



## House-Senate Conference Committee Approves Conference Report on Dodd-Frank Wall Street Reform and Consumer Protection Act

At 5:39 a.m. last Friday morning, by separate votes along strict party lines of 20 to 11 and 7 to 5, House and Senate conferees separately approved the [Conference Committee Report](#) on the financial regulatory reform bill, H.R. 4173, now known as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). Different versions of the Act had been approved by the House in December and by the Senate in May. Following reaction by some legislators to the so-called “bank tax” to fund the estimated \$22 billion administrative and other costs of the Act over ten years, conferees reconvened on June 29 to adopt an alternative funding mechanism provision by a similar partisan vote. House Financial Services Chairman Barney Frank presided over the seven-plus days of televised public hearings of the conferees. The Act was approved by the House on June 30 by a 237 to 192 vote, with Senate action to follow. President Obama is expected to sign the measure into law shortly after final approval by the Senate. Except for certain provisions that we have highlighted, the Act will generally take effect one day after the date of enactment.

In attempting to summarize the over 2,300 pages of the Act, we are able to cover only the highlights in this Sidley update. It should be noted that Chairman Frank indicated during the course of the reconvened Conference Committee that a correction/clarification bill is anticipated. Moreover, many provisions of the Act require the adoption of rules to implement. In addition, the Act mandates multiple studies, which could result in additional legislative action. Clients affected by various aspects of financial regulation reform should contact their principal Sidley lawyers for more information. We will issue updates as developments warrant.

### Executive Summary

#### Financial Stability Oversight Council

##### Composition of the Oversight Council

[Title I](#), Subtitle A, of the Act establishes an interagency council (“Oversight Council”) to identify and monitor systemic risks posed by financial firms and financial activities and practices. The Oversight Council comprises ten voting members, who are the heads of the Federal financial regulatory agencies, the new Bureau of Consumer Financial Protection and an independent member with insurance expertise; and five nonvoting members, who are the heads of the new Office of Financial Research and the new Federal Insurance Office, a State insurance commissioner, a State banking supervisor and a State securities commissioner. The Oversight Council is chaired by the Secretary of Treasury.

## Oversight Council Authority

*Designation of Nonbank Financial Companies for Supervision.* The Oversight Council is charged with designating U.S. and foreign nonbank financial companies that could pose a threat to the financial stability of the United States (each a “Designated Company”). Designated Companies are required to register with the Board of Governors of the Federal Reserve System (“Federal Reserve Board”) and, along with bank holding companies with consolidated assets of \$50 billion or more (“Large Bank Holding Companies”), are subject to supervision and enhanced prudential standards established by the Federal Reserve Board.

*Supervision Recommendations.* The Oversight Council can make recommendations to the Federal Reserve Board for stricter prudential standards to be applied to Designated Companies and Large Bank Holding Companies on an individual basis or by category. The Oversight Council also can make recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices. The primary financial regulatory agency must adopt recommended standards within 90 days or explain its determination not to follow the recommendation.

*Other Duties.* The Oversight Council’s other duties are, among other things, to facilitate information sharing and coordination among the member agencies and other Federal and State agencies, identify gaps in regulation, identify systemically important financial market utilities and payment, clearing and settlement activities and monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and advise Congress and make recommendations in these areas. The Oversight Council also can authorize the Federal Reserve Board to take certain actions with respect to a Designated Company or Large Bank Holding Company to mitigate grave threats to financial stability, including limiting new affiliations or financial products, requiring the company to terminate one or more activities or imposing conditions on conduct of activities.

## Enhanced Supervision and Prudential Standards

### Covered Entities

*U.S. and Foreign Nonbank Financial Companies --Threat to U.S. Financial Stability.* Companies subject to designation for enhanced supervision and prudential standards are U.S. and foreign nonbank financial companies that are “predominantly engaged in financial activities” that could pose a threat to the financial stability of the United States in the event of their material financial distress, or based on their activities.

*U.S. and Foreign Nonbank Financial Companies -- Predominantly Engaged in Financial Activities Standard.* A company is “predominantly engaged in financial activities” if 85% or more of its consolidated annual gross revenues are derived from, or 85% or more of its consolidated assets relate to, activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act of 1956 (the “BHCA”) or the ownership or control of one or more insured depository institutions.

*U.S. and Foreign Nonbank Financial Companies -- Criteria for Designation.* The criteria for designation of a U.S. nonbank financial company for prudential regulation by the Federal Reserve Board include: extent of leverage, extent of off-balance-sheet exposures, nature, scope, size, scale, concentration, interconnectedness and mix of activities, the degree to which the company is already regulated by one or more primary financial regulatory agencies, the degree of reliance on short-term funding and any other risk-related factors deemed appropriate by the Oversight Council. The criteria are substantially the same for foreign nonbank financial companies. The Federal Reserve Board, on behalf of and in consultation with the Oversight Council, can establish criteria for exempting certain types or classes of nonbank financial companies from Board supervision.

### Large Bank Holding Companies

*Large Bank Holding Companies.* Bank holding companies with total consolidated assets of \$50 billion or more (each a “Large Bank Holding Company”) are subject to the enhanced supervision and prudential standards established under the Act. Under the so-called “Hotel California” provision of the Act, Large Bank Holding Companies that have received TARP funds cannot avoid Federal Reserve supervision by dropping their banks.

