (2) refusing credit cards if a transaction is below a certain amount.
    - Any discounts and/or incentives given by a vendor cannot differentiate on the basis of issuer or payment card network.
    - Vendors cannot set a minimum transaction threshold in excess of $10, but the Fed can increase this threshold through regulation.
        - However, issuers with less than $10 billion in assets are excluded from the Durbin amendment provisions.

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X. INSURANCE REFORMS

- The Act establishes the FIO within the Treasury, the first office in the Federal government focused on insurance. The FIO has authority to:
  - monitor all aspects of the insurance industry, including identifying 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;
  - recommend to the Council that it designate an insurer, including the affiliates of such insurer, as an entity subject to regulation as a nonblank financial company supervised by the Fed; and
  - gather information about the insurance industry, including access to affordable insurance products by minorities, low- and moderate- income persons and underserved communities.
- The Act also streamlines regulation of surplus lines insurance and reinsurance through state-based reforms.

* * *

Please contact any of the individuals named on the attached schedule with questions.

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