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FINANCIAL REGULATORY REFORMS UPDATE

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 (74 MB file) 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.

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Table of Contents

Title I — Financial Stability I–1
Subtitle A — Financial Stability Oversight Council I–1
Oversight Council Authority I–1
Criteria for Designation I–2
Procedure for Designation I–3
Other Oversight Council Authority I–3
Subtitle B — Office of Financial Research I–4
Subtitle C —Additional Federal Reserve Board Oversight of Nonbank Financial Companies and Bank Holding Companies I–4
Supervision and Prudential Standards I–4
Title II — Orderly Liquidation Authority II–1
Relationship Between Normally Applicable Bankruptcy Regime and the Orderly Liquidation Regime II–1
Institutions Subject to the Orderly Liquidation Regime II–1
Triggering Process II–2
General Principles Applicable to Exercise of the Receivership Authority II–3
Time Limit on Receivership II–3
Reducing Inconsistencies with the Bankruptcy Code II–4
Other Significant Features II–5
Orderly Liquidation Fund II–6
Studies II–7
Title III — Transfer of Powers to the Comptroller of the Currency, the Corporation and the Federal Reserve Board III–1
Subtitle A and Subtitle B – Transfer of Powers and Duties; Transitional Provisions III–1
Subtitle C – Federal Deposit Insurance Corporation III–2
Subtitle D – Other Matters III–2
Title IV — Regulation of Advisers to Hedge Funds and Others IV–1
Registration of Advisers to "Private Funds" IV–2
Exclusions and Exemptions from Registration IV–2
Registration and Examination Requirements for "Mid-Sized Private Fund" Advisers IV–3
AUM Threshold for SEC Registration IV–3
Adjustment of Accredited Investor Standard IV–3
Other Significant Title IV Provisions IV–3
Section 205 of the Advisers Act and State-Regulated Advisers IV–5
Studies Authorized IV–5
One-Year Transition Period IV–5
Title V — Insurance V–1
Subtitle A — Federal Insurance Office Established (subtitle may be cited as the "Federal Insurance Office Act of 2010") V–2
Subtitle B — State-Based Insurance Reform (subtitle may be cited as the "Nonadmitted and Reinsurance Reform Act of 2010") V–3
Streamlining of Regulation of Nonadmitted Insurers V–3
Regulation of Certain Reinsurance Matters V–3
Title VI — Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions VI–1
Commercial Firm Ownership of Limited Purpose Banks VI–1

Provisions Regarding Control of a Savings Association ... VI–2
Bank Holding Company Regulation ... VI–3
The Volcker Rule ... VI–3
Concentration Limits ... VI–5
Securities Holding Company Registration ... VI–5
Other Provisions ... VI–6
Title VII — Over-the-Counter Derivatives ... VII–1
Subtitle A — Regulation of Over-the-Counter Swaps Markets and Subtitle B — Regulation of Security-Based Swaps Markets ... VII–1
Title VIII — Payment, Clearing and Settlement Supervision ... VIII–1
New Oversight Authorities ... VIII–1
Designation of Financial Market Utilities and Payment, Clearing or Settlement Activities as Systemically Important ... VIII–1
Risk Management Standards ... VIII–2
Advance Notice of Changes to Rules, Procedures or Operations ... VIII–2
Annual Examinations ... VIII–2
Enforcement Authority ... VIII–2
Examination of and Enforcement against Financial Institutions ... VIII–3
Backup Authority ... VIII–3
Information Gathering and Reporting ... VIII–3
Consultation with the Federal Reserve Board ... VIII–3
Report on Common Clearing Entity Risk Management Framework ... VIII–3
Access to the Discount Window ... VIII–3
Title IX — Investor Protections and Improvements to the Regulation of Securities ... IX–1
Subtitle A – Increasing Investor Protection ... IX–2
Subtitle B – Increasing Regulatory Enforcement and Remedies ... IX–4
Subtitle C – Improvements to the Regulation of Credit Rating Agencies ... IX–7
Subtitle D — Improvements to the Asset-Backed Securitization Process ... IX–10
Securitization Risk Retention Requirement ... IX–10
Effective Date of Regulations ... IX–12
Increased Disclosure and Reporting by Issuers; New Asset Review ... IX–13
Representations and Warranties; Repurchase Requests; Repeal of the Securities Act Section 4(5) Exemption ... IX–13
Securitization Conflicts of Interest ... IX–13
Credit Ratings of Structured Finance Securities ... IX–14
Amendments to the Truth in Lending Act of 1968 (“TILA”) ... IX–14
Covered Bonds ... IX–14
Subtitles E and G — Corporate Governance and Executive Compensation Requirements ... IX–14
Proxy Access ... IX–14
Say on Pay ... IX–14
Compensation Committee Independence ... IX–15
Independent Compensation Consultants and Counsel ... IX–15
Expanded Clawback Requirements ... IX–16
Hedging Disclosure ... IX–16
Increased Compensation Disclosure ... IX–16
Disclosures Regarding Chairman and CEO Structures ... IX–16
Excessive Compensation of Covered Financial Institutions ... IX–16

Broker Discretionary Voting IX–17
Disclosure Regarding Use of Certain Minerals IX–17
Disclosure Applicable to Mine Operators IX–18
Disclosure Applicable to Entities Engaged in Resource Extraction IX–18
Subtitle F — Improvements to the Management of the SEC IX–18
Subtitle H — Municipal Securities IX–19
Subtitle I — Public Company Accounting Oversight Board, Portfolio Margining and Other Matters IX–20
Title X — Bureau of Consumer Financial Protection X–1
Creation and Organization of the Consumer Protection Bureau X–1
Authority of the Consumer Protection Bureau X–2
Preemption/State Authority X–4
Private Right of Action X–4
Other Provisions X–5
Title XI — Federal Reserve System Provisions XI–1
Federal Reserve Emergency Lending Authority XI–1
One-Time GAO Audit of Pre-enactment Federal Reserve Assistance and Federal Reserve Governance XI–2
FDIC Debt Guarantee XI–2
Title XII — Improving Access to Mainstream Financial Institutions XII–1
Expanded Access to Mainstream Financial Institutions XII–1
Low-Cost Alternatives to Payday Loans XII–1
Title XIII — Pay It Back Act XIII–1
Title XIV — Mortgage Reform and Anti-Predatory Lending Act XIV–1
Residential Mortgage Loan Origination Standards XIV–1
Minimum Standards for Mortgages XIV–1
Other Provisions XIV–3
Effective Date of Regulations and Amendments XIV–3
Title XV — Miscellaneous Provisions XV–1
Restrictions on the Use of U.S. Funds for Foreign Governments XV–1
Disclosure Related Provisions XV–1
Title XVI — Section 1256 Contracts XVI–1

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% 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 Predispute 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 predispute 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 issues 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.

Title I — Financial Stability

- The Act establishes an Oversight Council to identify and monitor systemic risks posed by financial firms and financial activities and practices.
- The Act subjects Designated Companies and Large Bank Holding Companies to enhanced prudential supervision and examination by the Federal Reserve Board.
- Prudential standards imposed include increased capital requirements (excluding trust preferred securities from Tier I capital on a scheduled phase-out), limitations on leverage, liquidity requirements, resolution plan, credit exposure reporting, concentration limits and semiannual stress tests.
- Non-mandatory standards include a contingent capital requirement and short-term debt limits.
- Designated Companies can establish an intermediate holding company out of which to conduct non-financial activities.
- The Act subjects a Designated Company's acquisition of bank shares to the BHCA as if the Designated Company were a bank holding company. In addition, Designated Companies and bank holding companies with total consolidated assets of $50 billion or more generally must notify the Federal Reserve Board before acquiring control of voting shares of certain large financial companies.
- Effective Dates: Federal Reserve Board final regulations regarding the Oversight Council and prudential regulation required within 18 months.

Subtitle A — Financial Stability Oversight Council

The Act establishes an interagency council, the Financial Stability Oversight Council ("Oversight Council") to identify and monitor systemic risks posed by financial firms and financial activities and practices. Voting members are the Secretary of the U.S. Department of the Treasury (Chairperson) ("Treasury Secretary"), heads of the Board of Governors of the Federal Reserve System ("Federal Reserve Board"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Securities and Exchange Commission ("SEC"), the Commodity Futures Trading Commission ("CFTC"), the Federal Housing Finance Agency ("FHFA"), the new Bureau of Consumer Financial Protection ("Consumer Protection Bureau"), the National Credit Union Administration Board ("NCUA") and an independent member with insurance expertise to be appointed by the President and confirmed by the Senate. Nonvoting members who will serve in an advisory capacity are the heads of the new Office of Financial Research ("Office") and the new Federal Insurance Office, a State insurance commissioner, a State banking supervisor and a State securities commissioner (or officer performing like functions).

Oversight Council Authority

- *Designation of Nonbank Financial Companies for Federal Reserve Board Supervision.* By a two-thirds vote of its members that must include the Treasury Secretary, the Oversight Council is charged with designating U.S. nonbank financial companies, and foreign nonbank financial companies, that pose a threat to the financial stability of the United States in the event of their material financial distress, or based on the nature, scope, size, scale, concentration, interconnectedness or mix of activities (each a "Designated Company").
    - *Effect of Designation.* Designated Companies are required to register with the Federal Reserve Board within 180 days after final determination of designation and will become subject to supervision and prudential standards

established by the Federal Reserve Board, along with "large interconnected bank holding companies" (not defined).

- *U.S. Nonbank Financial Company Definition.* A "U.S. nonbank financial company" is defined as any U.S. company that is "predominantly engaged in financial activities," but does not include a bank holding company, Farm Credit institution, national securities exchange (or parent thereof), clearing agency (or parent thereof, unless the parent is a bank holding company), security-based swap execution facility ("SB-SEF"), security-based swap data repository registered with the SEC, board of trade designated as a contract market (or a parent thereof), derivatives clearing organization (or a parent thereof, unless the parent is a bank holding company), swap execution facility or swap data repository registered with the CFTC.
- *Foreign Nonbank Financial Company Definition.* A "foreign nonbank financial company" is defined as any company (other than a company that is, or is treated in the United States as, a bank holding company) organized in a country other than the United States that is "predominantly engaged in financial activities."
- 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.

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 and nature of off-balance-sheet exposures;
  - extent and nature of transactions and relationships with other significant nonbank financial companies and bank holding companies;
  - importance of the company as a source of credit for households, businesses and State and local governments, and as a source of liquidity for the financial system;
  - importance of the company as a source of credit for low-income, minority or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;
  - extent to which assets are managed rather than owned and ownership of assets under management is diffuse;
  - nature, scope, size, scale, concentration, interconnectedness and mix of activities;
  - degree to which the company is already regulated by one or more primary financial regulatory agencies;
  - amount and nature of financial assets;
  - amount and types of liabilities, including 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, but take into account the amount and nature of the U.S. financial assets of the company, and the extent to which the company is subject to prudential standards on a consolidated basis in the home country of such foreign financial parent administered and enforced by a comparable foreign supervisory authority.

Procedure for Designation

- The Oversight Council must consult with the primary financial regulatory agency for each nonbank financial company or subsidiary of a nonbank financial company being considered for designation. The Act does not require consultation with the Federal Reserve Board.
- With regard to foreign nonbank financial companies (as well as foreign-based bank holding companies and cross-border activities and markets), the Oversight Council must consult with appropriate foreign regulatory authorities, to the extent appropriate.
- The Oversight Council can require reports from any nonbank financial company to assess the extent to which an activity or market in which it participates, or the company itself, poses a threat to financial stability. If the Oversight Council is unable to determine whether financial activities of a nonbank financial company pose a threat to financial stability, it can request the Federal Reserve Board to conduct an examination of any U.S. nonbank financial company for the purpose of determining whether the company should be a Designated Company.
- The Oversight Council must provide notice and opportunity for hearing for a nonbank financial company to contest designation, but procedures can be waived or modified by the Oversight Council when necessary to prevent or mitigate threats to financial stability (with consultation with the appropriate home country supervisor in the case of a foreign nonbank financial company being considered).
- The Act provides for judicial review and rescission of the Oversight Council's designation in the U.S. district court for the district in which the home office of the company is located. Review is subject to an "arbitrary and capricious" standard.
- The Oversight Council is required to review designations at least annually, which can be rescinded by a two-thirds vote.

Other Oversight Council Authority

- *Recommend Prudential Standards.* The Oversight Council can make recommendations to the Federal Reserve Board for stricter prudential standards and reporting and disclosure requirements to be established by the Federal Reserve Board and applied to Designated Companies and large, interconnected bank holding companies.
  - *Recommend Standards or Safeguards For Adoption by Primary Financial Regulatory Agencies for Financial Stability Purposes.* If the Oversight Council determines that a financial activity or practice could create significant liquidity, credit or other problems spreading among bank holding companies and nonbank financial companies or the U.S. financial markets, the Oversight Council can make recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards for the financial activity or practice. The Council's recommendations may differentiate among companies on an individual basis or by category. The primary financial regulatory agency must adopt recommended standards within 90 days or explain its determination not to follow the recommendation.
- *Federal Reserve Board Action to Mitigate Risks to Financial Stability.* If the Federal Reserve Board determines that a Large Bank Holding Company with total consolidated assets of $50 billion or more ("Large Bank Holding Company") or a Designated Company poses a grave threat to U.S. financial stability, the Oversight Council can authorize the Federal Reserve Board, by a two-thirds vote of its members, to limit the ability of the company to merge with, acquire or otherwise become affiliated with another company, restrict the company's ability to offer financial products, require the company to terminate one or more of its activities or impose conditions on conduct of activities. If the foregoing are inadequate to mitigate the threat, the Federal Reserve Board can compel the subject company to transfer assets or off-balance-sheet items to unaffiliated entities.

- *Other Duties.* The Oversight Council's other duties are, among other things, to monitor the financial services marketplace to identify threats to financial stability; monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues and advise Congress and make recommendations in these areas, facilitate information sharing and coordination among the member agencies and other Federal and State agencies; recommend to the member agencies supervisory priorities and principles; identify gaps in regulation that could pose risks to financial stability; identify systemically important financial market utilities and payment, clearing and settlement activities; make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies and U.S. financial markets; and review and, as appropriate, submit comments to the SEC and any standard-setting body regarding existing or proposed accounting standards.

Subtitle B — Office of Financial Research

The Act establishes an Office of Financial Research (the "Office") within the U.S. Department of the Treasury ("Treasury Department"), to be headed by a director appointed for a six-year term by the President and confirmed by the Senate. The Office will be funded by the Federal Reserve Board for the first two years and self-funded thereafter through assessments on Designated Companies and Large Bank Holding Companies.

- *Purpose to Support the Oversight Council.* The purpose of the Office is to support the Oversight Council and its member agencies by collecting and providing data and information; standardizing types and formats of data reported and collected by member agencies; performing applied and long-term research; developing risk measurement and monitoring tools; and making results available to financial regulatory agencies. The Office is to be comprised of a Data Center and a Research and Analysis Center.
    - The Data Center is required to prepare and publish, in a publicly accessible format, databases of financial companies and financial instruments and formats and standards for reporting financial transaction and position data to the Office.
    - The Research and Analysis Center is to develop and maintain analytical capabilities and computing resources to do the following: develop and maintain metrics and reporting systems for risks to financial stability; monitor, investigate and report on changes in system-wide risk levels and patterns; conduct, coordinate and sponsor research to support and improve regulation of financial entities and markets; evaluate and report on stress tests or other stability-related evaluations of financial entities overseen by the member agencies; and maintain expertise in such areas as may be necessary to support specific requests for advice and assistance from financial regulators.
- *Can Require Reports and Issue Subpoenas.* The Oversight Council is authorized to require periodic and other reports from financial companies and has rule-making authority to standardize types and formats of data reported and collected on behalf of the Oversight Council. Rules are to be implemented by member agencies within three years, or the Office can implement them directly with respect to the financial entities under the jurisdiction of the member agency. The Office is empowered to enforce data requests through subpoena authority.

Subtitle C —Additional Federal Reserve Board Oversight of Nonbank Financial Companies and Bank Holding Companies

Supervision and Prudential Standards

- *Prudential Standards and Requirements.* On its own or pursuant to recommendations of the Oversight Council, the Federal Reserve Board is required to establish, by regulation or order, prudential standards applicable to

Designated Companies and Large Bank Holding Companies that are more stringent than those applicable to nonbank financial companies and bank holding companies that do not present similar risks to U.S. financial stability.

- *Tailored Application.* In prescribing standards, the Federal Reserve Board may differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including financial activities of their subsidiaries), size and any other risk-related factors the Federal Reserve Board deems appropriate.
- *Bank Holding Companies.* The Federal Reserve Board can set higher (but not lower) bank holding company asset thresholds for applying particular standards, pursuant to recommendation by the Oversight Council. Large Bank Holding Companies as of January 1, 2010, and companies that received equity infusions under TARP cannot escape supervision by the Federal Reserve Board by debanking. Even if these companies give up their banks, they will be treated as Designated Companies, subject to the right to appeal such determination.
- *Safe Harbor.* 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.
- *Prudential Standards.* Prudential standards must include risk-based capital requirements and leverage limits; liquidity requirements; overall risk management requirements; resolution plan requirement (periodic reporting of a plan for the company's rapid and orderly resolution in the event of material financial distress or failure) and credit exposure report requirement (periodic reporting of credit exposure to other significant nonbank financial companies and bank holding companies, and vice versa); and concentration limits.
  - *Exception for Risk-Based Capital and Leverage Limits.* Risk-based capital requirements and leverage limits are not required if the Federal Reserve Board, in consultation with the Oversight Council, determines that such requirements are not appropriate because of the activities (such as investment company activities or assets under management) or structure of the company, in which case the Federal Reserve Board is required to apply other standards that result in similar stringent risk controls.
  - *Resolution Plan.* If the resolution plan is found deficient and the deficiencies are not remedied, the Federal Reserve Board may impose more stringent capital, leverage or liquidity requirements, or restrictions on the growth, activities, or operations of the company or any subsidiary of the company, until the company re-submits a plan that remedies the deficiencies.
  - *Concentration Restrictions.* The Federal Reserve Board is required to prohibit each Designated Company and Large Bank Holding Company from having credit exposure to any unaffiliated company exceeding 25% of capital stock and surplus (or such lower amount as the Federal Reserve Board may determine by regulation to be necessary to mitigate risks to the financial stability of the United States) of the company. Such regulations will not become effective until three years after enactment and the Federal Reserve Board is authorized to extend the effective date for up to an additional two-year period.
  - "Credit exposure" includes extensions of credit, repurchase agreements, reverse repurchase agreements, securities borrowing and lending, guarantees, acceptances or letters of credit issued on behalf of the company, purchases of or investment in securities issued by the company, counterparty credit exposure to the company in connection with a derivative transaction, and any similar transactions that the Federal Reserve Board determines by regulation to be a credit exposure for purposes of the statute, and any transaction in which the proceeds are used for the benefit of, or transferred to, that company.