### More Stringent Standards

[Title I](#), Subtitle C, of the Act authorizes the Federal Reserve Board to establish prudential standards applicable to Designated Companies and Large Bank Holding Companies. Standards must be more stringent than those applicable to nonbank financial companies and bank holding companies that do not present similar risks to U.S. financial stability, and can be imposed on an individual basis or by category, taking into consideration risk-related factors such as capital structure, riskiness, complexity, financial activities and size. Standards will include risk-based capital requirements and leverage limits, liquidity requirements, overall risk management requirements, resolution plan and credit exposure report requirements, concentration limits and stress tests, and may also include a contingent capital requirement and short-term debt limits (other than deposit liabilities), among others.

### Other Supervisory Requirements

*Intermediate Holding Company.* Designated Companies engaged in commercial activities can, or may be required to, segregate financial activities in an intermediate holding company, which is not required to conform activities to the requirements of Section 4 of the BHCA, and the company’s non-financial activities are expressly excluded from the Federal Reserve Board’ supervision and prudential standards.

*Acquisitions of Bank Shares Subject to BHCA.* Designated Company acquisitions of bank shares are made subject to Section 3 of the BHCA as if such companies were bank holding companies. In addition, Designated Companies and Large Bank Holding Companies must provide written notice to the Federal Reserve Board prior to acquisition of voting shares of a company engaged in financial activities that has total consolidated assets of \$10 billion or more, with certain exceptions.

### Increased Leverage and Risk-Based Capital Requirements

*Minimum Leverage and Capital Ratios.* Under the so-called “Collins Amendment,” the Federal banking agencies must adopt minimum leverage and risk-based capital requirements on a consolidated basis for all insured depository institutions, depository institution holding companies and Designated Companies. The minimum requirements cannot be less than minimum ratios currently in effect for depository institutions. The intent is to require large banks and bank holding companies, as well as Designated Companies, to meet, at a minimum, the same capital standards imposed on small banks. Small bank holding companies (with consolidated assets under \$500 million), debt or equity securities issued to the United States under TARP, and any Federal Home Loan Bank are excepted. Capital ratios for leverage purposes are measured by average total assets, thereby eliminating any incentive to engage in so-called “Repo 105” transactions.

*Trust Preferred Securities.* The Act phases in a requirement that depository institution holding companies and Designated Companies exclude trust preferred securities from Tier I capital. Existing trust preferred securities that were issued before May 19, 2010 are grandfathered for all depository institution holding companies with less than \$15 billion in total consolidated assets and mutual holding companies. Holding companies with \$15 billion or more in total assets have five years to comply with the provision, with three years to phase out their trust preferred securities, beginning on January 1, 2013. Thrift holding companies are also subject to the three-year phase-out of their trust preferred securities, but have five years to comply with the minimum leverage and risk-based capital requirements.

## Financial Market Utilities

[Title VIII](#) of the Act grants new powers to the Federal Reserve Board and Oversight Council (acting in conjunction with the SEC and CFTC) over “financial market utilities” (including clearinghouses) designated as systemically important, and over financial institutions other than clearinghouses that engage in systemically important payment, clearing and settlement activities. [Title VIII](#) authorizes these regulatory bodies to mandate risk management standards, provides new examination and enforcement powers, and authorizes imposition of new information gathering, reporting and record-keeping requirements. [Title VIII](#) also grants designated financial market utilities access to certain Federal Reserve Bank services, including discount and borrowing privileges, under certain limited circumstances.

## Orderly Liquidation

With a view to ending “too big to fail,” [Title II](#) of the Act creates a special orderly liquidation regime (the “Orderly Liquidation Regime”) for the orderly dissolution of systemically important “financial companies,” modeled on the currently-existing Federal Deposit Insurance Act (“FDIA”) regime for the resolution of failed FDIC-insured depository institutions, and administered by the FDIC as receiver.

Under the Act, a financial company can be taken out of the bankruptcy regime that would normally apply to it and placed into the Orderly Liquidation Regime upon certain determinations by the Treasury Secretary, in consultation with the President. This can occur before a financial company would have become subject to a proceeding under the normally applicable bankruptcy regime or even after such a proceeding has commenced. Once a financial company is placed into the Orderly Liquidation Regime, its receivership must be completed within three years, subject to two one-year extensions. Although the Orderly Liquidation Regime allows for the use of “bridge financial companies” for the purpose of liquidating a failed financial company, there is no option for rehabilitation or reorganization or for an FDIA-style conservatorship under which the failed financial company can continue to be run as a going concern.

The FDIC’s powers as receiver under the Orderly Liquidation Regime are similar to the powers it has as receiver under the FDIA, with certain modifications intended to reduce differences between the FDIA and the Bankruptcy Code regime. The FDIC is required to exercise such powers in a manner that mitigates significant risk to the financial stability of the United States and minimizes “moral hazard” so that (1) creditors and shareholders will bear the risk of losses of such financial company, (2) management responsible for the financial condition of the financial company will not be retained, and (3) all parties having responsibility for the condition of the financial company bear losses consistent with their responsibilities, including actions for damages, restitution and recoupment of compensation and gains not compatible with such responsibility.

An Orderly Liquidation Fund, which is to be funded only after an insolvency of a financial company subjected to the Orderly Liquidated Regime, is established to fund liquidations under the regime. The Orderly Liquidation Fund is to be funded with repayments to the FDIC with respect to the insolvent financial company, through assessments, and with borrowings from the Treasury (subject to specified limitations). Amounts needed to repay Treasury borrowings are required to come first from assessments on entities that received more under the Orderly Liquidation Regime than they would have received in a liquidation of the financial company and then from assessments on bank holding companies with total consolidated assets of \$50 billion or more, nonbank financial companies supervised by the Federal Reserve Board and other financial companies with total consolidated assets of \$50 billion or more. Assessments are to be levied on a graduated basis, with larger and riskier companies paying a higher assessment rate.

## Banking Reform

### Elimination of OTS

While the Act preserves the thrift charter, [Title III](#) of the Act abolishes the OTS. OTS authority with respect to savings associations, their holding companies and their affiliates will be transferred to the OCC, the FDIC and the

Federal Reserve Board. The effective date for the elimination of the OTS is one year after enactment of the Act, unless the timeline is extended.

### **Deposit Insurance Changes**

[Title III](#) of the Act modifies the calculation of the “assessment base” upon which deposit insurance premiums are calculated. In general, the new assessment base will equal the average total consolidated assets of an insured depository institution minus the sum of the average tangible equity of the insured depository institution during the assessment period. Additional amounts will be subtracted from average total consolidated assets for custodial banks and banker’s banks. In addition, the Act grants the FDIC greater authority to build up excess reserves when the Bank Insurance Fund has otherwise met its targets.

[Title III](#) of the Act increases the Deposit Insurance Fund reserve ratio from 1.15% to 1.35% by September 30, 2020. The cost of this increase will be borne by insured depository institutions with assets of \$10 billion or more.

[Title III](#) of the Act makes permanent the increase in standard maximum Federal deposit and share insurance limits from \$100,000 to \$250,000. Although unlimited Federal insurance of the net amount of “noninterest-bearing transaction accounts” is extended from December 31, 2010 through December 31, 2013, the definition of “noninterest-bearing transaction account” is more restrictive than the definition currently used in the FDIC’s Transaction Account Guarantee program.

### **Emergency Lending and Financial Stabilization Authority**

[Title XI](#) of the Act requires the Federal Reserve to establish policies and procedures governing emergency lending under Section 13(3) of the Federal Reserve Act. The Act requires that these procedures be designed to ensure that emergency lending is used to provide liquidity to the financial system and not to aid failing financial companies and that collateral for emergency loans is sufficient to protect taxpayers from losses. The Act includes several provisions aimed at making the use of such emergency lending programs transparent, including a requirement that the Federal Reserve make reports to Congress on the programs and facilities created under this authority, a requirement that the Federal Reserve publicly disclose the identity of participants in such programs and facilities and a grant of authority to the GAO to audit the programs and facilities created under this authority.

[Title XI](#) of the Act also requires the FDIC to establish a debt guarantee program to guarantee the obligations of solvent insured depository institutions or solvent depository institution holding companies if it is determined that a statutorily defined “liquidity event” exists and to establish policies and procedures governing the issuance of such guarantees. The amount of debt the FDIC may guarantee under a debt guarantee program will be subject to a maximum cap.

### **Shift of Regulatory Focus**

[Title III](#) of the Act contains several provisions aimed at shifting the economic burden of regulation to the largest institutions and increasing regulatory focus on fairness and nondiscriminatory treatment. Such provisions include expressly charging the OCC with assuring “fair access to financial services and fair treatment of customers by the institutions and other persons subject to its jurisdiction,” requiring the Federal Reserve to impose fees on certain large bank holding companies and savings and loan holding companies and requiring each Federal banking agency to establish an Office of Minority and Women Inclusion that will be responsible for all matters of the agency relating to diversity in management, employment and business activities, including increasing women- and minority-owned business in the programs and contracts of the agency.

### Capital Rules and Source of Strength

In [Title VI](#) of the Act, the authority of the Federal banking regulators to establish bank holding company and savings and loan holding company capital standards is clarified, and Federal banking regulators are instructed to make capital requirements for such holding companies and for depository institutions countercyclical.

A source of strength doctrine is applied to all depository institution holding companies, including commercial companies that control a depository institution. If a holding company is not a bank holding company or savings and loan holding company, it may be required to submit a report under oath assessing its ability to serve as a source of strength.

### The Volcker Rule

In [Title VI](#) of the Act, Federal banking agencies, through a rule-making, are required to jointly prohibit proprietary trading or sponsoring or investing in a hedge fund or private equity fund by a “banking entity,” defined as an insured depository institution, a company that controls a depository institution, a company treated as a bank holding company and any subsidiaries of such institutions or companies (including broker-dealer and fund manager affiliates or subsidiaries). Several exceptions to the rule may apply, including with respect to risk-mitigating hedging activities and trading conducted on behalf of customers. Regulators are directed to impose additional capital requirements and quantitative limits on excepted activities.