- *Foreign Nonbank Financial Companies.* In applying the required standards to foreign nonbank financial companies, the Federal Reserve Board is required to give due regard to principles of national treatment and take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards comparable to those applied to financial companies in the United States.

- *Additional Standards.* The Federal Reserve Board may, but is not required to, adopt additional prudential standards that may include a contingent capital requirement (maintenance of long-term hybrid debt convertible to equity in times of financial distress), enhanced public disclosures, short-term debt limits and such other standards as the Federal Reserve Board, on its own or pursuant to a recommendation made by the Oversight Council, determines are appropriate. A contingent capital requirement may be adopted only following a mandated Oversight Council study and report to Congress.

- *Short-Term Debt Limits.* The Federal Reserve Board may, by regulation, prescribe a limit on the amount of short-term debt (other than deposit liabilities) that may be accumulated by a Designated Company or Large Bank Holding Company, as a percentage of capital stock and surplus or such other measure as the Federal Reserve Board deems appropriate.

- *Risk Committees for Publicly Traded Companies.* Publicly traded Designated Companies and bank holding companies with consolidated assets of $10 billion or more must establish a risk committee to oversee enterprise-wide risk management practices. The Federal Reserve Board may require risk committees for bank holding companies with total consolidated assets less than $10 billion.

- *Stress Tests.* Designated Companies and Large Bank Holding Companies are subject to annual stress tests by the Federal Reserve Board, and their own semiannual stress tests pursuant to regulations to be adopted by each Federal primary financial regulatory agency, to evaluate whether they have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions. All other financial companies with total consolidated assets greater than $10 billion that are regulated by a primary Federal financial regulatory agency are also required to conduct annual stress tests pursuant to the foregoing regulations.

- *Leverage Limit.* The Federal Reserve Board must require Designated Companies and Large Bank Holding Companies to maintain a debt to equity ratio of no more than 15 to 1, upon a determination that the company poses a grave threat to the financial stability of the United States and that the leverage limit is necessary to mitigate the risk.

- *Inclusion of Off-Balance-Sheet Activities in Computing Capital.* The computation of capital of Designated Companies and Large Bank Holding Companies must take into account off-balance-sheet activities. "Off-balance-sheet activity" means an existing liability of a company that is not currently a balance sheet liability, but may become one upon the happening of some future event, including the following transactions, to the extent that they may create a liability: direct credit substitutes in which a bank substitutes its own credit for a third party, irrevocable letters of credit, risk participations in bankers' acceptances, sale and repurchase agreements, asset sales with recourse, interest rate swaps, credit swaps, commodities contracts, forward contracts, securities contracts and such other activities or transactions as the Federal banking agencies may, by rule, define.

- *Prompt Corrective Action Requirements.* The Federal Reserve Board, in consultation with the Oversight Council and the FDIC, is required to establish by regulation requirements for early remediation of financial distress of Designated Companies and large interconnected bank holding companies designed to avoid insolvency, including requirements that become increasingly stringent as the financial condition of the company declines, such as limitations on capital distributions, acquisitions and growth.

- *Intermediate Holding Company for Non-Financial Activities.* The Federal Reserve Board may require Designated Companies engaged in commercial activities to segregate financial activities in an intermediate holding company within 90 days of designation, and must require a Designated Company engaged in commercial activities to

establish an intermediate holding company if necessary in order for the Federal Reserve Board to appropriately supervise the company's financial activities or to ensure that its supervision does not extend to commercial activities. Intermediate holding companies are not required to conform activities to the restrictions of Section 4 of the BHCA.

- *Internal Financial Activities.* A Designated Company is not required to segregate "internal financial activities," such as treasury, investment and employee benefit functions conducted for the Designated Company or an affiliate and a non-affiliate during the year prior to enactment of the Act, provided two-thirds of the revenue or assets generated from the activities are from or attributable to such Designated Company or an affiliate. Moreover, the non-financial activities of a Designated Company or its affiliates are expressly excluded from the Federal Reserve Board' supervision and prudential standards. However, the Federal Reserve Board may issue regulations prohibiting affiliate transactions between an intermediate holding company (or a Designated Company) and its affiliates.
- *Enforcement.* A company that directly or indirectly controls an intermediate holding company must serve as a source of strength to the intermediate holding company, and the company and its officers and directors may be required to make reports to the Federal Reserve Board. The Federal Reserve Board may enforce compliance with respect to a company that controls an intermediate holding company under Section 8 of the Federal Deposit Insurance Act ("FDIA") in the same manner and to the same extent as if it were a bank holding company.
- *Reports, Examinations.* The Federal Reserve Board may require reports from and may examine any Designated Company and any subsidiary of such company regarding its operations or financial condition, systems for monitoring and controlling financial, operating and other risks, the extent to which its activities and operations pose a threat to the safety and soundness of the company or to the financial stability of the United States and compliance with prudential oversight requirements.

- *FDIA Enforcement Provisions.* Designated Companies and their subsidiaries (other than depository institution subsidiaries) are subject to the enforcement provisions of the FDIA to the same extent as if they were bank holding companies. The Federal Reserve Board can recommend that the primary financial regulatory agency for a depository institution subsidiary or functionally regulated subsidiary of a Designated Company initiate a supervisory or enforcement proceeding, and may take the recommended action itself if the primary financial regulatory agency fails to take acceptable action within 60 days of the Federal Reserve Board's recommendation.
  - Designated Companies and Large Bank Holding Companies are subject to special examination under the FDIA for purposes of implementing the FDIC's liquidation authority under the Act.
  - Depository institution holding companies (bank holding companies and savings and loan holding companies) are subject to FDIC back-up enforcement authority if the appropriate Federal banking agency fails to take action recommended by the FDIC, and the FDIC determines that the conduct or threatened conduct of the holding company poses a risk to the Deposit Insurance Fund.
- *Acquisitions.* 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 interconnected bank holding companies must provide written notice to the Federal Reserve Board prior to acquisition of direct or indirect control of any voting shares of a company engaged in financial activities that has total consolidated assets of $10 billion or more, except for acquisitions of shares in connection with underwriting, dealing in or making a market in securities, or acquisitions subject to an exemption under BHCA Section 4(c). In addition to other factors, the Federal Reserve Board is required to consider the extent to which an acquisition will result in greater or more concentrated risks to global or U.S. financial stability or the U.S. economy.

- *Management Interlocks.* Designated Companies are made subject to the prohibition against management interlocks as if they were bank holding companies. The Federal Reserve Board cannot exercise its rule-making authority to exempt service by a management official of a Designated Company as a management official of a Large Bank Holding Company, or other nonaffiliated Designated Companies.
- *Leverage and Risk-Based Capital Requirements.* 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 established under the prompt corrective action regulations for depository institutions, regardless of size, in effect as of the date of enactment. 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), companies that issued debt or equity securities to the United States under TARP and any Federal home loan bank are excepted.
  - The provision phases in a requirement that depository institution holding companies and Designated Companies exclude trust preferred securities from their Tier I capital components. Capital ratios for leverage purposes are measured by average total assets, thereby eliminating any incentive to engage in so-called "Repo 105" transactions.
  - The provision grandfathers existing trust preferred securities that were issued before May 19, 2010 for all depository institution holding companies with less than $15 billion in total consolidated assets and mutual holding companies.
  - Holding companies (including bank holding company subsidiaries of foreign banking organizations) with more than $15 billion or more in total assets have five years to comply with the provision, and beginning on January 1, 2013, have a three-year period to phase out their trust preferred securities. 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.
  - Depository institution holding companies and Designated Companies are not required to deduct their investments in financial subsidiaries from regulatory capital, unless required by the Federal Reserve Board or their primary financial regulatory agency.
  - In addition, subject to the recommendations of the Oversight Council, the Federal banking agencies must develop capital regulations that address the risks posed by certain types of activities, including risks that arise from a significant volume of transactions involving derivatives, securitized products, financial guarantees and repurchase agreements.
- *Foreign Bank Offices.* In considering applications by foreign banks to establish a branch, agency or commercial lending company in the United States, the Federal Reserve Board can consider, for a foreign bank that presents a risk to the stability of the U.S. financial system, whether the home country of the foreign bank has adopted, or is making demonstrable progress toward adopting, an appropriate system of financial regulation for the financial system of such home country to mitigate such risk. Failure of the home country to adopt or make progress towards adopting such a system of financial regulation is also grounds for termination of a foreign bank's U.S. offices.

Title II — Orderly Liquidation Authority

- **Creation of Orderly Liquidation Regime**. 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 FDIA regime for the resolution of failed FDIC-insured depository institutions and administered by the FDIC as receiver.
- **Operation of the Regime**. 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 proceeding under the normal regime would have commenced or even after it has started.
- **Powers of the FDIC, as receiver.** The FDIC's powers as receiver under the Orderly Liquidation Regime are similar to the powers it has as receiver of an insured depository institution under the FDIA, with certain modifications intended to reduce differences between the FDIA and the Bankruptcy Code regime. Financial companies made subject to the Orderly Liquidation Regime must be liquidated. There is no option for rehabilitation or reorganization or for an FDIA-style conservatorship.
- **The Orderly Liquidation Fund.** An Orderly Liquidation Fund, which would be funded only after a financial company has been placed into the Orderly Liquidation Regime, is established to fund liquidations under such 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).

With a view to addressing "too big to fail," the Act creates a special Orderly Liquidation Regime (modeled on the FDIA regime for the resolution of FDIC-insured depository institutions) for the orderly dissolution of failing "financial companies" that pose a significant risk to the financial stability of the United States.

Relationship Between Normally Applicable Bankruptcy Regime and the Orderly Liquidation Regime

- According to the Act's legislative history, there is a presumption that most financial companies will continue to be resolved under the Bankruptcy Code or other normally applicable bankruptcy regime rather than under the Orderly Liquidation Regime. However, upon a financial company being made subject to the Orderly Liquidation Regime (which can occur before a financial company would have become subject to a proceeding under the Bankruptcy Code or other normal regime or even after such a proceeding has commenced), such resolution will cease to be conducted under the Bankruptcy Code or other normal regime and become subject to the Orderly Liquidation Regime instead. Consequently, in their dealings with financial companies that could become subject to the Orderly Liquidation Regime, counterparties need to consider the impact on their rights of both regimes, because either could apply. In addition, they need to take into account, as best as they can, that they may not know which of the two regimes will apply to a financial company, even after a proceeding under the normal regime has commenced with respect to such company.

Institutions Subject to the Orderly Liquidation Regime

- Only "financial companies" may be made subject to the Orderly Liquidation Regime. The Act defines a "financial company" as any company incorporated or organized under Federal or State law (*i.e.,* only U.S. institutions) that is:
  - a bank holding company, as defined in the BHCA;

  - a company that has been subjected to stricter prudential regulation by the Federal Reserve Board under the Act;
  - a company that is "predominantly engaged" in activities that are financial in nature or incidental thereto for purposes of the BHCA; or
  - any subsidiary of any of the foregoing that is "predominantly engaged" in activities that are financial in nature or incidental thereto for purposes of the BHCA (other than a subsidiary that is an insured depository institution or an insurance company).

- No company is considered "predominantly engaged" for purposes of the above tests unless at least 85% of its total consolidated revenues (including revenues derived from ownership or control of a depository institution) are derived from activities that are financial in nature or incidental thereto for purposes of the BHCA. The "predominantly engaged" requirement is intended to exclude non-financial companies from being subjected to the Orderly Liquidation Regime.
- "Government entities," Farm Credit System institutions, GSEs and Federal Home Loan Banks are also excluded from the Orderly Liquidation Regime.
- Insured depository institutions are not subject to the Orderly Liquidation Regime. Their resolution would continue to be conducted under the FDIA and other applicable law.

Triggering Process

- Liquidation proceedings are initiated when the FDIC and the Federal Reserve Board, on their own initiative or at the request of the Treasury Secretary, by two-thirds vote of their board members, make a written recommendation that such proceedings be commenced against the financial company. Where the financial company is a broker-dealer, or a financial company whose largest U.S. subsidiary (measured by assets) is a broker-dealer, the SEC and the Federal Reserve Board, on their own initiative or at the request of the Treasury Secretary, must make the recommendation by two-thirds vote. In the case of a financial company that is an insurance company, or whose largest U.S. subsidiary (measured by total assets) is an insurance company, the Director of the Federal Insurance Office and the Federal Reserve Board, on their own initiative or at the request of the Treasury Secretary, must make the determination, by two-thirds vote of the Federal Reserve Board and the affirmative approval of the Director of the Federal Insurance Office, in consultation with the FDIC.
- If such a recommendation is made for the Orderly Liquidation Regime to be triggered, the Treasury Secretary, in consultation with the President, must determine that:
  - the financial company is "in default or in danger of default"(meaning (1) a case has been, or likely will be, commenced with respect to the financial company under the Bankruptcy Code, (2) the financial company has incurred, or is likely to incur, losses that will deplete substantially all of its capital, (3) the assets of the financial company are, or are likely to be, less than its obligations to creditors or (4) the financial company is, or is likely to be, unable to pay its obligations in the normal course of its business);
  - the failure of the financial company and its resolution under applicable Federal or State law will have serious adverse effects on financial stability in the United States;
  - no viable private sector alternative is available;
  - any effects on claims or interests of creditors, counterparties and shareholders of the financial company and other market participants as a result of actions taken under the resolution authority are appropriate;
  - any action taken under the resolution authority will avoid or mitigate serious adverse effects on U.S. financial stability;

- a Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and
- the company satisfies the definition of "financial company."

- The Treasury Secretary must then notify the financial company and the FDIC of such determination. If the board of directors of the financial company acquiesces or consents to the appointment of the FDIC as receiver, the Treasury Secretary must then appoint the FDIC as receiver.
- If the board of directors of the financial company does not so acquiesce or consent, the Treasury Secretary would need to petition the U.S. District Court for the District of Columbia ("DC District Court") for an order authorizing the appointment of the FDIC as a receiver. In such case, the DC District Court, on a confidential basis and without any public disclosure, must make a determination that the findings by the Treasury Secretary that the financial company (1) is "in default or in danger of default" and (2) satisfies the definition of "financial company" were not arbitrary and capricious. The financial company will be given notice of the DC District Court hearing and an opportunity to be heard. If the DC District Court makes such determination, it will issue an order authorizing the Treasury Secretary to appoint the FDIC as receiver. If the DC District Court does not make any determination within 24 hours following the Treasury Secretary's petition, the FDIC is automatically appointed receiver.
- The DC District Court's decision is appealable, on an expedited basis, to the U.S. Court of Appeals for the District of Columbia and then to the U.S. Supreme Court (which is given discretionary jurisdiction to review the Court of Appeals' decision). The issue of whether the Treasury Secretary properly determined failure of the financial company will have serious adverse effects on U.S. financial stability is not subject to review.

General Principles Applicable to Exercise of the Receivership Authority

- The FDIC is required to exercise the receivership powers in a manner that mitigates risk to the financial stability of the United States and minimizes "moral hazard" so that:
  - creditors and shareholders will bear the risk of losses of the financial company;
  - management responsible for the condition of the financial company will not be retained; and
  - all parties having responsibility for the financial condition of the financial company bear losses consistent with their responsibility.
- In addition:
  - all financial companies put into receivership under the Orderly Liquidation Regime must be liquidated and no taxpayer funds may be used to prevent the liquidation of any financial company;
  - all funds expended by the liquidation of a financial company under the Orderly Liquidation Regime are required to be recovered from the disposition of assets of such financial company or will be the responsibility of the financial sector through assessments; and
  - taxpayers must be protected from bearing any losses from the exercise of authority under the Orderly Liquidation Regime.

Time Limit on Receivership

- The maximum period of the receivership is 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 FDIC can continue to run a failed financial company as a going concern.