Additionally, a banking entity that organizes and offers a hedge fund or private equity fund may make and retain an initial investment if, within one year after establishment of the fund, the investment is reduced to 3% or less of total ownership interests and is immaterial to the banking entity (the maximum of all such investments must be 3% or less of the banking entity’s Tier 1 capital). The Federal Reserve Board may extend the one-year period for two additional years.

Banking entities must dispose of prohibited investments or relationships within two years after the Volcker Rule requirements become effective (which occurs on the earlier of 12 months after the issuance of final regulations or two years after enactment of the Act) or two years after a banking entity becomes a nonbank financial company subject Federal Reserve Board supervision under [Title I](#) of the Act, subject to up to three possible one-year extensions. An additional exemption of up to five years may be granted by the Federal Reserve Board to the extent necessary in the case of a banking entity that is subject to a contractual obligation that was in effect on May 1, 2010 regarding an investment in or capital commitment to an illiquid fund. Regulators are directed to issue rules to apply during the divestiture period that impose additional capital requirements and other restrictions on banking entities that sponsor or invest in hedge funds or private equity funds.

While the Volcker Rule does not apply to nonbank financial companies that are not banking entities, the Federal Reserve Board is required to adopt rules that impose additional capital requirements and quantitative limits on nonbank financial companies it supervises pursuant to [Title I](#) of the Act that engage in proprietary trading or sponsoring or investing in hedge funds or private equity funds.

### Concentration Limit on Expansion

In [Title VI](#) of the Act, depository institution mergers and acquisitions are prohibited if they result in a greater than 10% concentration of U.S. deposits in a single holding company or institution. Also, financial company mergers and acquisitions are prohibited if the total consolidated liabilities of the acquiring financial company upon consummation of the transaction would exceed 10% of the aggregate consolidated liabilities of all financial companies. Financial companies include depository institutions, companies that control them and nonbank financial companies supervised by the Federal Reserve Board under [Title I](#) of the Act.

## Derivatives Reform

[Title VII](#) of the Act represents the first attempt to bring comprehensive regulation to the U.S. over-the-counter (“OTC”) derivatives markets since the Commodity Futures Modernization Act of 2000 placed these markets largely beyond the regulatory authority of the CFTC and SEC. The centerpieces of [Title VII](#) are mandates for traders to execute OTC derivative transactions on regulated exchanges and to submit those trades for clearing to regulated clearinghouses, as well as new regulatory regimes for dealers and major OTC derivative market participants. Many OTC derivatives will now be subject to mandatory margin requirements and many market participants will now be required to maintain specified amounts of regulatory capital. [Title VII](#) eliminates virtually all exemptions from the Federal securities and commodities laws for OTC derivatives. It takes a bifurcated approach to regulation of OTC derivatives, giving the CFTC jurisdiction over swaps that are not security-based swaps (“SB swaps”) and the SEC jurisdiction over SB swaps. A participant in both the swaps and SB swaps markets will therefore be subject to regulation by multiple regulators. The swap and SB swap provisions of [Title VII](#) have limited extraterritorial effect.

### Exchange Trading and Central Clearing Requirements

Two central pillars of [Title VII](#) are the mandatory clearing and exchange trading requirements. [Title VII](#) requires swaps and SB swaps to be submitted to a central clearinghouse if they belong to a category of swaps/SB swaps that such a clearinghouse has been approved to clear, provided that the applicable regulator has mandated that such swaps or SB swaps be centrally cleared. [Title VII](#) does not create a new regulatory category for swap clearinghouses, instead relying on the existing definitions of DCOs and clearing agencies and new definitions of “cleared swaps/SB swaps.” These clearinghouses will, however, be subject to significant new requirements, including more extensive “core principles.” Clearinghouses will be required to submit proposals to their regulators before accepting a swap or SB swap for clearing and the regulators will be required, on an ongoing basis, to evaluate which categories of swaps/SB swaps must be centrally cleared. Swaps and SB swaps entered into prior to enactment of the Act are exempt from the mandatory clearing requirement. Certain non-regulated parties to swaps and SB swaps will also be able to opt into clearing, notwithstanding that there is no mandatory clearing for a given contract, if a clearinghouse will accept the trade.

Going forward, swaps and SB swaps that are subject to the mandatory clearing requirement must also be executed on a regulated exchange, including newly created categories of exchange known as “swap execution facilities” and “security-based swap execution facilities.” The mandatory exchange trading requirement will not apply to a swap/SB swap if no exchange lists it for trading.

### Exceptions to Exchange Trading and Central Clearing Requirements

[Title VII](#) includes an exemption from the mandatory central clearing and exchange trading requirements for certain end-users. In order to rely on the end-user exemption and thereby opt out of mandatory central clearing and exchange trading, a trader must not be a “financial entity,” must use the swap/SB swap to hedge or mitigate commercial risk, and must notify the applicable regulatory agency how it generally meets its financial obligations associated with entering into non-cleared swaps or SB swaps. “Financial entity” is a term that includes many dealers and participants in the swap and SB swap markets, commodity pools, private funds, employee benefit plans and other persons predominately engaged in banking and financial activities. The inability of financial companies to rely on the end-user exemption, notwithstanding whether they are hedging, was a major point of contention in debates about [Title VII](#).