Reducing Inconsistencies with the Bankruptcy Code

- Under the Act, the powers of a receiver of a financial company are similar to those the FDIC has under the FDIA as a receiver of an FDIC-insured depository institution. Such powers include a number of powers not accorded to a trustee-in-bankruptcy under the Bankruptcy Code, including:
  - subject to certain exceptions and limitations, the power to repudiate any contract (whether or not executory) which the FDIC determines to be burdensome (in which case, damages for repudiation are generally limited to actual direct compensatory damages determined as of the date of the appointment of the receiver);
  - the power to enforce contracts, notwithstanding *ipso facto* clauses in such contracts; and
  - the power to selectively transfer assets and liabilities of the failed institution without any approval, assignment or consent.
- In addition, as under the FDIA, there is a 90-day stay on the ability to declare a default under and accelerate most contracts.
- However, the Act attempts to reduce certain differences in the treatment of creditors under an FDIA-like receivership regime and the Bankruptcy Code:
  - *Claims Process/Maximum Liability of the Receiver to Claimants.* While the Act provides for a claims process similar to that contained in the FDIA, the maximum liability of the FDIC to claimants would generally be the amount the claimant would have received in a Chapter 7 liquidation.
  - *Preferential Transfers and Fraudulent Conveyances.* The FDIA does not provide the FDIC with the power to set aside preferential transfers as defined in the Bankruptcy Code. However, under the Act, the FDIC, as receiver of a failed financial company, is generally granted such power. The Act also adopts, with certain modifications, the Bankruptcy Code standard for fraudulent conveyances.
  - *Secured Claims.* The Act provides that legally enforceable security interests are protected to the extent of the fair market value of the collateral. Any claim in excess of such value is treated as an unsecured claim, the maximum amount of which is limited to what such creditor would have been entitled to receive if the financial company had been liquidated under Chapter 7 of the Bankruptcy Code. The FDIC is able to prime a security interest to secure a loan to a bridge financial company, but it must provide the secured creditor with adequate protection.
  - *Contingent Claims.* In contrast to the FDIC's view that contingent claims (such as those arising under guarantees or letters of credit) do not present provable claims under the FDIA, under the Act, the FDIC is authorized by rule or regulation to recognize such contingent claims in an amount equal to their estimated value as of the date of the appointment of the receiver.
  - *Damages for Repudiation of a Debt Obligation.* The Act provides that damages for repudiation of a debt obligation may be no less than the amount lent, plus accrued interest, plus any accreted original issue discount. Such amount is determined as of the date of the appointment of the receiver, and, to the extent secured by property, the value of which is greater than the amount of the claim, through the date of repudiation.
  - *Rights of Set-Off.* Like the Bankruptcy Code, the Act generally protects set-off rights, subject to certain exceptions and limitations, including limitations designed to allow the receiver to transfer liabilities to a bridge financial company or other third party.

- *Rule-Making.* The FDIC is required to issue rules and regulations that it considers necessary to implement the Orderly Liquidation Regime and to harmonize such rules and regulations, to the extent possible, with insolvency laws that would apply to the financial company if the Orderly Liquidation Regime did not apply.

Other Significant Features

- *Priority of U.S. Government and Certain Other Claims Over Unsecured General Creditors.* The Act provides a priority over unsecured general creditors (in the following order) to: certain post-receivership financings; claims for administrative expenses of the receivership; claims of the United States against the financial company; certain claims for wages, salaries and commissions; and certain contributions owed to employee benefit plans. Administrative expenses are broadly defined to include any obligation "necessary and appropriate to facilitate the smooth and orderly liquidation" of the financial company. Wages, salaries and commissions owed to senior executives and directors are expressly subordinated to amounts owed to unsecured general creditors. Creditors similarly situated are required to be treated in a similar manner, except in certain situations, such as where different treatment is necessary to maximize the value of assets of the financial company, continue operations necessary to implement a bridge financial company or maximize the present value return from, or minimize losses on, the sale of assets of the financial company (in which cases they are subject to being assessed for the cost of dissolving the financial company as described below under "Orderly Liquidation Fund").
- *Treatment of Subsidiaries of Financial Companies.* In any case in which the FDIC is appointed as receiver of a financial company under the Orderly Liquidation Regime, the FDIC may appoint itself as receiver for any subsidiary (other than an insured depository institution, an insurance company or a covered broker-dealer subsidiary) of the financial company that is organized under Federal or State law if the FDIC and the Treasury Secretary determine (1) the subsidiary is in default or in danger of default, (2) such action would mitigate serious adverse effects on financial stability or economic conditions of the United States and (3) such actions would facilitate the orderly liquidation of the financial company. In such case, the subsidiary will itself be considered a financial company subject to the Orderly Liquidation Regime and the FDIC will have all of the powers with respect to such subsidiary as it has with respect to a financial company subject to the Orderly Liquidation Regime.
- *Treatment of Covered Broker-Dealers.* If a broker-dealer that is a member of the Securities Investor Protection Corporation ("SIPC") is made subject to the Orderly Liquidation Regime, the FDIC will be appointed receiver and the SIPC will be appointed as trustee of the broker-dealer. In such case, the SIPC is generally authorized to exercise the powers provided under the Securities Investor Protection Act ("SIPA") for trustees. However, qualified financial contracts will be handled under special provisions governing such contracts. The FDIC retains the power to create a bridge financial company and to transfer assets and liabilities of the broker-dealer to such company. All customer claims against the broker-dealer would be resolved in the same manner and amount as under the SIPA.
- *Treatment of Insurance Companies.* If an insurance company is a financial company, or a subsidiary or affiliate of a financial company, then the liquidation or rehabilitation of the insurance company, and any subsidiary or affiliate of such company that is an insurance company, is generally required to be conducted as provided under State law. However, notwithstanding this general rule, if within 60 days after a determination has been made to subject such entity to the Orderly Liquidation Regime the appropriate regulatory agency has not filed the appropriate judicial action in the appropriate State court to place such company into orderly liquidation under the laws and requirements of the State, the FDIC is given the authority to stand in the place of the appropriate regulatory agency and file the appropriate judicial action.
- *Treatment of Guaranteed Subsidiary and Affiliate Contracts.* The FDIC, as receiver of a financial company or of a subsidiary of a financial company (including an insured depository institution), is empowered to enforce contracts of subsidiaries or affiliates of the financial company, the obligations under which are guaranteed or otherwise

supported by or linked to the financial company, notwithstanding any contractual right to cause the termination, liquidation or acceleration of such contracts based solely on the insolvency, financial condition or receivership of the financial company if such guarantee or other support and all related assets and liabilities are transferred to or assumed by a bridge financial company or third party within the transfer period applicable to such contract or the FDIC as receiver otherwise provides adequate protection with respect to such obligations.

- *Automatic Stay For Qualified Financial Contracts; Walk-away Clauses.* The Act includes safe harbor provisions for qualified financial contracts that are similar to those in the FDIA. Like the FDIA, the Act provides for a one business day automatic stay (reduced from three business days in the Senate Bill) on the close out netting of qualified financial contracts after the appointment of a receiver. There is no comparable stay in the Bankruptcy Code with respect to protected derivatives. Like the FDIA, the Act denies the enforceability against financial companies being resolved under the Orderly Liquidation Regime of "walk-away clauses" in qualified financial contracts. There is no analogous provision in the Bankruptcy Code. Clearing organizations are generally exempted from the stay with respect to the exercise of contractual rights that would not be unenforceable as "walk-away clauses."
- *Written Agreement Requirement.* The Act requires that for an agreement which tends to diminish or defeat the interest of the FDIC in an asset to be enforceable against the FDIC as receiver it must be:
  - in writing;
  - executed by an authorized officer or representative of the financial company or confirmed in the ordinary course of business by the financial company; and
  - an official record of the financial company since the time of its execution or the counterparty to the financial company must provide documentation, acceptable to the receiver, of such agreement and its authorized execution or confirmation by the financial company.

This is similar, though not identical, to the written agreement requirement in the FDIA.

Orderly Liquidation Fund

- The Act provides for the establishment of an orderly liquidation fund that would be available to the FDIC to carry out its authorities as receiver, including liquidating financial companies, paying administrative expenses and repaying the FDIC obligations described below. The Act eliminates a proposed provision in the House Bill that called for prefunding the orderly liquidation fund with $150 billion from risk-based assessments on large financial institutions (*i.e.,* with $50 billion or more in assets) and large hedge funds (*i.e.,* with $10 billion or more in assets under management). Instead, under the Act, upon its appointment as receiver of a financial company, the FDIC is authorized to issue obligations to the Treasury Secretary to fund the orderly liquidation fund in an amount not to exceed, during the first 30 days after the receiver is appointed, 10% of the total consolidated assets of the financial company and, thereafter, 90% of the fair value of the total consolidated assets of the financial company available to repay the fund. No amounts may be provided by the Treasury Secretary to the FDIC under this authority unless a mandatory repayment plan is put into place which contains a schedule for repayment of such amounts and demonstrates that income to the FDIC from the liquidated assets of the financial company and assessments will be sufficient to repay such amounts within the period set forth in the schedule.
- To the extent needed to repay such FDIC obligations to the Treasury Secretary within 60 months (subject to extension if necessary to avoid serious adverse effects on the U.S. financial system), the FDIC must first impose assessments on any creditor that received more than it would have received in a liquidation under Chapter 7 of the Bankruptcy Code.

- If such amounts are insufficient to meet the repayment requirement specified above, the FDIC is required to impose risk-based assessments on bank holding companies with consolidated assets of $50 billion or more, nonbank financial companies supervised by the Federal Reserve Board and other financial companies with total assets of $50 billion or more. Assessments would be levied on a graduated basis, using a risk-matrix, with financial companies having greater assets and risks paying a higher assessment rate.
- The FDIC is authorized to claw back from any current or former senior executive or director substantially responsible for the failed condition of the financial company any compensation received during the two-year period prior to its appointment as receiver (with no time limit in the case of fraud).

Studies

- Although the Act does not contain a provision, similar to that contained in the House Bill, that would treat a portion of certain secured claims as unsecured claims, it provides for a study to be conducted to determine whether such treatment may be appropriate in certain cases. The Act also calls for a study by the Federal Reserve Board regarding the resolution of financial companies under the Bankruptcy Code (including the effectiveness of Chapter 7 of the Bankruptcy Code in facilitating the orderly liquidation or reorganization of systemic financial companies, whether amendments to the Bankruptcy Code should be made to enhance the ability of the Bankruptcy Code to resolve financial companies and whether amendments should be made to the Bankruptcy Code, the FDIA and other insolvency laws to address the manner in which qualified financial contracts are treated). The Federal Reserve Board is also directed to conduct a study regarding international coordination relating to the resolution of systemic financial companies under the Bankruptcy Code and applicable foreign law.

Title III — Transfer of Powers to the Comptroller of the Currency, the Corporation and the Federal Reserve Board

- **Elimination of the OTS.** The OTS is abolished effective one year after enactment of the Act, unless the timeline is extended, and the authority of the OTS with respect to savings associations, their holding companies and their affiliates is transferred to the OCC, the FDIC and the Federal Reserve Board.
- **Changes to FDIC Insurance Assessment Base.** The assessment base on which deposit insurance premiums are calculated will shift from deposits to average consolidated total assets minus average tangible equity.
- **Increases to the DIF Reserve Ratio.** The reserve ratio of the Deposit Insurance Fund will be increased from 1.15 % 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.
- **Changes to FDIC Insurance Coverage.** Federal deposit insurance limits are increased from $100,000 to $250,000, and for a period of two years from December 31, 2010, deposits in non-interest bearing demand deposit accounts will continue to be insured.
- **Shift in Regulatory Focus.** Other provisions further the themes of shifting the economic burden of regulation to the largest institutions and increasing regulatory focus on fairness and nondiscriminatory treatment.

Subtitle A and Subtitle B – Transfer of Powers and Duties; Transitional Provisions

- *Transfer of the Office of Thrift Supervision ("OTS") Powers and Duties.* Transfers of powers and duties of the OTS to the FDIC, OCC and Federal Reserve Board will be effected as follows:
  - The OCC will have all rulemaking authority of the OTS relating to State and Federal savings associations, except as noted below and will supervise all Federal savings associations.
  - The FDIC will supervise all State savings associations.
  - The Federal Reserve Board will regulate all savings and loan holding companies and all nonbank subsidiaries of savings and loan holding companies. The Federal Reserve Board also will succeed to all rulemaking authority of the OTS relating to savings and loan holding companies and to savings association transactions with affiliates, insider loans by savings associations and tying arrangements involving savings associations.
- *Timing of Abolishment of OTS.* Transfer of OTS powers and duties must be accomplished within one year after enactment, with ability to extend for an additional six months if certain procedural requirements are met. The OTS and the position of Director of the OTS will be abolished 90 days after transfer of the OTS' powers and duties.
- *Continuation of OTS Obligations, Documents.* The Act provides for the continuation of lawsuits, existing OTS orders, resolutions, determinations, agreements and regulations, interpretive rules, procedures and other advisory materials (including pending regulations).
- *OCC Independence.* The Act limits the oversight of the OCC by the Treasury Secretary by prohibiting the Treasury Secretary from intervening in any OCC matter or proceeding unless the law expressly provides for such intervention.
- *Shift of Regulatory Focus.* Although the Federal banking agencies have always attempted to balance safety and soundness and consumer protection in their oversight of depository institutions, the Act now expressly tasks the

OCC with "assuring the safety and soundness of, and compliance with the laws and regulations, fair access to financial services and fair treatment of customers by, the institutions and other persons subject to its jurisdiction."

- *Fees for Large Institutions and Companies.* In another of the many financial burdens that the Act places on large financial institutions, the Act *requires* the Federal Reserve Board to collect assessments, fees and other charges from all bank holding companies and savings and loan holding companies with total consolidated assets of $50 billion or more and all nonbank financial companies supervised by the Federal Reserve Board in an amount equal to the expenses the Federal Reserve Board estimates is necessary or appropriate to carry out its responsibilities with respect to the institution or company. The OCC is also granted broad, permissive authority to assess fees to institutions subject to its jurisdiction "as necessary or appropriate to carry out [its] responsibilities."

Subtitle C – Federal Deposit Insurance Corporation

- *Membership of FDIC Board.* The Director of the Consumer Financial Protection Bureau will replace the Director of the OTS on the FDIC Board, giving an additional voice for consumer advocacy to that organization.
- *Deposit Insurance Assessments.* The "assessment base" upon which deposit insurance premiums are calculated will be changed to 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. Contrary to the original concept of paying for insurance on the basis of the insured obligation, this change should shift some of the costs of deposit insurance to insured depository institutions that are proportionately *less* reliant on deposit funding (generally larger institutions). In addition, in a provision entitled "Elimination of Procyclical Assessments," the Act actually does nothing to ease assessments in times of financial stress, but does grant the FDIC greater authority to build up excess reserves when the Bank Insurance Fund has otherwise met its targets.
- *Increase in DIF Reserve Ratio.* The Act includes provisions to increase by September 30, 2020, the reserve ratio of the Deposit Insurance Fund from 1.15 % to 1.35 % of estimated insured deposits or the comparable percentage of the assessment base. Insured depository institutions with assets of $10 billion or more will pay the increased assessments necessary to satisfy the higher reserve ratio.
- *Permanent Increase in Federal Deposit and Share Insurance Limits.* The Act makes permanent the increase in standard maximum Federal deposit and share insurance limits from $100,000 to $250,000. (See also the two-year retention of unlimited FDIC insurance for certain transaction accounts in Subtitle D below.)

Subtitle D – Other Matters

- *Branching.* The Act permits any savings association that becomes a bank to continue to operate any branch or agency that it operated immediately before becoming a bank, and to continue establishing, acquiring and operating branches and agencies in the States in which such branches and agencies are located if a bank chartered by such State would be permitted to establish a "branch." (Some ambiguity is created by the Act's express comparison only to an in-State bank's branching authority and not to its authority to establish an agency office.)
- *Two-Year Extension of Unlimited Deposit Insurance.* As another concession to smaller institutions, the Act extends the unlimited Federal insurance of the net amount of "noninterest-bearing transaction accounts" through December 31, 2013. While this provision has widely been reported as an extension of the FDIC's "Transaction Account Guarantee" program, the Act actually narrows the current definition of "noninterest-bearing transaction account" by excluding from the definition accounts that earn *de minimis* interest and accounts on which institutions reserve a right to required advance notice of withdrawals (*e.g.*, NOW accounts). The changes from the current law take effect on December 31, 2010.

- *Office of Minority and Women Inclusion.* The Act requires each agency to create 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. The director of each such office is charged with developing and implementing certain standards for the agency, including increasing women- and minority-owned business in the programs and contracts of the agency.
- *Anti-Tying Exceptions.* The Federal Reserve Board must consult with the OCC and FDIC prior to permitting any exceptions to anti-tying restrictions.

Title IV — Regulation of Advisers to Hedge Funds and Others

- **Elimination of Private Adviser Exemption.** The Act eliminates the "private adviser exemption" from registration for all U.S. resident advisers. The Act also excludes private funds from the exemption for intra-state advisers.
- **General Exemptions.** The Act exempts from registration an adviser that solely advises one or more venture capital funds and an adviser that solely advises private funds and has U.S. assets under management of less than $150 million, but the Act authorizes the SEC to impose recordkeeping and reporting requirements on such advisers. The Act excludes family offices, subject to certain grandfathering provisions, and exempts advisers to small business investment companies from both registration and reporting/recordkeeping requirements. The Act gives the SEC authority to impose registration and examination requirements on "mid-sized" private fund advisers.
- **Foreign Private Adviser Exemption.** The Act contains a narrow exemption from registration and reporting/recordkeeping requirements for foreign private advisers. Among other requirements, the Act requires a non-U.S. adviser to count both U.S. clients and U.S. investors in private funds the adviser manages for purposes of the "fewer than 15 U.S. persons" test, and to include assets attributable to such U.S. clients and U.S. investors towards the "less than $25 million in AUM" test.
- **AUM Threshold for SEC Registration.** An adviser in the United States with more than $100 million in AUM must, absent an exemption, register with the SEC. Subject to certain exceptions, a U.S. adviser with $100 million or less in AUM must register with applicable State securities regulators.
- **Information Sharing.** The SEC may not compel registered investment advisers to share the private fund information they disclose to the SEC with non-government third parties (*i.e.*, investors, prospective investors, counterparties and creditors); however, the SEC may share private fund information with the Oversight Council, other U.S. Government agencies or instrumentalities or a U.S. court under specified circumstances. Any "proprietary information of an investment adviser" obtained by the SEC is subject to special limitations on public disclosure.
- **Effective Dates.** The Act provides for a one-year transition period from the date of enactment before the private fund adviser registration and recordkeeping/disclosure requirements go into effect. Private fund advisers may register voluntarily during the one-year transition period. However, *the net worth threshold for natural person accredited investors is effective immediately upon enactment of the Act.*

The "Private Fund Investment Advisers Registration Act of 2010" (the formal name for Title IV of the Act) significantly affects registration requirements for advisers to private pools of capital under the Investment Advisers Act of 1940 (the "Advisers Act") by, among other things, 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. Title IV also creates new registration exceptions and exemptions and raises the minimum asset level to qualify 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.