### Lincoln Provision

[Title VII](#) also includes a significant provision (Section 716) referred to as the “spin out” or “push out” provision, which limits the ability of insured depository institutions and other entities benefiting from federal financial support to act as OTC derivatives dealers. This provision was included in the Act at the behest of Senator Blanche Lincoln, chairperson of the Senate Agriculture Committee. It was significantly revised in the final hours leading up to adoption of the

Conference Report, represents a somewhat softer approach than that originally advocated by Senator Lincoln, although it also contains several important ambiguities. Section 716 includes a two-year transition period during which affected entities will need to restructure their OTC derivative operations.

### **Regulation of Market Participants**

[Title VII](#) creates new regulatory regimes for swap dealers, SB swap dealers, major swap participants and major SB swap participants. The new regulatory regimes include requirements relating to registration, record-keeping, reporting, business conduct, disclosure, minimum capital and margin, and examination. The CFTC and SEC will have broad authority to determine the substantive scope of regulation. The new regulatory categories applicable to entities are independent of existing categories, so that investment advisers, CTAs, commodity pool operators (“CPOs”), broker-dealers, banks and FCMs that engage in swap/SB swap activities will be required to register in the applicable additional categories. The Act may require certain market participants that have no ongoing involvement in the swap/SB swap markets, but which maintain legacy positions in swaps or SB swaps, to register and become subject to the new regulations.

### **Margin and Capital Requirements and Bankruptcy Treatment**

[Title VII](#) requires that any person that accepts collateral in connection with a swap cleared through a DCO be registered as an FCM and any person that accepts collateral in connection with an SB swap be registered as an SB swap dealer or a broker-dealer. FCMs, SB swap dealers and broker-dealers are required to segregate collateral they receive and treat it as belonging to their customers. [Title VII](#) also clarifies the bankruptcy treatment of cleared swaps, which is important because it was previously unclear whether cleared OTC derivatives should be treated as “commodity contracts” under the Bankruptcy Code. Further steps will be needed to clarify the proper treatment of cleared SB swaps.

### **Securities Law Amendments**

#### **Fiduciary Duty and Mandatory Pre-dispute Arbitration Agreements**

[Title IX](#) of the Act, known as the “Investor Protection and Securities Reform Act of 2010,” provides greater protections to investors and expands the SEC’s authority to oversee the activities of registered brokers, dealers and investment advisers. The Act permits the SEC, after conducting a study, to impose a fiduciary duty upon brokers and dealers that provide personalized investment advice to retail investors about securities and also gives the SEC the power to limit the use of mandatory pre-dispute arbitration agreements between brokers, dealers and investment advisers with their customers and clients.

#### **Access to the SEC and Whistleblowers**

The Act gives the public and investors greater access to the SEC by establishing an Investor Advisory Committee, Office of Investor Advocate and Ombudsman. These roles were created to protect and assist investors. The Act further expands the SEC’s whistleblower provisions to create incentives for the public to provide information to the SEC that leads to successful enforcement proceedings.

#### **SEC Authority to Require Investor Disclosures Before Purchase of Investment Products and Services**

The Act amends the Securities Exchange Act of 1934 (“Exchange Act.”) to clarify that the SEC may issue rules designating documents or information to be provided by a broker or dealer to a retail investor before the purchase of an investment product or service.

## Aiding and Abetting

[Title IX](#) expands the SEC's ability to bring enforcement actions in district courts against aiders and abettors. Among other things, the Act authorizes aiding and abetting actions for violations of the Securities Act and the Investment Company Act of 1940 (the "Investment Company Act") and clarifies that the SEC can seek civil monetary penalties against persons who aid and abet Investment Advisers Act of 1940 (the "Advisers Act") violations. In addition, the Comptroller General must conduct a study on the impact of allowing aiding and abetting claims in private securities actions.

## Credit Rating Agencies

The SEC will have more oversight of nationally recognized statistical rating organizations ("NRSROs") and will do so through an Office of Credit Ratings. This Office will administer the SEC's rules relating to NRSROs and will conduct at least annual examinations of each NRSRO. The SEC will, through rule-making, require NRSROs to provide more detailed information on their ratings as well as their methodologies. The Act gives investors recourse against credit rating agencies that misrepresent the credit-worthiness of securities and companies. The Act rescinds Securities Act Rule 436(g) and, as a result, NRSROs may be liable for misstatements or material omissions in registration statements if NRSROs consent to be named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with a registration statement. The SEC must conduct a study of the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and subscriber-pay compensation models.

## Management of the SEC

The management of the SEC will be under more scrutiny because of the Act. The SEC has to provide detailed reports on management and internal controls to Congress and will be the subject of reviews by the Comptroller General.

## Relief from SOX 404(b) for Non-Accelerated Filers

[Title IX](#) of the Act provides a permanent exemption for non-accelerated filers from the auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act. This means that such issuers will not have to bear the expense and burden of having their external auditor attest to management's assessment of the effectiveness of internal control over financial reporting.