Moreover, as discussed in more detail below, the Act includes additional important developments affecting both private fund advisers and private issuers, including revision of the accredited investor standard under the 1933 Act, new disclosure and recordkeeping requirements for both registered and unregistered investment advisers and enhanced custody provisions.

Registration of Advisers to "Private Funds"

- "Private fund" is defined as any issuer that would be an investment company under the Investment Company Act of 1940 (the "Investment Company Act") but for Section 3(c)(1) or 3(c)(7) (funds sold privately and either beneficially owned by fewer than 100 holders or owned exclusively by "qualified purchasers"). Because the definition of a "private fund" is limited to funds excepted by Sections 3(c)(1) and 3(c)(7), traditional futures funds and other funds that hold a limited amount of securities are not "private funds" under the Act.

Exclusions and Exemptions from Registration

- *No Exemption for Private Equity Fund Advisers*. Unlike prior versions of the related bills, the Act does not exempt advisers to private equity funds.
- *Venture Capital Funds*. The Act exempts from registration advisers that solely advise one or more venture capital funds, requires the SEC to define "venture capital fund" and authorizes the SEC to impose recordkeeping and reporting requirements on unregistered venture capital fund advisers.
- *Family Offices*. Rather than provide an exemption from registration, the Act excludes family offices altogether from the definition of investment adviser; however, certain family offices that existed prior to January 1, 2010 will continue to be subject to the antifraud requirements in Sections 206(1), 206(2) and 206(4) of the Advisers Act. Accordingly, family offices will not be subject to the recordkeeping requirements of the Advisers Act, and non-grandfathered family offices will not be subject to its anti-fraud requirements. The SEC is directed to define the term "family office" in a manner that is consistent with current exemptive orders and in light of the range of organizational, management and employment structures that family offices employ.
- *Private Fund Advisers with U.S. Assets under Management ("AUM") under $150 Million*. The Act directs the SEC to exempt from registration any adviser that solely advises private funds and has U.S. AUM of less than $150 million but authorizes the SEC to impose recordkeeping and reporting requirements on such advisers.
- *Foreign Private Advisers*. Foreign private advisers are exempt from registration and reporting/recordkeeping requirements. A "foreign private adviser" is defined as any investment adviser that:
    - has no place of business in the United States;
    - has, in total, fewer than 15 clients and investors in the United States in private funds advised by the adviser;
    - has aggregate AUM attributable to clients in the United States and to U.S. investors in private funds it advises of less than $25 million or such higher amount as the SEC may, by rule, deem appropriate; and
    - neither holds itself out generally to the public in the United States as an investment adviser; nor acts as an investment adviser to a registered investment company or a business development company.

As a practical matter, as enacted, many currently unregistered non-U.S. private fund advisers will be required to register, because such advisers must include U.S. investors in the private funds they manage and the assets attributable to such investors towards the fewer than 15 U.S. persons and less than $25 million AUM limits, respectively. The Act does not specify the time period during which an adviser must meet both the "fewer than 15 U.S. persons" and the "less than $25 million AUM" tests, but if the SEC imposes current requirements, presumably those tests will apply on a rolling 12 month basis.

- *Small Business Investment* Companies *("SBICs")*. Any investment adviser (other than a business development company) who solely advises SBICs licensed under the Small Business Investment Act of 1958 is exempt from registration.

- *Narrowing of Intra-State Exemption.* The Act narrows the registration exemption for investment advisers all of whose clients reside in the same State as the adviser's principal place of business by excluding advisers to private funds from the exemption.
- *Narrowing of CTA Exemption.* The Act narrows the existing exemption for commodity trading advisors ("CTAs") that are registered with the CFTC and whose business does not consist primarily of acting as an investment adviser by requiring that if such a CTA also advises a private fund, the CTA must register with the SEC if its predominant business becomes providing securities-related advice after the date of enactment of Title IX of the Act.

Registration and Examination Requirements for "Mid-Sized Private Fund" Advisers

- The Act requires the SEC to take into account the size, governance and investment strategy of mid-sized private funds to determine whether they pose systemic risk and to prescribe registration and examination requirements for investment advisers to such private funds that reflect those risks.

AUM Threshold for SEC Registration

- As a general matter, the Act amends Section 203A(a)(2) of the Advisers Act to prohibit an investment adviser in the United States with AUM of not less than $25 million and not more than $100 million from registering with the SEC if it is required to register and subject to examination in the State in which it maintains its principal place of business. Advisers to registered investment companies, business development companies and advisers that would be required to register in 15 or more States are excepted from this prohibition, as is an adviser that is not required to both register and be examined in its State of residence. The SEC may increase the $100 million AUM threshold by rule. This AUM threshold does not apply to non-U.S. investment advisers if they have no presence in the United States and thus cannot register in any States.
- An investment adviser in the United States with AUM of less than $25 million continues to be prohibited from registering with the SEC unless such an adviser advises a registered investment company or has its principal place of business in a State that does not regulate investment advisers.

Adjustment of Accredited Investor Standard

- The Act fixes the 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. This threshold applies either individually or jointly with the person's spouse and, unlike the current 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 under* Regulation D *(not just offerings by private funds).* Except for this net worth threshold, the SEC may review and adjust or modify the standards by notice and comment rulemaking during this initial four year period. The Senate Bill requires the SEC to review the natural person accredited investor standards at least once every four years thereafter and, if necessary, to adjust or modify them by notice and comment rulemaking.

Other Significant Title IV Provisions

- *Broad Recordkeeping and Reporting Requirements for Registered Advisers to Private Funds.* Such requirements include:
    - the amount of assets under management and use of leverage, including off-balance sheet leverage;
    - counterparty credit risk fund exposure;
    - trading and investment fund positions;
    - valuation polices and practices of the fund;

  - types of assets held;
  - side arrangements or side letters;
  - trading practices; and
  - such other information as the SEC, in consultation with the Oversight Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

The SEC may vary such reporting requirements according to the type or size of private fund being advised. The Act empowers the SEC to examine these records and to share them with the Oversight Council.

- *Custody of Client Assets.* The Act adds to the Advisers Act an explicit requirement that client assets over which a registered adviser has custody must be verified by an independent public accountant. Custody requirements are currently imposed by an anti-fraud rule that is subject to amendment by the SEC.
- *Confidentiality of Information.* The Act provides that neither the SEC nor the Oversight Council may be compelled to disclose private fund information but also states that this confidentiality requirement does not authorize the SEC or the Oversight Council to withhold information from Congress. The confidentiality requirement also does not prevent the SEC or the Oversight Council from complying with proper requests for information from any other Federal department, agency or self-regulatory organization or an order of a U.S. court in an action brought by the U.S. Government or the SEC. In addition, the Act:
  - imposes the same confidentiality requirements on other Federal agencies, departments and self-regulatory organizations that receive private fund information;
  - exempts the SEC, the Oversight Council and other such recipients of private fund information from the Freedom of Information Act; and
  - states that any "proprietary information of an investment adviser" obtained by the SEC shall be subject to the same limitations on public disclosure as facts the SEC ascertains during an examination, as provided by Section 210(b) of the Advisers Act. The Act defines such proprietary information as sensitive, nonpublic information regarding:
    - the investment or trading strategies of the investment adviser;
    - analytical or research methodologies;
    - trading data;
    - computer hardware or software containing intellectual property; and
    - any additional information the SEC determines to be proprietary.
- *New Exception from SEC Disclosure Restrictions.* Section 210(c) of the Advisers Act prohibits the SEC from requiring an investment adviser to disclose the identity, investment or affairs of any of its clients, except as may be necessary or appropriate in a particular enforcement investigation or proceeding. The Act amends Section 210(c) to provide a new exception from this prohibition, "for purposes of assessment of systemic risk."
- *CFTC/SEC Provisions.* The Act requires the CFTC and the SEC within 12 months of enactment to promulgate jointly rules governing disclosure for advisers that are dually registered under the Advisers Act and the Commodity Exchange Act.
- The Act also provides that the new registration requirements for advisers to private funds under the Advisers Act do not absolve these advisers of any existing registration requirements to which such advisers may be subject under the Commodity Exchange Act.

- *Adjustment of Qualified Client Standard*. The Act amends Section 205(e) of the Advisers Act to require the SEC to adjust the net asset threshold for status as a qualified client for inflation within one year of the date of enactment of the Act, and every five years thereafter. Such adjustments are to be rounded to the nearest multiple of $100,000.

Section 205 of the Advisers Act and State-Regulated Advisers

- Title IX of the Act amends Section 205(a) of the Advisers Act to clarify that the Section, which imposes various restrictions on investment advisory contracts, does not apply to State-registered investment advisers.

Studies Authorized

- The Act authorizes several studies, including:
    - a study by the U.S. Comptroller General on compliance costs associated with the SEC custody rule and the additional costs that would be incurred if the provision relating to operational independence of affiliated custodians was eliminated;
    - a study by the Comptroller General on private fund investor eligibility standards;
    - a study by the Comptroller General regarding the feasibility of forming a self-regulatory organization to oversee private funds; and
    - an SEC study regarding short selling on national securities exchanges and over-the-counter markets, with particular focus on the impact of recent rule changes and the incidence of failed or late deliveries of shares sold short, and the feasibility, benefits and costs of requiring real time reporting of short sale positions.

One-Year Transition Period

- The majority of Title IV's provisions take effect one year from the date of enactment, meaning that the private fund advisers subject to new requirements must be registered and/or meet recordkeeping/disclosure requirements by July 2011. Private fund advisers may register voluntarily during the one-year transition period. As noted above under "Adjustment of Accredited Investor Standard," however, the new standard takes effect immediately upon enactment of the Act; a natural person investor will no longer be allowed to include the net value of the investor's primary residence in calculating his or her net worth.

Title V — Insurance

- **Federal Insurance Office.** The Act establishes the FIO within the Treasury Department.
  - The FIO shall be headed by the FIO Director who shall serve in an advisory capacity on the Oversight Counsel.
  - The FIO is authorized to perform functions including the following with respect to all lines of insurance (excluding health insurance, certain long-term care insurance and crop insurance): (1) monitoring the insurance industry; (2) recommending to the Oversight Counsel that certain insurers be subject to regulation as Designated Companies; (3) assisting in administering the Terrorism Insurance Program; and (4) coordinating Federal efforts and developing Federal policy on prudential aspects of international insurance matters, including the ability to preempt State laws that conflict with international insurance agreements between the United States and other foreign governments.
  - The FIO Director must submit to the President and to specified Congressional Committees reports regarding the following topics: (1) the modernization and improvement of U.S. insurance regulation; (2) the insurance industry and the global reinsurance market; (3) any action taken by the FIO regarding preemption of State law; and (4) the impact of the Nonadmitted and Reinsurance Reform Act of 2010.
- **Nonadmitted Insurers, Surplus Lines Insurance and Reinsurance.** 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 and promoting uniformity of requirements and standards among States. Additionally, the Act regulates certain reinsurance matters by prohibiting any State, other than the domiciliary State of the ceding company, from denying credit for reinsurance if the State of domicile of the ceding company is NAIC-accredited or has financial solvency requirements substantially similar to the NAIC accreditation requirements. The Act also delegates sole responsibility for the regulation of a reinsurer's financial solvency to such reinsurer's State of domicile, provided such State is NAIC-accredited or has financial solvency requirements substantially similar to the NAIC accreditation requirements.
- **Deadline Dates.**
  - Within 330 days following enactment, the NAIC may submit to certain Congressional Committees a report regarding any adopted procedures for allocation of premium taxes among the States.
  - Beginning September 30, 2011 and on or before September 30 of each subsequent calendar year, the FIO Director shall submit to the President and to certain Congressional Committees a report on the insurance industry and a report regarding any actions taken by the FIO regarding preemption of State law.
  - Not later than 18 months post-enactment, the FIO Director shall submit to Congress a report and recommendations regarding how to modernize and improve U.S. insurance regulation.
  - Not later than September 30, 2012, the FIO Director shall submit to certain Congressional Committees a report regarding the global reinsurance market.
  - Not later than January 1, 2013, the FIO Director shall submit to certain Congressional Committees a report regarding the impact of the Nonadmitted and Reinsurance Reform Act of 2010. Such report shall be updated not later than January 1, 2015.
  - Not later than 30 months post-effective date, the U.S. Comptroller General shall submit to certain Congressional Committees a report on the nonadmitted insurance market.

Subtitle A — Federal Insurance Office Established (subtitle may be cited as the "Federal Insurance Office Act of 2010")

- The Act establishes the Federal Insurance Office (the "FIO") within the Treasury Department, headed by a director (the "FIO Director") appointed by the Treasury Secretary.
- The FIO Director shall serve in an advisory capacity on the Oversight Council.
- The FIO is authorized to perform the following functions with respect to all lines of insurance (excluding health insurance, long-term care insurance (other than long-term care insurance included with life or annuity components) and crop insurance):
    - monitor the insurance industry, including identifying gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or in the U.S. financial system;
    - monitor the extent to which traditionally underserved communities and consumers, minorities and low and moderate-income persons have access to affordable insurance products;
    - recommend to the Oversight Council that any particular insurer be classified as a Designated Company subject to regulation and supervision by the Federal Reserve Board pursuant to Title I of the Act;
    - assist in administering the Terrorism Insurance Program;
    - coordinate Federal efforts and develop Federal policy on aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors and assisting the Treasury Secretary in negotiating certain agreements between the United States and one or more foreign governments, authorities or regulatory entities regarding prudential measures with respect to the business of insurance or reinsurance (each such agreement, a "covered agreement");
    - determine whether State insurance measures are preempted by covered agreements;
    - consult with States and State insurance regulators regarding insurance matters of national and international importance; and
    - advise the Treasury Secretary on major domestic and international insurance policy issues.
- Notwithstanding the establishment of the FIO, State insurance regulators will remain the primary regulatory authority over insurance. No optional Federal insurance charter is established. The Act specifically withholds from the FIO and the Treasury Department general supervisory or regulatory authority over the business of insurance.
- In connection with its performance of the functions listed above, the FIO may receive and collect data on and from the insurance industry for analysis and dissemination, and may require, by subpoena, an insurer meeting a minimum size threshold (to be established by the FIO) to submit such data to the FIO.
- The FIO may determine that a State insurance measure may be preempted if such measure: (1) results in less favorable treatment of a non-U.S. insurer than a U.S. insurer domiciled, licensed or otherwise admitted in the relevant State and (2) is inconsistent with a covered agreement.
- Certain reports must be submitted to specified Congressional Committees and to the President by the FIO Director. Specifically, the Act requires submission by the FIO Director to certain House and Senate Committees of: (1) a report and recommendations on how to modernize and improve the system of insurance regulation in the United States; (2) annual reports on the insurance industry and on any actions taken by the FIO regarding preemption of State law; (3) a report on the global reinsurance market and its role in supporting insurance in the United States.; and (4) a report, and an update of such report, describing the impact of the Nonadmitted and Reinsurance Reform Act of 2010 (See Subtitle B below).

Subtitle B — State-Based Insurance Reform (subtitle may be cited as the "Nonadmitted and Reinsurance Reform Act of 2010")

Streamlining of Regulation of Nonadmitted Insurers

- The Act is intended to streamline the regulation of nonadmitted insurers and surplus lines insurance (which generally does not include certain workers' compensation insurance) by providing exclusive regulatory authority to an insured's home State and promoting uniformity of requirements and standards among States.
- Among other provisions, the Act specifically provides that:
    - where risks are located in multiple States, only the home State of an insured may require any premium tax payment for nonadmitted insurance; however, the States may establish procedures to allocate such premium taxes among relevant States;
    - only an insured's home State may require a surplus lines broker to be licensed in order to sell, solicit or negotiate nonadmitted insurance with respect to such insured;
    - unless a State has adopted nationwide uniform requirements and procedures (to be developed in accordance with this Subtitle of the Act), a State may only impose eligibility requirements on nonadmitted insurers domiciled in a U.S. jurisdiction in conformance with the requirements set forth in the National Association of Insurance Commissioners ("NAIC") Nonadmitted Insurance Model Act;
    - if a nonadmitted insurer domiciled outside the United States is listed on the NAIC Quarterly List of Alien Insurers, a State may not prohibit a surplus lines broker from placing nonadmitted insurance with, or procuring nonadmitted insurance from, such insurer; and
    - if certain specified and requested information is provided, a surplus lines broker seeking to procure or place nonadmitted insurance in a State for certain large commercial insureds shall not be required to satisfy any State requirement to make a due diligence search to determine whether coverage can be obtained from an admitted insurer.

Regulation of Certain Reinsurance Matters

- Where a ceding insurer's domiciliary State recognizes such credit for reinsurance and such State is NAIC-accredited or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, no other State may deny credit for reinsurance to the ceding insurer.
- Where a reinsurer's domiciliary State is NAIC-accredited or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, such State shall be solely responsible for regulating the financial solvency of the reinsurer. No other State may require the reinsurer to provide any additional financial information other than the information the reinsurer is required to file with its domiciliary State.

Title VI — Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions

- **Commercial Firm Ownership of Limited Purpose Banks.** A three-year moratorium applies to the formation of new industrial bank, credit card bank and trust company charters and changes in control of existing industrial bank, credit card bank and trust company charters.
- **Intermediate Savings and Loan Holding Companies.** Grandfathered unitary savings and loan holding companies may be required to establish an intermediate savings and loan holding company structure over their savings association and most of their other financial activities. If grandfathered unitary savings and loan holding companies are required to do so, such companies themselves cease to be savings and loan holding companies.
- **Volcker Rule.** Depository institutions and their affiliates are prohibited from engaging in proprietary trading activities and investing in or sponsoring hedge funds or private equity funds. Such entities must dispose of prohibited investments or relationships within two years after the Volcker Rule requirements become effective, subject to up to three possible one-year extensions. An additional extension of up to five years may be granted by the Federal Reserve Board to the extent necessary in the case of an 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. Several exceptions to the general prohibitions apply, including with respect to risk-mitigating hedging activities and trading conducted on behalf of customers. 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.
- **Concentration Limits.** 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.

Commercial Firm Ownership of Limited Purpose Banks

- *Moratorium on New Limited Purpose Banks.* A three-year moratorium applies to the FDIC's approval of deposit insurance applications received after November 23, 2009 by industrial banks, credit card banks or trust companies that are directly or indirectly owned by a commercial firm.
- *Moratorium on Commercial Firm Acquisitions of Limited Purpose Banks.* A three-year moratorium applies to changes in control that would result in a commercial firm acquiring direct or indirect control of an industrial bank, credit card bank or trust company, unless the change in control involves an institution in danger of default, involves a commercial firm engaging in a bona fide merger or whole acquisition of the commercial firm parent of the institution or results from an acquisition of voting shares of a publicly traded company that controls an industrial bank, credit card bank or trust company, if, after the acquisition, the acquiring shareholder (or group of shareholders acting in concert) holds less than 25% of any class of the voting shares of the company. For each exception, the commercial firm that is acquiring control also must obtain all required regulatory approvals.
- *Commercial Firm Definition.* A company is a "commercial firm" if its consolidated annual gross revenues derived from activities that are financial in nature (as defined in Section 4(k) of the BHCA), including from insured

depository institutions that it controls, represent less than 15% of the consolidated annual gross revenues of the company.

- *GAO Study of BHCA Exemptions.* The U.S. Government Accountability Office ("GAO") is directed to carry out a study, and provide a report within 18 months, to determine whether it is necessary, in order to strengthen the safety and soundness of institutions or the stability of the financial system, to eliminate the BHCA exemptions for holding companies of savings associations, credit card banks, trust companies and industrial banks.

Provisions Regarding Control of a Savings Association

- *Exemption for Trust-Only Savings Associations.* A company is not a savings and loan holding company by virtue of controlling a saving association that functions solely in a trust or fiduciary capacity.
- *Clarification of Savings and Loan Holding Company Powers*. Savings and loan holding companies are permitted to engage in all activities permissible for financial holding companies, subject to all the qualifications and standards that apply to the conduct of such activities by financial holding companies.
- *Commercial Firms that Control Savings Associations.* If a grandfathered unitary savings and loan holding company engages in any activities other than those permissible for non-grandfathered savings and loan holding companies (generally, these are financial activities permissible for a financial holding company under BHCA Section 4(k)), then the Federal Reserve Board may require such company to establish and conduct all or a portion of its financial activities in or through an intermediate savings and loan holding company, established pursuant to regulations of the Board. However, the Federal Reserve Board must require a grandfathered unitary savings and loan holding company to establish an intermediate holding company, if the Federal Reserve Board determines that the intermediate holding company is necessary to appropriately supervise the company's financial activities or to ensure that supervision by the Federal Reserve Board does not extend to the activities of such company that are not financial activities. The Federal Reserve Board is required to establish standards for these determinations by regulation. By virtue of a new exemption, a grandfathered unitary savings and loan holding company that is required to establish an intermediate savings and loan holding company ceases to be a savings and loan holding company itself. Internal financial activities conducted by a former grandfathered unitary savings and loan holding company or any affiliate and internal treasury, investment and employee benefit functions are not required to be conducted in an intermediate holding company. Also, a former grandfathered unitary savings and loan holding company may continue to engage in an internal financial activity outside of its intermediate holding company, unless the Federal Reserve Board determines that engaging in such activity presents undue risk to the former grandfathered unitary savings and loan holding company or to the financial stability of the United States, if the former grandfathered unitary savings and loan holding company engaged in the activity during the year before the date of enactment of the Act and at least ⅔ of the assets or ⅔ of the revenues generated from the activity are from or attributable to the former grandfathered unitary savings and loan holding company. A former grandfathered unitary savings and loan holding company that directly or indirectly controls an intermediate savings and loan holding company must serve as a source of strength to its intermediate savings and loan holding company, and the Federal Reserve Board may examine and require reports from the former grandfathered unitary savings and loan holding company to ensure its compliance with these requirements and may enforce noncompliance. The Federal Reserve Board may issue regulations establishing affiliate transaction limits between an intermediate holding company and its parent former grandfathered unitary savings and loan holding company (and the parent's nonbank subsidiaries), but the regulations may not restrict or limit transactions in connection with a bona fide acquisition or lease by an unaffiliated person of assets, goods or services.

Bank Holding Company Regulation

- *FHC Requirements.* Financial holding companies are required to be well-capitalized and well-managed, which supplements the current requirement that the banks in a financial holding company be well-capitalized and well-managed.
- *Approval of FHC Acquisitions.* Financial holding companies must obtain prior approval from the Federal Reserve Board before acquiring a nonbank company with consolidated assets in excess of $10 billion.
- *Standards for Interstate Acquisitions and Mergers.* A bank holding company must be well-capitalized and well-managed, not merely adequately capitalized and adequately managed, in order to acquire a bank located outside of the bank holding company's home State. Also, banking agency approval of interstate bank mergers is conditioned on the requirement that the resulting bank be well-capitalized and well-managed upon consummation of the transaction, not merely adequately capitalized and adequately managed.
- *Source of Strength.* 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

- *Definition of Banking Entity.* The term "banking entity" is defined as an insured depository institution, a company that controls an insured depository institution, a company treated as a bank holding company and any subsidiaries of such institutions or companies (including broker-dealer and fund manager subsidiaries). A limited exception from the term "insured depository institution," which is used in this definition, is provided for an institution that functions solely in a trust or fiduciary capacity.
- *Prohibition of Proprietary Trading.* Federal banking agencies, through a rule-making, are required to jointly prohibit proprietary trading by a banking entity. "Proprietary trading" is defined as engaging as a principal for one's trading account in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative or contract or any other security or financial instrument that the appropriate Federal banking agency, the SEC or CFTC determines by regulation.
- *Prohibition on Sponsoring or Investing in a Hedge Fund or Private Equity Fund.* Federal banking agencies, through a rule-making, are required to jointly prohibit banking entities from sponsoring or investing in a hedge fund or private equity fund (each defined as a company that is exempt from registration under the Investment Company Act by virtue of Section 3(c)(1) or 3(c)(7) thereof). "Sponsoring" is defined as serving as a general partner, managing member or trustee of a fund; selecting or controlling a majority of the fund's directors, trustees or management; or sharing the same name or variation of the same name of the fund.
- *Exceptions.* The foregoing prohibitions do not apply to certain activities, including: (1) investments in obligations of the U.S. government and any agency of the U.S. government, obligations, participations or other instruments of or issued by Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution or to obligations of an State or a political subdivision thereof, (2) underwriting and market-making-related activities, (3) risk-mitigating hedging activities designed to reduce the specific risks to a banking entity in connection with and related to its positions, contracts or other holdings, (4) trading conducted on behalf of customers, (5) investments in small business investment companies, (6) insurance company general account investment activities, subject to certain conditions, (7) organizing or offering a private equity or hedge fund if the banking entity provides bona fide trust services or investment advisory services, the fund is offered in connection therewith and only to the banking entity's customers and the banking entity complies

with certain other conditions generally designed to limit the banking entity's risk exposure to the fund, (8) activities conducted by a foreign company solely outside the U.S. provided the company is not directly or indirectly controlled by a U.S. domestic company and that no interest in a hedge fund or private equity fund in which the company invests or that it sponsors is offered for sale or sold to a resident of the U.S. and (9) such other activity as permitted by regulation of the Federal banking agencies, SEC and CFTC to promote and protect the safety and soundness of the banking entity and the financial stability of the U.S. The exceptions do not apply if, as determined by regulation of the Federal banking agencies, SEC and CFTC, an activity involves or results in a material conflict of interest between the banking entity and its clients, customers or counterparties; results, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; poses a threat to the safety and soundness of such banking entity; or poses a threat to the financial stability of the U.S. Moreover, the Federal banking agencies, SEC and CFTC must issue regulations imposing additional capital requirements and quantitative limits on such activities.

- *De Minimis Investments.* If a banking entity organizes and offers a hedge fund or private equity fund, the banking entity may make and retain an initial investment. Within one year after establishment of the fund, the investment must be reduced to 3% or less of total ownership interests and be 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.
- *Council Study.* The Oversight Council must conduct a study of the provisions of the Volcker Rule and issue recommendations to the Federal banking agencies within six months of the enactment of the Act. Within nine months of the date the study is completed, the Federal banking agencies, the SEC and CFTC must issue coordinated final rules implementing the Volcker Rule.
- *Divestiture Period.* 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) 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 extension 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. Thus, in some instances, a banking entity could have up to 12 years to divest a prohibited investment. The Federal banking agencies, SEC and CFTC must 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.
- *Affiliate Transaction Restrictions.* Entities covered by these provisions that serve as an investment manager or investment adviser to a hedge fund or private equity fund, or that organize or offer a hedge fund or private equity fund under the exception for trust services and investment advisory services, and their affiliates are prohibited from entering into covered transactions, as defined in Section 23A of the Federal Reserve Act, with such hedge fund or private equity fund (*e.g.*, loans to the fund, purchasing assets from the fund, guaranteeing an obligation of the fund). In addition, each such entity is subject to Section 23B of the Federal Reserve Act as if such entity were a member bank and such hedge fund or private equity fund were an affiliate. A limited exception from the 23A prohibition is provided for prime brokerage, although neither the Act nor the BHCA define "prime brokerage." Under this exception, a banking entity may engage in a covered transaction with a hedge fund or private equity fund in which a hedge fund or private equity fund managed, sponsored or advised by such banking entity has taken an ownership interest. The following conditions apply to the exception: (1) with regard to a hedge fund or private equity fund organized and offered by such banking entity, the banking entity must comply with each of the conditions in the exemption for banking entities that provide bona fide trust services or investment advisory services in connection with organizing or offering a private equity or hedge fund, (2) the chief executive officer (or equivalent officer) of the banking entity provides an annual certification that the banking entity does not, directly

or indirectly, guarantee, assume or otherwise insure the obligations or performance of the hedge fund or private equity fund or of any hedge fund or private equity fund in which such hedge fund or private equity fund invests and (3) the Federal Reserve Board has determined that the transaction is consistent with the safe and sound operation and condition of the banking entity.

- *Limitations on Nonbank Financial Companies*. 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 Limits

- *Concentration Limit on Financial Companies*. A financial company is prohibited from merging or consolidating with or acquiring another company 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 at the end of the calendar year preceding the transaction. Exceptions are provided for acquisitions of failing banks, FDIC-assisted transactions and transactions that result in a *de minimis* increase in the liabilities of a financial company.
- *Financial Company Definition*. "Financial company" is defined as an insured depository institution, bank holding company, savings and loan holding company, company that controls an insured depository institution, nonbank financial company supervised by the Federal Reserve Board under Title I of the Act and a foreign bank or other company treated as a bank holding company.
- *Concentration Limit on Insured Depository Institution Mergers and Acquisitions*. An insured depository institution is prohibited from engaging in an interstate merger transaction if the resulting insured depository institution (including all insured depository institutions which are affiliates of the resulting insured depository institution), upon consummation of the transaction, would control more than 10% of the total amount of deposits of insured depository institutions in the U.S. An exception is provided for acquisitions of failing banks and FDIC-assisted transactions. The prohibition and exception also apply to bank holding company and savings and loan holding company interstate acquisitions of insured depository institutions that together with affiliates control more than 10% of the total deposits in the U.S.

Securities Holding Company Registration

- *Federal Reserve Board Registration*. A securities holding company required by a foreign regulator or foreign law to be subject to comprehensive consolidated supervision may register with the Federal Reserve Board.
- *Securities Holding Company Definition*. "Securities holding company" is defined as a company that owns or controls one or more SEC-registered broker-dealers and does not include a systemically important nonbank financial company supervised by the Federal Reserve Board or other entities already subject to comprehensive supervision by the Federal Reserve Board or a foreign regulator.
- *Federal Reserve Board Supervisory Authority*. The Federal Reserve Board is permitted to examine any registered securities holding company and any affiliate and to impose capital adequacy and other risk management standards on registered securities holding companies.
- *Application of BHCA*. Registered securities holding companies are generally subject to the provisions of the BHCA, except for the restrictions on nonbanking activities and investments in Section 4 of the BHCA and except as the Federal Reserve Board may otherwise provide by regulation or order.

Other Provisions

- *Affiliate Transactions.* Existing restrictions on transactions with affiliates are enhanced, including by adding securities lending transactions and derivative transactions as "covered transactions."
- *Lending Limits on State Bank Derivatives Activities.* State banks may only engage in derivatives transactions if the law with respect to lending limits of the State in which the State bank is chartered takes into consideration credit exposure to derivative transactions.
- *Insider Lending.* Existing restrictions on lending limits to insiders are enhanced, including by expanding transactions subject to limits to include credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction.
- *De Novo Branching.* National banks are authorized to establish a *de novo* branch in another State.
- *Capital Regulations.* 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.
- *Interest on Demand Deposits.* The prohibition on paying interest on demand deposits is repealed, effectively allowing depository institutions to offer interest checking to business customers.
- *Conflicts of Interest Relating to Securitizations.* For a description of the Act's provisions relating to securitization conflicts of interest, *see* "Title IX—Investor Protections and Improvements to the Regulation of Securities—Subtitle D—Improvements to the Asset-Backed Securitization Process—Securitization Conflicts of Interest."
- *Credit Card Bank Activities.* Credit card banks are authorized to engage in credit card lending to small businesses as defined in Small Business Administration regulations.

Title VII — Over-the-Counter Derivatives

- **Regulatory Regime.** Historical CFTC/SEC regulatory structure maintained and authorities strengthened as prior statutory exemptions from regulation eliminated.
- **"Spin Out" of OTC Derivative Activities.** Limited "spin out" provision will require certain depository institutions to move their swap/SB swap operations into separately capitalized affiliates. Initial compliance period of up to 24 months for certain dealers, subject to potential extension by Federal banking agencies for up to one further year.
- **Mandatory Clearing.** Mandatory central counterparty clearing and exchange trading of swaps/SB swaps are not as comprehensive as previously proposed but nevertheless may require most transactions to be centrally cleared and traded on a regulated exchange or execution facility, depending on CFTC and SEC rule-making.
- **Exemptions.** Limited exemption from mandatory clearing and exchange trading for end-users of swaps/SB swaps.
- **Dealer and Participant Regulation.** Registration with, reporting to and regulation by CFTC, SEC and prudential regulators of swap/SB swap dealers and major swap/SB swap participants, including capital and margin requirements.
- **Trade Reporting.** Mandatory reporting of virtually all swap/SB swap transactions in real time.
- **Position Limits.** CFTC and SEC authorized to prescribe position and trading limits, potentially on a class-wide basis.
- **Duties to Special Entities.** New responsibilities of swap/SB swap dealers that act as advisors to certain governments, pensions and endowments that engage in swaps/SB swaps.
- **Preemption.** Federal preemption of State regulation of swaps/SB swaps as insurance. Federal preemption of State regulation of SB swaps regulated by the SEC (but no comprehensive preemption for swaps regulated by the CFTC) under State gaming and bucket shop laws.
- **Extraterritorial Effect.** Limited extraterritorial effect of swap/SB swap provisions.

Subtitle A — Regulation of Over-the-Counter Swaps Markets and Subtitle B — Regulation of Security-Based Swaps Markets

- *Elimination of Regulatory Exemptions.* The Act eliminates virtually all exemptions from the Federal securities and commodities laws created by the Commodity Futures Modernization Act of 2000 for OTC derivatives.
- *Bifurcated SEC/CFTC Regulation.* The Act retains the historically-based two-regulator structure within the executive branch and sets up bifurcated regulatory regimes for OTC derivatives, OTC market participants and OTC markets based on whether the OTC derivative is a swap or a security-based swap ("SB swap"). The Act gives the SEC jurisdiction over SB swaps and the CFTC jurisdiction over non-SB swaps. Participants in both swap and SB swap markets will therefore be subject to regulation by both the SEC and the CFTC, as in the case of a dually registered broker-dealer/futures commission merchant ("FCM"). The Act prohibits swaps on agricultural commodities except to the extent specifically permitted by the CFTC pursuant to its general exemptive authority or a CFTC rule or order. The base definition of a "swap" is sufficiently broad to include virtually any OTC derivative with the important exception of options on individual securities or any group or index of securities (whether broad-based

or narrow-based) and certain other limited exceptions.[1] SB swaps are then excluded from the "swap" definition. SB swaps are defined as swaps based on single securities or loans, narrow-based securities indices, and credit events with respect to single issuers or the issuers in a narrow-based securities index. Thus, as in the case of other non-option derivatives, jurisdiction over credit default swaps and total return swaps is split between the SEC and the CFTC based upon the broad-based/narrow-based distinction. Options on securities and securities indices are neither swaps nor SB swaps, but remain within the definition of a "security" under the Exchange Act and consequently remain subject broadly to regulation by the SEC.