## Registration and Reporting Requirements for Investment Advisers to Hedge Funds and Others

### Amendments to Investment Adviser Registration Requirements and Exemptions

*Elimination of the "Private Adviser" Exemption.* [Title IV](#) of the Act significantly affects registration requirements for advisers to private pools of capital under the Advisers Act by, among other things: (1) eliminating the current "private adviser" exemption from registration for any U.S. resident adviser that has fewer than 15 clients and does not "hold itself out as an investment adviser" to the U.S. public; (2) creating new registration exceptions and exemptions; and (3) raising the minimum asset threshold for Federal registration for most U.S. resident advisers from \$25 million to \$100 million, thereby delegating supervision of a significant number of "smaller" advisers to State securities regulators. Unless exempted or excepted, most advisers to "private funds" (those funds excepted from the Investment Company Act by Sections 3(c)(1) or 3(c)(7)) will be required to register as investment advisers.

*Exemptions from Registration.* The Act exempts from registration (1) an adviser that solely advises one or more venture capital funds, and (2) an adviser that solely advises private funds and has U.S. assets under management ("AUM") of less than \$150 million, but the Act authorizes the SEC to impose reporting and record-keeping requirements on all such exempted advisers. The Act excludes family offices from the definition of "investment adviser" subject to certain

grandfathering provisions, and exempts advisers to small business investment companies from both registration and reporting/record-keeping requirements. Additionally, the Act contains a narrow exemption from both registration and reporting/record-keeping requirements for foreign private advisers, but as a practical matter many currently unregistered non-U.S. advisers to private funds will be required to register, because the Act requires such advisers to count both U.S. clients and U.S. investors in private funds toward the \$25 million and 15 client thresholds. Furthermore, subject to various exceptions, the Act prohibits from registering with the SEC an investment adviser that (1) has AUM of between \$25 million and \$100 million and (2) is required to be registered as an investment adviser in the State(s) in which it has its principal office and place of business, and, if registered, would be subject to examination as an investment adviser in such State(s).

*Amendment to Accredited Investor Standard.* The Act fixes a net worth threshold of \$1 million for a natural person accredited investor for a period of four years beginning on the date the Act is enacted, but, unlike the current net worth threshold, excludes the value of the individual's primary residence. This provision is immediately effective upon enactment of the Act and affects all private offerings, not just offerings by private funds.

*Other Significant Provisions.* The Act authorizes the SEC to impose broad record-keeping and reporting requirements on advisers to private funds, whether such advisers are registered or exempt. The Act does not authorize the SEC to require registered investment advisers to share private fund information they disclose to the SEC to nongovernment third parties such as investors, prospective investors, counterparties and creditors, but the SEC may share such information with the U.S. Government, its agencies or instrumentalities, or a U.S. court under certain circumstances. The Act also adds an explicit custody requirement to the Advisers Act; adviser custody requirements are currently imposed by an anti-fraud rule that may be amended by the SEC.

*Effective Dates.* Except for the revised accredited investor standard, provisions of [Title IV](#) become effective one year from enactment.

## **Corporate Governance and Executive Compensation**

[Titles IX](#) of the Act includes a number of corporate governance and executive compensation-related provisions that apply to all public companies (or, in some instances, to all companies with securities listed on a securities exchange) without regard to industry.

### **Proxy Access**

[Title IX](#) clarifies that the SEC has the ability to adopt rules giving stockholders access to the management proxy to nominate directors.

### **Say-on-Pay**

[Title IX](#) requires issuers to include in their proxy statements, at least once every three years, a separate resolution subject to a non-binding shareholder vote to approve the compensation of executives. At least once every six years, the issuer's proxy statement must include a separate nonbinding resolution subject to shareholder vote as to whether the say-on-pay vote should occur every one, two or three years. The Act also requires issuers to include non-binding say-on-pay votes with respect to change in control, or "parachute," compensation arrangements in any proxy statements distributed to shareholders in connection with a corporate transaction.

### **Independence of Compensation Committees and Consultants**

[Title IX](#) will have the effect of requiring exchange-listed companies to comply with additional listing requirements regarding the independence of compensation committees. Compensation committees of listed companies will also be obligated to consider a list of independence related factors, to be identified by the SEC, prior to selecting a

compensation consultant, legal counsel or other adviser. The factors to be identified by the SEC must be “competitively neutral” among categories of advisers.

### **Additional Compensation Disclosures**

[Title IX](#) requires additional proxy statement disclosure regarding (1) the relationship of pay and performance, (2) the median of annual total employee compensation other than the CEO, (3) the annual total compensation of the CEO and (4) the ratio of median annual total employee compensation to CEO compensation.

### **Adoption of Clawback Policy**

[Title IX](#) will have the effect of requiring exchange-listed companies to adopt a clawback policy. The policy must provide that if an issuer is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements, the issuer will recover certain incentive-based compensation from current and former executive officers.

### **Disclosure of Hedging Policy**

[Title IX](#) requires proxy disclosure of whether directors or employees are permitted to hedge their position in any equity security of the company.

### **Disclosures Regarding Chairman and CEO Structures**

[Title IX](#) requires proxy disclosure of why the issuer has chosen the same person to serve as chairman of the board of directors and CEO or different individuals to serve in those positions.

### **Excessive Compensation of Covered Financial Institutions**

[Title IX](#) requires regulators of financial institutions to establish regulations that require financial institutions with assets of at least \$1 billion to disclose to the regulators the structures of their incentive-based compensation and prohibit any arrangements that encourage inappropriate risks.