- *Foreign Exchange.* The definition of "swap" includes foreign exchange forwards and swaps that are cleared through a derivatives clearing organization ("DCO") or traded on a designated contract market ("DCM") or swap execution facility ("SEF"). However, OTC foreign exchange forwards or swaps that are not cleared or traded through one of these facilities may be excluded from the requirements of Title VII if the Treasury Secretary determines that they should not be regulated as swaps under Title VII and they were not structured to evade Title VII in violation of a rule adopted by the CFTC. Such foreign exchange forwards and swaps must nevertheless be reported to a swap data repository. In addition, any swap dealer or major swap participant entering into such trades will be subject to business conduct rules. Agreements, contracts or transactions in foreign currency offered or sold to retail investors will continue to be subject to existing CFTC requirements.
- *New Regulation of OTC Dealers and Market Participants.* New substantive regulatory regimes will apply to swap/SB swap dealers and major swap/SB swap participants ("regulated swap entities"). The new regimes include registration with the applicable regulator, record-keeping, reporting, supervision, position limits, business conduct standards, disclosure, balanced communication, restrictions on conflicts of interest, capital and margin requirements, and examination provisions, among other broad areas in which the CFTC and SEC are required to regulate. Each regulated swap entity will be required to appoint a compliance officer.
  - The new regulatory categories are independent of existing regulatory categories, so investment advisers, broker-dealers, banks, other dealers, CTAs, CPOs and FCMs that engage in transactions in swaps or SB swaps would generally be required to register and be regulated under the new categories as well.
  - The Act does not include an express requirement that associated persons ("APs") of regulated swap entities register with the CFTC or SEC. It is possible that the SEC and/or CFTC will use their broad rule-making authority to require APs to register or to pass qualifying exams in order to be associated with a regulated swap entity.
  - Certain parties to swaps/SB swaps, even though they do not act as dealers, may nevertheless be subject to registration and regulation under the new major swap/SB swap participant categories, which include:
    - Any market participant with a "substantial position" in swaps/SB swaps in any category specified by the CFTC or SEC, respectively (excluding certain positions that hedge or mitigate commercial risk);
    - Any market participant with substantial counterparty exposure that could have serious adverse effects on U.S. financial stability; and

[1] Other exclusions from the base definition include exchange traded futures contracts and commodity options; physically-settled forwards; exchange traded options on currencies; certain securities contracts; foreign exchange swaps and forwards; and counterparty transactions with a Federal Reserve Bank, the U.S. government or an agency backed by the full faith and credit of the United States.

    - Any financial entity[2] that is highly leveraged, is not subject to capital requirements established by an appropriate Federal banking regulator and maintains a substantial position in outstanding swaps in any categories specified by the CFTC or SEC, respectively.
    - The second (substantial counterparty exposure) and third (highly leveraged financial companies) categories do not establish distinctions in the scope of regulation based on whether outstanding positions are held for hedging or mitigating commercial risk. Category two could therefore capture non-financial operating companies that engage in no speculative OTC derivatives trading, but merely use OTC derivatives to hedge commercial risks, and category three could capture investment funds that use OTC derivatives solely to hedge non-OTC positions.

- *No Express Grandfathering from Registration, Substantive Regulation, Capitalization and Margining.* The Act could require market participants with legacy swap/SB swap positions but no ongoing involvement in the swap/SB swap markets to register and become subject to substantive regulation, including minimum capitalization and initial and variation margin requirements for outstanding non-cleared swap/SB swap positions. Minimum capital and margin requirements for major swap/SB swap participants will be set by the respective prudential regulators with respect to those participants subject to regulation by the prudential regulators and by the CFTC or SEC, as appropriate, with respect to all other major swap/SB swap participants. Margin and capital requirements must be appropriate for the risk associated with the positions held by the participant.
- *Risk Disclosure to Unregulated Counterparties.* The Act requires a regulated swap entity to disclose to a counterparty that is not a regulated swap entity the material risks and characteristics of swaps/SB swaps, conflicts of interest, and receipt of daily marks of the transaction from the clearinghouse (for cleared swaps/SB swaps) or the regulated swap entity (for non-cleared swaps).
- *Agency Information Gathering.* The Act gives the CFTC and SEC broad authority to gather information about swaps and SB swaps, respectively.
- *Preemption of State Regulation as Insurance.* The Act provides that neither swaps nor SB swaps may be regulated as insurance under State law. Although this provision is helpful in preventing conflict between Federal and State law with respect to traditional OTC derivatives, such as credit default swaps, that have recently come under scrutiny by State insurance regulators, this new preemption could have unexpected consequences with respect to traditional insurance products that arguably fall within the broad definitions of swap and SB swap under Title VII, with the effect that State insurance regulators could arguably be prevented from exercising jurisdiction over such insurance products.
- *Prohibition against Federal Assistance to Swaps Entities.* Section 716 of the Act, often referred to as the derivatives "spin out" or "push out" provision was significantly revised in the final hours leading up to adoption of the Conference Report. Section 716 prohibits "Federal assistance" to any "swaps entity" with respect to any swap, security-based swap or other activity of the swaps entity. However, the definition of "swaps entity" has been narrowed substantially from previous proposals (with additional exceptions based upon the type of entity and its regulation by a prudential regulator). Compliance periods have also been put in place to attempt to limit disruption to those entities that will be subject to Section 716.
    - "Federal assistance" is defined broadly and generally includes any resort to Federal Reserve lending facilities (other than facilities with broad-based eligibility), including the Federal Reserve discount window, as well as reliance on FDIC insurance, for the purpose of: (1) making any loan to, or purchasing any stock, equity interest or debt obligation of, any swaps entity, (2) purchasing the assets of any swaps entity, (3) guaranteeing

[2] "Financial entity" is a broad term that includes an insurance company, a domestic or foreign central bank or government-owned or sponsored enterprise, a development bank or similar international organization, a non-dealer bank, a pension fund, a non-bank mortgage lender, a credit union or other lending cooperative, a hedge fund, commodity pool or an advisor to any of the foregoing.

any loan or debt issuance of any swaps entity or (4) entering into any assistance arrangement (including tax breaks), loss sharing or profit sharing with any swaps entity.

- "Swaps entity" has the same definition as "regulated swap entity,"[3] except that it excludes: (1) any major swap/SB swap participant that is an insured depository institution and (2) any insured depository institution or covered financial company in conservatorship or receivership, or a bridge bank operated by the FDIC.
- The prohibition on Federal assistance to a swaps entity does not apply to:
  - An affiliate of an insured depository institution if the depository institution is "part of" a bank holding company or savings and loan holding company. Such affiliate must comply with Section 23A and 23B of the Federal Reserve Act, as well as any requirements of the CFTC, SEC and Federal Reserve Board.
  - An insured depository institution that limits its swaps/SB swaps activities to hedging and other risk mitigating activities directly related to the insured depository institution's activities, and acting as a swaps entity for swaps/SB swaps involving rates or reference assets that are permissible for investment by a national bank under the National Bank Act (excluding CDS that are not cleared by a DCO or clearing agency). In essence, this exclusion aims to allow insured depository institutions to continue to engage in swap/SB swap activities (other than non-cleared CDS transactions) to substantially the same degree that such institutions can engage in cash market transactions on assets that are bank-eligible under the OCC's established eligibility rules.
- *Transition Period.* The Section 716 prohibition on Federal assistance to swaps entities does not apply to swaps/SB swaps entered into by a depository institution prior to the end of a transition period to be determined by the appropriate Federal banking agencies (after consulting with and considering the views of the CFTC and SEC). This transition period will be up to 24 months, during which the insured depository institution may divest itself of, or cease to, conduct the activities that would otherwise require it to be registered as a swaps entity. The Federal banking agencies may extend the foregoing transition period for up to an additional year. The Section 716 prohibition will not be effective until two years after the effective date of the Act.
- *Prohibition on Unregulated Combination of Swaps Entities and Banking.* Following adoption of rules by the prudential regulators, Section 716 will prohibit a bank or bank holding company from being or becoming a swap entity unless it conducts its swap or SB swap activities in compliance with minimum standards set by its prudential regulator as are reasonably calculated to permit the swaps entity to conduct its swap or SB swap activities in a safe and sound manner and to mitigate systemic risk.
- *Required Liquidation of Certain Swaps Entities and Termination or Transfer of Swap/SB Swap Activity.* Section 716 requires that any FDIC-insured swaps entity or swaps entity subject to heightened prudential supervision under Section 113 of the Act (*i.e.*, "Designated Company swaps entities") that is put into receivership or declared insolvent as a result of swap or SB swap activity must have its swap or SB swap activity terminated or transferred. Any funds expended on the termination or transfer of the swap or SB swap activity of a swap entity is required to be recovered out of the disposition of the swaps entity's assets or through assessments, including assessments on the financial sector. The Act also prohibits: (1) "taxpayer funds" from being used to prevent receivership of *any* swap entity resulting from swap or SB swap activity (note that this prohibition is not limited to FDIC-insured and Designated Company swaps entities) and (2) "taxpayer resources" from being used for the orderly liquidation of any swaps entity that is neither an FDIC-insured institution, nor a Designated Company swaps entity. The terms "taxpayer funds" and "taxpayer resources" are not defined under the Act, raising potentially serious interpretive issues over whether certain forms of "Federal assistance"

[3] The term "regulated swap entity" is used for convenience herein but is not a defined term under the Act.

(most notably reliance on FDIC insurance) could constitute a use of "taxpayer funds" or "taxpayer resources." The absence of definitions for such terms is particularly important in that the prohibitions on use of taxpayer funds and taxpayer resources are not subject to the transition period described above. It is also unclear whether "taxpayer funds" and "taxpayer resources" should be read as being equivalent to each other.

  - *Prohibition on Taxpayer Losses.* Section 716 includes a provision that states that "taxpayers shall bear no losses from the exercise of any authority under [Title VII]." The meaning of this provision and its impact on other provisions of Section 716 and Title VII in general is unclear.
  - *Oversight Council Override.* If the Oversight Council determines that other provisions of the Act are "insufficient to effectively mitigate systemic risk and protect taxpayers," it can prohibit swaps entities from accessing Federal assistance with respect to any swap, SB swap or other activity of the swaps entity. Such an override of the limitations on the Section 716 prohibition would be made on an *institution-by-institution* basis and require the vote of at least two-thirds of the members of the council, as well as the votes of the chairpersons of each of the Oversight Council, the Federal Reserve Board and the FDIC. Any such determination will be subject to notice and hearing requirements consistent with the standards provided in Title I of the Act.

- *Registration of Holders of Collateral.* The Act requires any person that accepts collateral in connection with a swap cleared through the facilities of a DCO to be registered with the CFTC as an FCM. It requires any person that accepts collateral in connection with an SB swap to be registered with the SEC *either* as a broker-dealer or as a SB swap dealer. These requirements are applicable to *any person* that accepts money, securities or property to margin, guarantee or secure a cleared swap/SB swap, whether or not the party holding the collateral has any other involvement in the trade. This could be interpreted to mean that third-party custodians will be required to register in the applicable capacity to hold swap/SB swap collateral. An SB swap dealer may hold customer funds without registration as a broker-dealer, but a swap dealer (*i.e.*, a non-SB swap dealer) must also be registered as an FCM to hold customer property. This is one of the few areas in which the rules for swaps and SB-swaps are not parallel under the Act. An FCM, broker-dealer or SB swap dealer, as applicable, is required to treat and deal with swap/SB swap collateral of customers as belonging to those customers and may not commingle such property with its own property or the property of other non-swap/SB swap customers. The CFTC retains the authority to issue orders permitting the commingling of property of swap and futures customers if it deems appropriate.

- *Clarification of Bankruptcy Treatment of Cleared Swaps.* The Act adds a new provision to the Commodity Exchange Act that provides that swaps that are cleared through a DCO are "commodity contracts" for purposes of Section 761 of Title 11 of the Bankruptcy Code, with regard to property of any swaps customer received by an FCM or DCO. This is an important provision because it clarifies that customers of an insolvent FCM or participants in an insolvent DCO would be given priority over other creditors with respect to claims arising from cleared swaps in a manner that is similar to the treatment of customer claims arising from futures contracts and commodity options. Although the CFTC has taken the position in both an interpretive release and a formal rule-making that cleared OTC derivatives should be considered "commodity contracts," this provision of the Act is intended to end lingering uncertainty about the issue. Further steps are needed to clarify the bankruptcy treatment of cleared SB swaps in the event of the insolvency of an SB swaps dealer or central counterparty.

- *Segregation of Collateral.* Outstanding swaps and SB swaps will be subject to new collateral segregation requirements. A trader that is not a regulated swap entity and that posts collateral to a counterparty that is a regulated swap entity in connection with a non-cleared swap or SB swap may require the regulated swap entity counterparty to segregate its initial margin in an account separate from the assets of the regulated swap entity. This account must be held with an independent third-party custodian. If the counterparty that is not a regulated swap entity does not opt to have its initial margin segregated, the regulated swap entity must make quarterly reports to its counterparty indicating that the regulated swap entity's back office procedures are in compliance with the agreement of the parties. The Act does not indicate whether a non-regulated swap entity will be given only a one-time option to

require segregation of initial margin posted to a regulated swap entity or whether the non-regulated counterparty will be able to change its election over the life of either a trade or an associated master agreement governing ongoing trades. Given that certain swaps and SB swaps can have very long durations and master agreements do not generally have defined maturity or termination dates, this will be an important area for clarification by the regulators. It is not clear what will be considered "back office" procedures under the Act, and this is potentially another area in which the regulators may provide clarification.

- *Mandatory Clearing through Regulated Central Counterparty*. The Act requires swaps and SB swaps to be submitted to a DCO or clearing agency, respectively, if the swap/SB swap belongs to a category of swap/SB swap that a DCO/clearing agency has been approved to clear, provided that the CFTC or SEC, as applicable, has mandated that such category of swaps/SB swaps be cleared.
  - Although no new regulatory category is created for clearing organizations that clear swaps or SB swaps, DCOs and clearing agencies will be subject to significant new requirements, including more extensive "core principles" and a requirement that they offer clearing services to unaffiliated SEFs and exchanges on a nondiscriminatory basis.
  - DCOs and clearing agencies that seek to clear swaps or SB swaps will be required to submit proposals to the CFTC or SEC, respectively, for prior approval.
  - The CFTC and SEC must conduct an ongoing review of each category of swaps/SB swaps to determine whether such swaps/SB swaps must be cleared. If the CFTC or SEC determines that a swap/SB swap should be subject to the mandatory clearing requirement but no DCO or clearing agency has "listed" the swap/SB swap for clearing, the applicable agency is required to investigate, issue a report, and take such actions as it determines to be "necessary and in the public interest," including imposing margin or capital requirements on the parties to such swaps/SB swaps. Note that this authority to impose capital and margin requirements is not limited to regulated swap entities.
  - The Act contains no express authority for the agencies to require a clearing organization to accept any category or class of swaps/SB swaps for clearing, and the agencies are specifically not authorized to require a clearing organization to clear any category or class of swaps/SB swaps if it would "threaten the financial integrity" of the clearing organization. While this appears to be a very limited restraint on the coercive power of the agencies, it seems doubtful that a clearinghouse could be compelled to clear a product against its will absent specific authority. On the other hand, the Act assumes that the CFTC or SEC, as applicable, would have authority to enforce the non-discrimination requirement.
  - The Act exempts swaps/SB swaps entered into before enactment of Title VII or before application of a clearing requirement (*i.e.*, "legacy swaps") from the mandatory clearing requirement if they comply with applicable reporting requirements under the Act. The mandatory clearing requirements will go into effect no sooner than 360 days after enactment of the Act, but the clearing requirement will not apply until the applicable regulator has mandated clearing of the swap/SB swap or group of swaps/SB swaps and until a DCO or clearing agency, as applicable, has obtained permission from the regulatory agency to clear the swap/SB swap.
  - The Act requires the CFTC and SEC to prescribe rules to prevent evasions of the Act's mandatory clearing requirements.
- *End-User Exemption*. The Act's mandatory clearing requirement does not apply to a swap/SB swap if one of the counterparties to the swap/SB swap (*i.e.*, the end-user) is not a financial entity, is using swaps/SB swaps to hedge or mitigate commercial risk, notifies the CFTC/SEC how it generally meets its financial obligations associated with entering into non-cleared swaps, and opts out of mandatory clearing. The SEC and CFTC must also consider whether to exempt certain small banks, savings associations, farm credit system institutions and credit unions from

the mandatory clearing requirement. Note that "financial entity" is a fairly broad term that includes all regulated swap entities, commodity pools, private funds (*e.g.*, hedge funds and private equity 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 from the mandatory clearing requirement was a major point of contention in debates about the Act.