### **Broker Discretionary Voting**

[Title IX](#) further restricts the ability of brokers to vote shares in the absence of a direction from shareholders by requiring the rules of the national securities exchanges to prohibit broker discretionary voting with respect to the election of board members, executive compensation, or “any other significant matter.” Uncontested director elections at registered investment companies would not be subject to this restriction.

### **Additional Disclosure Regarding Use of Certain Minerals, Mine Safety and Oil, Gas and Mineral Extraction**

[Title XV](#) of the Act requires additional reporting to the SEC by (1) companies that use certain minerals sourced from the Democratic Republic of Congo and its adjoining countries, (2) coal and other mine operators relating to safety and (3) companies that engage in the commercial development of oil, natural gas or minerals.

### **Securitization**

The Act’s provisions related to securitization contained in [Title IX](#), Subtitle D (the “ABS Provisions”) effect a number of significant changes aimed at addressing perceived flaws in the structured finance securities market. Under the ABS Provisions, the applicable regulators must adopt regulations requiring securitizers to retain, subject to certain exemptions and exceptions, an unhedged economic interest in a portion of the credit risk on the assets they transfer.

Regulations adopted under the Act must require the risk to be allocated, as is determined to be appropriate, between the securitizer and an originator if the securitizer purchases assets from an originator.

Under regulations to be adopted under the Act, the minimum level of risk retention generally will be not less than 5% of the credit risk of the assets but may be less than 5% of the credit risk if the originator of the assets meets certain underwriting standards to be established by the Federal banking agencies under the ABS Provisions. Additionally, regulations adopted under the Act will define “qualified residential mortgages” which will be exempt from the risk retention requirement entirely. Other exemptions and exceptions from the risk retention requirement and the prohibition on hedging may be adopted jointly by the specified regulators. The Act requires the SEC to impose asset-level registration statement disclosure requirements if the data are necessary for investors to independently perform due diligence, and imposes ongoing Exchange Act reporting obligations on issuers of registered asset-backed securities.

The Act prohibits underwriters, placement agents, initial purchasers and sponsors (and their affiliates and subsidiaries) of asset-backed securities and synthetic asset-backed securities from engaging in any transaction during the one-year period following the date of the first closing of the sale of such securities that would involve or result in any material conflict of interest with respect to any investor in the transaction other than certain risk-mitigating hedging activities and purchases or sales made pursuant to and consistent with liquidity commitments or bona fide market-making activities.

While the Act’s adoption finalizes the legislation applicable to securitizations that has been under consideration since last year, each of the SEC and the FDIC currently have proposals pending with respect to securitization reform. It remains to be seen how, and if, these proposals will be reconciled.

## **Insurance**

### **Office of National Insurance**

Subtitle A of [Title V](#) of the Act establishes the Federal Insurance Office, which is authorized to perform various functions with respect to all lines of insurance (excluding health insurance, certain long-term care insurance and crop insurance). Such functions include monitoring the U.S. insurance industry, recommending to the Oversight Counsel that certain insurers be subject to regulation as Designated Companies, administering the Terrorism Insurance Program established under the Terrorism Risk Insurance Act of 2002 and coordinating Federal efforts on prudential aspects of international insurance matters. The Federal Insurance Office will be headed by a Director who shall serve in an advisory capacity on the Oversight Counsel.

### **Nonadmitted Insurers and Reinsurance Reform**

Subtitle B of [Title V](#) of the Act is intended to streamline the regulation of nonadmitted insurers and surplus lines insurance by providing exclusive regulatory authority to an insured’s home State. With respect to credit for reinsurance, the subtitle places limits on the ability of State regulators to supersede the regulatory primacy of a ceding company’s State of domicile. Similarly, the financial solvency of a reinsurer shall be regulated by its State of domicile.

## **Consumer Protection**

### **Bureau of Consumer Financial Protection**

[Title X](#) of the Act, as contemplated by the Obama administration’s original reform proposal, creates a new Federal entity to serve as a dedicated consumer protection watchdog. This element of the Act is intended to respond to the concern that existing Federal agencies have not adequately prioritized their consumer protection mission, and permitted the industry to offer products unsuited to consumers.

Structurally, the Act creates the Consumer Protection Bureau as a new office within the Federal Reserve. The new Bureau, however, will be independent of the Federal Reserve Board. The Federal Reserve Board will be prohibited from interfering with the personnel or functions of the Bureau. The Bureau will have broad authority to issue regulations and interpretations under the existing panoply of Federal consumer protection law (which will be transferred to the new Bureau), as well as under its new authorities to issue regulations concerning, among other things, unfair, deceptive and abusive practices, and disclosure requirements.

### Exemptions

A key political issue, finally resolved by the Conference Committee, concerned exclusions from the direct oversight of and examination by the new Bureau. Under the Act, only large depository institutions; mortgage lenders, brokers and servicers; lenders of private student loans and payday loans; and other large providers of consumer financial products are generally subject to direct examination by the Bureau. (The Bureau will have enforcement authority with respect to other non-bank entities as well.) In addition, certain entities are entirely exempt from Bureau oversight (although they may be subject to rules issued by the Bureau under its authorities), including: auto dealers, real estate brokers, and persons subject to regulation by the SEC, CFTC or State insurance regulators.