- *Captive Financing Companies*. An affiliate of an end-user that meets the end-user exemption described in the preceding paragraph (including an affiliate that is predominately engaged in providing financing for the purchase of the merchandise or manufactured goods of the end user (*i.e.*, a "captive financing company")) may itself rely on the end-user clearing exemption if the captive financing company, acting as agent on behalf of the end-user, uses the swap or SB swap to hedge or mitigate the commercial risk of the end-user or another affiliate of the end-user that is not a financial entity. Swap/SB swap dealers, major swap/SB swap participants, private funds, commodity pools and bank holding companies with over $50 billion in consolidated assets would not be eligible to rely on the exemption.
- *Optional Clearing*. It is possible that some categories of swaps/SB swaps will be accepted for clearing by a clearing organization but will not be subject to mandatory clearing. However, such a swap/SB swap must be cleared if it is entered into by a regulated swap entity with an end-user counterparty and the end-user counterparty elects to require clearing. If the end-user opts into clearing, the end-user has the sole right to select which clearinghouse is used.
- *Mandatory Exchange Trading*. Swaps and SB swaps that are subject to mandatory clearing must also be executed on a DCM, national securities exchange, registered or exempt SEF or registered or exempt SB-SEF, as applicable.
  - SEFs and SB-SEFs are facilities, trading systems or platforms in which multiple participants have the ability to execute or trade swaps/SB swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, including any trading facility that facilitates the execution of swaps/SB swaps between persons.
  - The terms "facility," "trading system" and "platform" are not defined under the Act. Therefore, the definitions of SEF and SB-SEF in the Act may be sufficiently broad to include so-called "voice brokers," thus potentially permitting such an entity to register and be regulated as an SEF or SB-SEF using its existing business model (subject to favorable agency interpretation of the core principles and approval of its rules).
- *Exceptions to Exchange-Trading Requirement*. The mandatory exchange-trading requirement will not apply if no such facility lists the swap/SB swap for trading or if the transaction is subject to the end-user exemption described above.
- *Clarification that Certain Swaps are not Treated as Section 1256 Contracts*. Section 1603 of the Act amends Section 1256 of the Internal Revenue Code to exclude from the definition of a Section 1256 contract "any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement." Thus the timing and character of income and expense from these common types of swaps will continue as under current law and will not be affected by being executed on a qualified exchange.
- *Approval of Exemptions by Public Companies*. The appropriate committee of a public company's board or governing body must review and approve any decision to rely on an exemption from the mandatory clearing or exchange-trading requirements of the Act.
- *Margin and Capital Requirements for Non-Cleared Trades*. The Act gives the CFTC and SEC (and prudential regulators with respect to those parties that have a prudential regulator) broad authority to impose capital requirements and both initial and variation margin requirements on non-cleared swaps/SB swaps. The intent of these provisions is

less than completely clear, however. It is unclear who must deposit margin with whom. In existing markets, dealers ordinarily obtain collateral from non-dealer counterparties, but the non-dealer counterparties are much less likely to obtain collateral from the dealer. Other provisions of the Act, however, give counterparties the right to require collateral, but do not compel them to do so. The Act provides no express guidance on whether non-cleared legacy swaps will be subject to margin requirements. The mandate on the regulators to adopt rules requiring margin could be interpreted as allowing no exceptions for legacy swaps, although it is not clear that they must be so interpreted. In any event, no margin requirements will exist until the agencies adopt rules that further define the scope of the requirements.

- *Reporting of Non-Cleared Trades*. The Act requires both parties to a non-cleared swap/SB swap to report the transaction either to a "swap data repository" (a new regulatory category) or to the CFTC or SEC, as applicable. Legacy positions will be exempt from mandatory clearing as long as they are appropriately reported. However, there is no similar exemption from possible agency-imposed margin and capital requirements.
- *Transparency into OTC Markets*. The Act requires the CFTC and SEC to provide for real-time public reporting of data with respect to virtually all swaps/SB swaps, whether or not they are cleared, required to be cleared or exempt from clearing. The specific data required to be reported will be determined by agency rule-making.
- *Position Limits*. The Act provides new authority to the CFTC and SEC to set position and trading limits.
    - The Act expands the CFTC's existing authority to set aggregate position limits and trading limits for futures contracts to include limits on transactions in swaps that perform or effect a significant price discovery function with respect to registered entities. The Act also authorizes the CFTC to impose position limits on the amount of a commodity across the futures and swaps markets that can be bought by any person, including a group or "class" (an undefined term) of trader. This power could effectively allow the CFTC to limit futures and swaps positions that unaffiliated traders of the same "class" are permitted to acquire, *e.g.*, the CFTC could impose position limits on a class of unaffiliated index traders in an effort to control what the CFTC may perceive as price fluctuations that the agency does not deem to be appropriate.
    - The CFTC is also required to establish limits on the amount of positions, other than bona fide hedge positions, that may be held by any person with respect to futures contracts, options on futures contracts or commodities traded on or subject to the rules of a DCM. These limits may be set with respect to the spot month, other months, or aggregated across all months. Notwithstanding the longer global rule-making timeframe under Title VII of the Act (as discussed below), these position limits must be established within 180 days of enactment of the Act with respect to "exempt commodities" (*e.g.*, metals and petroleum products) and within 270 days of enactment of the Act with respect to agricultural commodities.
    - The Act requires the CFTC to establish position limits on the amount of positions, including aggregate position limits, other than bona fide hedge positions, that may be held by any person with respect to swaps that are economically equivalent to futures or options on futures. The CFTC may also set aggregate monthly position limits for positions in contracts on the same underlying commodity held by any person, group or class of traders.
    - The Act requires the SEC to establish limits (including related hedge exemption provisions) on the size of positions in any SB swap that may be held by any person. The SEC may require any person to aggregate positions in an SB swap with positions in related securities or loans. The SEC may also direct a self-regulatory organization ("SRO"), such as the Financial Industry Regulatory Authority ("FINRA"), to establish position limits applicable to the SRO's members.
- *Large Traders and Position Limits*. The Act creates a new large swap/SB swap trader reporting regime that will apply to market participants that are not otherwise regulated swap entities.

- *Responsibilities to Certain Entities.* The Act imposes special requirements on swap/SB swap dealers and major swap/SB swap participants with respect to swaps entered into with any Federal agency, State, State agency, city, county, municipality, other political subdivision of a State, employee benefit plan, government plan or endowment (each, a "special entity"), as follows:
  - Prohibitions on fraud, deception and manipulation (applicable to a regulated swaps entity that *acts as adviser* to a special entity with respect to a swap/SB swap). This new provision does not seem to require proof of scienter to establish liability, merely that that act or practice operates as a fraud or deceit as to the special entity.
  - Duty to act in the best interests of the special entity and to obtain information necessary to determine that a swap/SB swap is in the best interests of the special entity (applicable *only* to a swap/SB swap dealer that *acts as adviser* to a special entity with respect to a swap/SB swap).
  - CFTC- or SEC-mandated duty to have a reasonable basis to believe that the counterparty has an independent representative (applicable to each swap/SB swap dealer or major swap/SB swap participant that offers to enter into or enters into a swap/SB swap with a *government* special entity). The independent representative must: (1) have sufficient knowledge to evaluate the transaction and its risks, (2) not be subject to a statutory disqualification, (3) be independent of the swap/SB swap dealer or major swap/SB swap participant, (4) undertake to act in the best interests of the counterparty that it represents, (5) make "appropriate disclosures," (6) provide written representations to the special entity regarding fair pricing and the appropriateness of the transaction and (7) in the case of a special entity that is an employee benefit plan subject to ERISA, must be a fiduciary.
  - Duty to disclose to the special entity, before initiation of a transaction, the capacity in which the swap/SB swap dealer is acting (applicable to each swap/SB swap dealer that offers to enter into or enters into a swap/SB swap with a special entity).
- *Destabilizing Swaps/SB Swaps.* The CFTC or the SEC may collect information concerning the markets for any types of swaps or SB swaps and issue a report on any swaps/SB swaps that they determine to be detrimental to the stability of a financial market or participants in a financial market. Note that this provision, as drafted, would allow the SEC to report on swaps or the CFTC to report on SB swaps, which diverges from the Act's general bifurcated approach to swaps and SB swaps.
- *Portfolio Margining.* The Act amends the Exchange Act and the Commodity Exchange Act to allow for portfolio margining accounts to be carried by a dually-registered FCM/broker-dealer either as securities accounts or as futures accounts. These provisions, which rely primarily on existing exemptive authority, are designed to facilitate the comingling of futures and securities in a single account. The development of portfolio margining has been identified by many industry participants as an important goal of modernizing the futures and securities regulatory framework in the United States. Related provisions in Title IX of the Act amend SIPA to facilitate portfolio margining in securities accounts.
- *Ban on Motion Picture Box Office Futures.* The Act amends the definition of "commodity" in the Commodity Exchange Act to exclude motion picture box office receipts (or any index, measure, value or data related to such receipts). The definition had previously excluded only onions and will continue to exclude onions if the Act is enacted. The exclusion of motion picture box office receipts is retroactive to June 1, 2010. The CFTC approved the first listing of motion picture box office receipt futures contracts in June; however, such contracts will become unlawful notwithstanding the CFTC's approval if the Act is enacted in its current form.
- *Extraterritorial Effect.* The Act's provisions on swaps and SB swaps do not generally apply to activities outside the United States; however, the provisions of Subtitle A of Title VII relating to swaps do apply to activities outside the United States that: (1) have a direct and significant connection with activities in, or effect on, commerce of the

United States or (2) contravene CFTC anti-evasion rules, and the provisions of Subtitle B of Title VII relating to SB swaps do apply to persons that transact SB swap business without the jurisdiction of the United States in contravention of SEC anti-evasion rules. The CFTC and SEC are empowered (but not required) to implement such rules as they deem necessary or appropriate to prevent evasion of any provision of the Commodity Exchange Act or Exchange Act, respectively, added by Title VII of the Act. The differing limitations on the territorial scope of the swaps and SB swaps provisions of Title VII are the result of the CFTC's and SEC's historically divergent statutory authorities for and approaches to extraterritoriality, but the practical impact of these differences remains to be seen.

- *Foreign Swaps Regulatory Schemes*. If the CFTC or the SEC determines that the regulation of swaps or SB swaps markets in a foreign country undermines the stability of the U.S. financial system, the agency may, in consultation with the Treasury Secretary, prohibit an entity domiciled in the foreign country from participating in the United States in any swap or SB swap activities.
- *Preemption of State Law*. The Act repeals the current preemption of State gaming and bucket shop laws that applies under the Commodity Exchange Act to certain OTC derivatives entered into by eligible contract participants. The Act does not contain any express comprehensive preemption for swaps, potentially creating uncertainty as to the legality of some swaps under State laws even if transacted between eligible contract participants. The Act does include new preemption of State gaming and bucket shop laws with respect to SB swaps between eligible contract participants or effected on a national securities exchange.
- *Change of Law Provisions in Legacy Swaps*. The Act provides that, unless "specifically" reserved in an applicable swap, neither the enactment of the Act, nor the application of any requirement under the Act or an amendment made by the Act, will constitute a termination event or similar event that would allow a party to terminate, renegotiate, modify, amend or supplement transactions under the swap. This is a very important provision of the bill in that it arguably implicates the "Illegality" termination event provision contained in standard master agreement documentation that is in widespread use in the OTC derivatives market, as well as additional termination event provisions for which market participants routinely bargain. In the absence of the Act's specificity requirement, the application of various provisions of Title VII to one or both parties to such an agreement could result in a party being construed to be allowed to terminate such an agreement – a result that was probably intended by the drafters of such standard master agreement forms and likely also reflects the intent of most of the parties that use such agreements, particularly those that have incorporated such additional termination event provisions. Whether this provision of Title VII will operate to prevent a wide swath of OTC derivate transactions from being subject to early termination (and attendant marking to market of terminated transactions, as would generally apply in such circumstances) remains to be seen. Given that enactment of the Act constitutes a significant shift in the regulatory environment that few parties could have anticipated well in advance, this "anti-event" provision seems particularly onerous. In addition, the Act provides no guidance on how "specific" a provision of applicable trading documentation would need to be in order for it to remain effective under the Act to allow for early termination of transactions. Some type of market-wide, voluntary protocol could well emerge from the efforts of major market participants and trade associations in this area to reduce the degree of economic uncertainty that is attendant to such interpretive ambiguities.
- *CFTC Anti-Manipulation Authority*. The Act gives the CFTC explicit anti-market manipulation authority with respect to swaps in addition to its current authority over futures and cash market transactions. This amendment effectively codifies authority the CFTC has successfully asserted under existing law in various enforcement actions commenced against OTC energy traders in recent years.
- *Studies*. Title VII calls for the CFTC and SEC to conduct several major studies and report the results to Congress. These studies include: (1) a CFTC study on the effects of position limits on excessive speculation and on movement of transactions from U.S. exchange to non-U.S. trading venues, (2) a joint CFTC/SEC study on the

feasibility of requiring use of standardized algorithmic descriptions for financial derivatives, (3) a joint CFTC/SEC study on swap and clearinghouse regulation in the United States, Asia and Europe and (4) a joint CFTC/SEC study on whether "stable value contracts" are "swaps." These studies may or may not lead to future legislative or regulatory changes. The Act also creates an inter-agency working group to study oversight of the carbon markets, as well as an energy and environmental markets advisory committee within the CFTC.

- *Jurisdictional Boundaries.* The Act requires the CFTC and the Federal Energy Regulatory Commission ("FERC") to negotiate a memorandum of understanding to establish procedures for applying their respective authorities in an efficient manner, resolve conflicts concerning overlapping jurisdiction, and avoid conflicting or duplicative regulation. The CFTC and FERC are also required to negotiate a memorandum of understanding regarding information sharing in investigations into potential manipulation, fraud or market power abuse cases. The Act includes provisions clarifying the jurisdictional boundary between the CFTC and FERC.
- *International Harmonization.* The Act requires the CFTC, SEC and prudential regulators to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards for the regulation of swaps, SB swaps and regulated swap entities. The Act also requires the CFTC to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards for regulation of futures contracts and options on futures contracts. The agencies may enter into information sharing arrangements to facilitate this consultation and coordination. Interestingly, the Act does not include a provision requiring the SEC to consult and coordinate with foreign regulators with respect to regulation of the securities markets.
- *Global Rule-making Timeframe and Effective Date.* Unless otherwise provided in Title VII, the provisions of Title VII will be effective 360 days after the date of enactment. To the extent any provision of Title VII requires rule-making, such provision will be effective not less than 60 days after publication of the final implementing regulation. Many of the provisions of the Act are not self-actuating and require some action by the applicable regulatory agencies before they will be effective.

Title VIII — Payment, Clearing and Settlement Supervision

- Broad authority granted to the Federal Reserve Board, SEC and CFTC to set standards for, and oversee risk management by, financial market utilities and payment, clearing and settlement activities of financial institutions designated by the Oversight Council as systemically important.
- Federal Reserve Board must generally act through or in conjunction with the primary supervisory agency having jurisdiction over the entity—*e.g.*, the SEC, CFTC or applicable Federal banking agency. SEC and CFTC have primary authority with respect to entities subject to their jurisdiction.
- Designated financial market utilities (including certain clearinghouses) are required to provide advance notice to supervisory agencies of proposed changes to rules, procedures or operations that could materially affect risk.
- New examination and enforcement authorities are granted to the principal supervisory agencies, as well as authority to prescribe reporting and record-keeping requirements.
- Oversight authority extends to financial institutions other than clearing organizations that provide systemically important services in connection with the clearing, payment and settlement activities and to certain service providers to designated financial market utilities.
- Title VIII will become effective upon enactment. Although relevant regulatory agencies are granted broad rule-making authority, Title VIII specifies no time frame for adopting rules.

New Oversight Authorities

- Title VIII of the Act grants broad new authorities to the Oversight Council, Federal Reserve Board, SEC and CFTC with respect to financial market utilities and payment, clearing and settlement activities conducted by financial institutions. These new authorities will affect not only entities such as clearinghouses that are already subject to extensive Federal government regulation, but also activities conducted by other financial institutions that may otherwise be subject to more limited Federal government oversight.

Designation of Financial Market Utilities and Payment, Clearing or Settlement Activities as Systemically Important

- The Oversight Council, by a two-thirds vote of its members may designate as "systemically important," or likely to become "systemically important": (1) any person that manages or operates any multilateral system for the purpose of transferring, clearing or settling payments, securities or other financial transactions among financial institutions or between financial institutions and such person (a "designated financial market utility") or (2) any payment, clearing or settlement activity, excluding offers and sales of securities and any quotation, order entry, negotiation and other pre-trade activity (a "designated activity") conducted by financial institutions.
  - A "designated activity" includes any payment, clearing or settlement activity (carried out by one or more financial institutions to facilitate the completion of "financial transactions") that the Oversight Council has designated as systemically important.
  - A "financial transaction" includes funds transfers, securities and futures contracts, forwards, repos, OTC derivatives, foreign exchange contracts and similar transactions. Financial transactions may include calculation and communication of unsettled financial transactions between counterparties, netting of transactions, provision and maintenance of trade, contract or instrument information, the management of risks and activities associated with continuing financial transactions, transmittal and storage of payment instructions, movement of funds, final settlement of financial transactions and other similar functions.

  - "Systemic importance" means any situation where the failure of, or a disruption to, the functioning of a financial market utility or the conduct of a payment, clearing or settlement activity could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States.
  - A "financial institution" includes a variety of depository institutions, financial intermediaries and other companies engaged in financial activities, but excludes regulated securities, futures, swap and SB swap markets, SEC- or CFTC-regulated clearinghouses and certain other regulated entities.

Risk Management Standards

- Title VIII authorizes the Federal Reserve Board, in consultation with the Oversight Council and the other supervisory agencies, to prescribe risk management standards applicable to designated financial market utilities and designated activities of financial institutions except that the initial responsibility for setting standards for SEC- and CFTC-regulated clearinghouses and other financial institutions for which they are otherwise the supervisory agency rests with the applicable supervisory agency. If the Federal Reserve Board determines that prudential requirements of the SEC or CFTC are insufficient, a review process is initiated with the Council as final arbiter.
  - The Act directs the Federal Reserve Board to establish thresholds at which a financial institution's conduct will be subject to risk management standards pursuant to the authorities granted under Title VIII.
  - The risk management standards prescribed pursuant to Title VIII for designated financial market utilities and designated activities may address such areas as margin and collateral requirements, participant or counterparty default policies and procedures, the ability to complete timely clearing and settlement of financial transactions, and capital and financial resource requirements for designated financial market utilities.

Advance Notice of Changes to Rules, Procedures or Operations

- Title VIII requires a designated financial market utility to provide 60 days advance notice to its supervisory agency of any proposed change to its rules, procedures or operations that could materially affect the nature or level of risks presented by the designated financial market utility. If the supervisory agency objects to the change within 60 days, the designated financial market utility may not make the change. The Act also provides the ability for a designated financial market utility to implement rule changes on an accelerated basis in the case of an emergency.

Annual Examinations

- The applicable supervisory agency for a designated financial market utility must conduct annual examinations of the designated financial market utility. Supervisory agencies may examine the provision of services integral to the operation of the designated financial market utility by outside service providers and the compliance of these services with applicable regulations. Additionally, supervisory agencies must consult annually with the Federal Reserve Board and the Federal Reserve Board may participate in examinations of designated financial market utilities, although the supervisory agencies will lead all such examinations.