### Enforcement

The Bureau will have broad investigative and enforcement authority, to enforce the existing statutes transferred to its jurisdiction, as well as existing regulations and any new regulations issued by the Bureau. In litigation, the Bureau will have the right to seek substantial relief, including restitution and damages on behalf of consumers, injunctive relief, and reformation of contracts. Civil penalties for violations can range from \$5,000 to \$1 million per day of violation.

### Federal Preemption

[Title X](#) of the Act, which creates the Bureau, also modifies existing Federal law regarding the preemption of State law with respect to the business and operations of national banks, under the National Bank Act, and Federal savings banks, under the Home Owners' Loan Act. Under the Act, the National Bank Act and Home Owners' Loan Act will only preempt State consumer laws if the State laws are determined by the court or the OCC, on a case-by-case basis, to prevent or significantly interfere with the exercise by the bank of its powers, "in accordance with the legal standard for preemption in ... *Barnett Bank of Marion County, N. A. v. Nelson*, 517 U.S. 25 (1996)." Non-bank operating subsidiaries of national banks and Federal savings banks will lose the benefit of Federal preemption. State attorneys-general will be permitted to enforce non-preempted laws against Federal depository institutions; States will also be free to enact additional consumer protections beyond those that may be adopted by the Bureau under its [Title X](#) authorities, and will have power to enforce their own regulations as well as the Bureau's regulations.

### Mortgage Reform and Anti-Predatory Lending

[Title XIV](#) of the Act, the "Mortgage Reform and Anti-Predatory Lending Act," includes a series of amendments to the Truth in Lending Act of 1968 ("TILA") with respect to mortgage loan origination standards affecting, among other things, originator compensation, minimum repayment standards and prepayments. With respect to mortgage loan originator compensation, except in limited circumstances, an originator is prohibited from receiving compensation that varies based on the terms of the loan (other than the principal amount). The amendments to TILA also prohibit a creditor from making a residential mortgage loan unless it determines, based on verified and documented information of the consumer's financial resources, that the consumer has a reasonable ability to repay the loan. The TILA amendments also prohibit certain prepayment penalties and require creditors offering a consumer a mortgage loan with a prepayment penalty to offer the consumer the option of a mortgage loan without such a penalty. The Act also expands the definition of a "high-cost mortgage" under TILA and imposes new requirements on high-cost mortgages

and new disclosure, reporting and notice requirements for residential mortgage loans, as well as new requirements with respect to escrows and appraisal practices.

### **Improving Access to Financial Institutions**

[Title XII](#) states that the Treasury Secretary is authorized to establish a multiyear program to promote initiatives to enable low- and moderate-income individuals to establish accounts in a Federally insured depository institution.

The Treasury Secretary is authorized to establish multiyear demonstration programs to provide low-cost, small loans to consumers that will provide alternatives to more costly payday loans.

### **Pay It Back Act**

[Title XVI](#) of the Act, as originally approved by the Conference Committee on June 22, established a \$19 billion Financial Crisis Special Assessment Fund (the “Fund”) to pay administrative and other costs of the Act. The Fund was to be funded by assessments levied on financial companies with \$50 billion or more in consolidated assets and financial companies that manage hedge funds with assets under management of \$10 billion or more.

However, as a result of objections to the Fund from Senator Scott Brown (R. Mass.) and others, the Conference Committee was reconvened on June 29 and the Fund was removed. In its place, [Title XIII](#) of the Act prohibits any new obligations from being incurred under the Troubled Asset Relief Program (“TARP”) for a program or initiative that was not initiated thereunder prior to June 25, 2010 and reduces the total authorization under the TARP from \$700 billion to \$475 billion. The other costs of the Act are to be funded by an increase (provided for in [Title III](#) of the Act) in the minimum reserve ratio for the Deposit Insurance Fund from 1.15% of estimated insured deposits to 1.35% of such deposits. Additional assessments needed to reach the 1.35% level are to be paid by depository institutions with more than \$10 billion in consolidated assets. The FDIC is given until September 30, 2020 to meet the new minimum level.

Proceeds from the sale of Fannie Mae, Freddie Mac and Federal Home Loan Bank debt purchased by the Treasury Department under its emergency authority and unused amounts under the American Recovery and Reinvestment Act are required to be used for the sole purpose of deficit reduction.

This Sidley update is a collaboration of several of our practices serving the financial services industry. Our Financial Institutions practice serves depository and nondepository financial institutions and their holding companies. Sidley's Structured Finance and Securitization practice is one of the most experienced in the world, and has been involved in virtually every industry innovation since the 1970s. Lawyers in our Securities practice handle all aspects of corporate finance and capital markets, and our Securities and Futures Regulatory practice represents major investment banks, broker-dealers, futures commission merchants, commercial banks, insurance companies, hedge fund complexes and exchanges on all aspects of securities and broker-dealer regulation. Our Investment Funds, Advisers and Derivatives practice team advises clients in the formation and operation of all types of alternative investment vehicles including mutual, private equity and hedge funds. Lawyers in our Executive Compensation practice advise employers, Boards of Directors and their Compensation Committees, as well as individual executives and directors. Our Insurance practice offers comprehensive services to insurers, reinsurers, receivers, brokers, creditors and guaranty associations. Sidley's Tax practice provides legal services related to U.S. Federal, state and local, and UK tax laws.

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