Enforcement Authority

- The Federal Reserve Board may, after consulting with the Oversight Council and the applicable supervisory agency, recommend that the supervisory agency take enforcement action against a designated financial market utility. If the supervisory agency refuses to act in the manner recommended, the Federal Reserve Board may refer the matter to the Oversight Council for a binding decision on whether enforcement action is warranted, and if the Oversight Council determines that action is warranted, it may require the supervisory agency to take enforcement action. The Federal Reserve Board may also, after consulting with the supervisory agency and upon an affirmative

majority vote of the Oversight Council, take emergency enforcement action against a designated financial market utility.

Examination of and Enforcement against Financial Institutions

- Title VIII authorizes the appropriate Federal financial regulator to examine a financial institution that is subject to heightened risk management standards under Title VIII with respect to a designated activity. The Federal Reserve Board may also participate in or conduct such examinations if requested to do so by the appropriate financial regulator. The financial regulators also have enforcement authority with respect to such financial institutions. The Federal Reserve Board may exercise this enforcement authority if requested to do so by the financial regulator.

Backup Authority

- The Federal Reserve Board also has backup examination and enforcement authority with respect to financial institutions subject to heightened risk management standards with respect to a designated activity. After obtaining the approval of the Oversight Council and the supervisory agencies, the Federal Reserve Board may take emergency enforcement action against such a financial institution, if the financial institution's non-compliance poses significant liquidity, credit, operational or other risks to the financial markets or U.S. financial stability.

Information Gathering and Reporting

- The Oversight Council is authorized to require any financial market utility or financial institution to submit information to the Oversight Council for the purpose of making the required systemic importance determinations. The Oversight Council and the Federal Reserve Board may require reporting by designated financial market utilities and financial institutions engaged in designated activities. The Federal Reserve Board may, upon a majority vote of the Oversight Council, impose record-keeping or reporting requirements on SEC- or CFTC-regulated clearinghouses and financial institutions engaged in designated activities.

Consultation with the Federal Reserve Board

- Title VIII requires the SEC and CFTC to consult with the Federal Reserve Board before exercising certain new authorities granted by Title VII with respect to clearing of SB swaps and swaps, as well as other Title VII authorities.

Report on Common Clearing Entity Risk Management Framework

- The Act requires the SEC and CFTC to coordinate with the Federal Reserve Board to jointly develop risk management supervision programs for SEC- and CFTC-regulated clearinghouses. Not later than one year after enactment of the Act, the SEC, CFTC and Federal Reserve Board are required to jointly submit a report to the applicable committees of the House and Senate providing recommendations.

Access to the Discount Window

- Title VIII provides that the Federal Reserve Board may authorize a Federal Reserve Bank to maintain accounts for, and provide certain services to, designated financial market utilities similar to those provided to depository institutions. Despite some political controversy, the Federal Reserve Board, after consultation with the Treasury Secretary, may authorize access to the discount window by, and provide borrowing privileges to, designated financial market utilities, including those that clear swaps or SB swaps, in unusual or exigent circumstances upon a vote of a majority of the Federal Reserve Board then and a showing that the designated financial market utility is unable to secure other sources of credit.

Title IX — Investor Protections and Improvements to the Regulation of Securities

- **Fiduciary Duty.** After conducting a study, the SEC is empowered to impose a higher standard of care (*i.e.,* a fiduciary duty) on brokers and dealers that provide personalized investment advice to retail investors. If the SEC decides to impose such a duty, brokers and dealers would not be subject to a continuing duty and payments of commissions would not, *per se*, violate such duty. [Subtitle A]
- **Mandatory Predispute Arbitration Agreements.** The SEC may, by rule, prohibit or impose conditions or limitations on the use by brokers, dealers and investment advisers of mandatory predispute arbitration agreements with customers or investors. [Subtitle B]
- **Securities Lending.** Brokers and dealers must notify customers that they may elect not to allow their fully paid securities to be used in connection with short sales. [Subtitle B]
- **Custody Recordkeeping Relating to Investment Companies and Investment Advisers.** Custodians for Investment Companies and Investment Advisers will be subject to reasonable periodic, special or other SEC examinations. [Subtitle B]
- **Securities Act Rule 436(g) Rescinded.** The rescission of Rule 436(g) opens NRSROs to liability under Section 11 of the Securities Act if they 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 the registration statement. [Subtitle C]
- **Securitization Risk Retention Requirement.** The Federal banking agencies (the OCC, the Federal Reserve Board and the FDIC) and the SEC (and, in the case of transactions involving residential mortgage assets, the FHFA and the Secretary of Housing and Urban Development) (the "applicable regulators") must jointly adopt regulations requiring securitizers to retain an unhedged economic interest in a portion of the credit risk on the assets they transfer, subject to certain exemptions and exceptions. Regulations adopted under the Act will provide for 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. [Subtitle D]
- **Amount of Risk Retention.** The Act requires the applicable regulators to jointly adopt regulations that set the minimum level of risk retention at not less than 5% of the credit risk or, if the originator of the assets meets certain underwriting standards established by the Federal banking agencies, less than 5% of the credit risk. [Subtitle D]
- **Exemption for "Qualified Residential Mortgages."** The regulations adopted under the Act must exempt securitizations of "qualified residential mortgages" from the risk retention requirement. [Subtitle D]
- **Effective Date of Regulations.** The Act requires the risk retention regulations to be adopted within 270 days of the Act's passage and to become effective one year, in the case of securities backed by residential mortgages, or two years, for all other asset-backed securities, after the date of publication of the final regulations in the Federal Register. [Subtitle D]
- **Increased Disclosure and Reporting by Issuers.** 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. [Subtitle D]

- **Corporate Governance and Executive Compensation.** 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. These provisions include:
  - shareholder use of the proxy materials to nominate directors;
  - shareholder "say on pay" voting;
  - independence of compensation committees and their advisers;
  - clawback requirements for incentive compensation paid to executives based on misstated financial statements;
  - increased compensation disclosure in proxy statements;
  - increased oversight of compensation arrangements at large financial institutions;
  - restrictions on the voting of shares by brokers; and
  - increased disclosure requirements of companies that use certain minerals sourced from the Democratic Republic of Congo or its adjoining countries, companies engaged in coal or other mining operations and companies engaged in the development of oil, natural gas or other minerals. [Subtitles E&G and Title XV]
- **Municipal Advisers.** Municipal advisers must register with the SEC and will owe a fiduciary duty to any municipal entity for whom such municipal adviser acts as a municipal adviser. [Subtitle H]
- **SOX External Audit of Internal Controls.** Certain small public issuers are exempt from the Sarbanes-Oxley Act's external audit of internal control requirement. [Subtitle I]

Subtitle A – Increasing Investor Protection

- *Fiduciary Duty for Brokers, Dealers and Investment Advisers.* Not later than six months from the enactment of the Act, the SEC shall complete a study and submit a report to Congress that addresses the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers and their respective associated persons for providing personalized investment advice concerning securities to retail investors, and whether there are legal or regulatory gaps or overlap in such standards of care. The SEC must seek public comments in preparing its report. Retail customer means a natural person, or the legal representative of a natural person, who receives personalized investment advice about securities and who uses such advice primarily for personal, family or household purposes. For Advisers Act purposes, the term "customer" will not include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.

  The Act authorizes the SEC to engage in rulemaking, in its discretion, to address the standard of care for brokers, dealers, investment advisers and their associated persons and, in particular, authorizes the SEC to establish a fiduciary duty for brokers and dealers. The SEC may promulgate rules to provide that brokers and dealers that provide personalized investment advice about securities to retail customers (and such other customers as the SEC deems appropriate) shall owe the same standard of care as applicable to investment advisers under the Advisers Act. The receipt of compensation based upon commissions or other standard compensation by brokers or dealers for the sale of securities shall not, in itself, be considered a violation of this standard of care. In addition, brokers, dealers and their registered persons will *not* have a continuing duty of care or loyalty to the customer after providing the personalized investment advice about securities.

  If a broker or dealer sells only proprietary or other limited range of products, the SEC may require, by rule, that the broker or dealer provide notice and obtain the consent or acknowledgement of each retail customer.

The SEC shall 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 further shall, if appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest and compensation schemes.

The Act harmonizes the SEC's enforcement authority for prosecuting violations of standards of care owed by brokers, dealers and investment advisers under both the Advisers Act and the Exchange Act.

- *Investor Advisory Committee, Office of Investor Advocate and Ombudsman.* The Act codifies the formation and continuation of an Investor Advisory Committee to advise and consult with the SEC on, among other things, regulatory priorities, fee structures, effectiveness of disclosures and investor protection. The SEC established this committee in June 2009. An Office of the Investor Advocate is also established within the SEC. The purpose of this office is, in general, to assist investors in resolving problems with the SEC and self-regulatory organizations. The Investor Advocate must appoint an Ombudsman to act as a liaison between the SEC and retail investors, and review and make recommendations regarding policies and procedures to encourage persons to present questions to the Investor Advocate regarding compliance with the securities laws. The Investor Advocate will be a member of the Investor Advisory Committee as will a representative of State securities commissions, a representative of interests of senior citizens, and individuals representing the interests of individual equity and debt investors and investors in mutual funds, and individuals representing the interests of institutional investors including pension funds and registered investment companies.
- *SEC Rule-Making Procedures.* The Act amends the Exchange Act to streamline rule filings submitted by self-regulatory organizations for approval or disapproval by the SEC. Moreover, within 180 days after the date of enactment, the Act requires the SEC to promulgate rules setting forth the procedural requirements for rule-making proceedings.
- *Clarification of SEC Authority to Require Investor Disclosures before Purchase of Investment Products and Services.* The Exchange Act is amended 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. Any documents or information provided to retail investors must be in summary format and contain clear information about costs, risks and any compensation or financial incentive to be received by a broker, dealer or other intermediary.
- *Study on Enhancing Investment Adviser Examinations.* The SEC must conduct a study, and report its findings within 180 days of enactment of the Act, on the need for enhanced examination and enforcement resources for investment advisers. Among other things, the SEC must consider the frequency of examinations, whether a self-regulatory organization would augment the SEC's oversight of investment advisers, and current and potential approaches to examining the investment adviser activities of dually registered broker-dealers and investment advisers or affiliated broker-dealers and investment advisers.
- *Additional Studies.* The Act requires several additional studies to be conducted:
  - *Financial Literacy.* The SEC must conduct a study to identify: (1) the level of financial literacy among retail investors, (2) methods to improve the timing, content and format of disclosures to investors with respect to financial intermediaries, (3) the most useful and understandable relevant information that retail investors need to make informed financial decisions before engaging a financial intermediary or purchasing an investment product or service (including open-end investment companies), (4) methods to increase transparency of expenses and conflicts of interest in transactions (including open-end investment companies), (5) the most effective existing private and public efforts to educate investors and (6) in consultation with the Financial Literacy and Education Commission, a strategy to increase financial literacy of investors to bring about a

positive change in investor behavior. The SEC must provide a report of this study to Congress within two years after the date of enactment of the Act.

- *Mutual Fund Advertising.* The Comptroller General must conduct a study on mutual fund advertising to identify, among other things, existing and proposed regulatory requirements for open-end investment company advertisements and current marketing practices for open-end investment companies, including the use of past performance data, funds that have merged and incubator funds. The study must be submitted to Congress not later than 18 months after enactment of the Act.
- *Research Analysts.* The Comptroller General must conduct a study to identify and examine potential conflicts of interest between the staffs of the investment banking and equity and fixed income securities analyst functions within the same firm. The Comptroller General is to consider the Global Analyst Research Settlement of 2003 and whether the undertakings set forth in that settlement should be codified. The report summarizing the study must be submitted to Congress not later than 18 months after the date of enactment of the Act.
- *Investor Access to Registration Information.* Within six months of enactment of the Act, the SEC must complete a study, including recommendations, of ways to improve the access of investors to registration information (including disciplinary actions, regulatory, judicial and arbitration proceedings and other information) about registered and previously registered investment advisers, brokers, dealers and their associated persons on the Central Registration Depository and Investment Adviser Registration Depository systems. Among other things, the SEC must consider consolidating the two systems. Not later than 18 months after the completion of the study, the SEC must implement any recommendations set forth in the study.
- *Financial Planners.* The Comptroller General must conduct a study on financial planners and the use of financial designations. The Comptroller General must consider the role of financial planners, whether there are sufficient ethical and professional standards for financial planners and the appropriate structure for regulation of financial planners and for persons who provide or offer financial planning services. The Comptroller General's report of financial planners must be submitted to Congress not later than 180 days after enactment of the Act.

Subtitle B – Increasing Regulatory Enforcement and Remedies

- *Mandatory Predispute Arbitration Agreements.* The SEC is given leeway to, by rule, prohibit or impose conditions or limitations on the use of agreements that require customers or clients of any broker, dealer, municipal securities dealer or investment adviser to arbitrate any future dispute if the SEC finds that such prohibition or limitation is in the public interest and appropriate for the protection of investors.
- *Whistleblower Protection.* The Act amends the Exchange Act to require the SEC, in any judicial or administrative action brought by the SEC under the securities laws that results in monetary sanctions exceeding $1 million, to pay awards to whistleblowers who voluntarily provide original information that leads to a successful enforcement of an action. The amount of payment would be not less than 10%, and not more than 30%, in total, that has been collected. Employers would be prohibited from firing or discriminating against a whistleblower because of any lawful act done by the whistleblower. The statute of limitations for a whistleblower to bring an action against his or her employer for unlawful retaliation is six years from the date of the violative conduct or three years from the date when facts material to the right of action are known or reasonably should have been known by the employee, but in no case may an action be brought more than ten years after the date of the violation. The SEC Inspector General must conduct a study of the whistleblower protections established by this amendment, including whether the SEC is prompt in responding to information provided by whistleblowers. The Inspector General must submit a report on his findings to Congress, and must make the report publicly available on the SEC's website, not later than 30 months after enactment of the Act.

- *Collateral Bars.* The Act expands the administrative sanctions that the SEC can impose under the Exchange Act (Sections 15(b)(6), 15B(c)(4) and 17A(c)(4)) and the Advisers Act (Section 203(f)) to include collateral bars (*i.e.*, bars under each provision from associating with broker-dealers, investment advisers, municipal securities dealers, transfer agents or nationally recognized statistical rating organizations).
- *Regulation D Bad Actors.* The Act disqualifies any offering or sale of securities by felons and other "bad actors" under Rule 506 of Regulation D. The SEC must issue rules in this regard no later than one year of enactment.
- *Section 205 of the Investment Advisers Act and State-Regulated Advisers.* Section 205(a) of the Advisers Act is amended to clarify that the section, which imposes various restrictions on investment advisory contracts, does not apply to State-registered investment advisers.
- *Nationwide Service of Subpoenas.* The Securities Act, the Exchange Act, the Investment Company Act and the Advisers Act are amended to permit nationwide service of SEC subpoenas in civil actions filed in Federal court.
- *Formerly Associated Persons.* Through amendments to the Exchange Act, the Investment Company Act and the Sarbanes-Oxley Act, the SEC has the power to sanction persons who were formerly associated with the Municipal Securities Rulemaking Board ("MSRB"), the Public Company Accounting Oversight Board ("PCAOB"), a government securities broker or dealer, a national securities exchange or registered securities association, registered clearing agency or public accounting firm as well as officers and directors of self-regulatory organizations and investment companies.
- *SIPC Reforms.* The Securities Investor Protection Act is amended to increase the amount payable to a customer if his or her net equity claim is for cash from $100,000 to a "standard maximum cash advance amount," which is $250,000. The Board of Directors of the Securities Investor Protection Corporation ("SIPC") shall determine whether such amount should be adjusted for inflation every five years.

  The minimum assessment paid by SIPC members is increased from $150 per annum to 0.02 % of the gross revenues of the securities business of the SIPC member. The sanctions for prohibited acts and misrepresenting SIPC membership also are increased.
- *Confidentiality of Materials Submitted to the SEC.* The Exchange Act, the Investment Company Act and the Advisers Act are amended to state that the SEC shall not be compelled to disclose records or information, or records or information based upon or derived from such records or information, if obtained in furtherance of the purpose of those acts, including surveillance, risk assessments and other regulatory and oversight activities.
- *Sharing Privileged Information with Other Authorities.* The SEC shall not be deemed to have waived any privilege applicable to information shared with certain Federal agencies, the PCAOB, any self-regulatory organization, any foreign securities authority, any foreign law enforcement authority or any State securities or law enforcement authority. The SEC shall not be compelled to disclose privileged information obtained from any foreign securities authority or law enforcement authority. Federal agencies, State securities and law enforcement authorities, self-regulatory organizations and the PCAOB shall not be deemed to have waived any privilege by sharing information with the SEC, except that, if the SEC uses such information in an action against the PCAOB or a self-regulatory authority, those entities will be deemed to have waived any applicable privilege.
- *Foreign Public Accounting Firms.* If a foreign public accounting firm performs material services upon which a registered public accounting firm relies in the conduct of an audit or interim review, issues an audit report, performs audit work or conducts interim reviews, the foreign public accounting firm must produce audit work papers and related documents to the SEC or the PCAOB upon request and be subject to U.S. jurisdiction for enforcement purposes. Any registered public accounting firm that relies, in whole or in part, upon a foreign public accounting firm also is responsible for producing the audit work papers and related documents of the foreign public accounting firm upon request. The foreign firm must furnish the domestic registered public accounting

firm with a written irrevocable consent and power of attorney designating the domestic firm as an agent upon whom service of process may be made in connection with SEC or PCAOB requests. The SEC and the PCAOB may allow a foreign public accounting firm to meet these requirements through alternative means.

- *Manipulation.* Sections 9 (relating to market manipulation) and 10(a)(1) (relating to short sales) of the Exchange Act are amended to expand their application to securities that are *not* registered on national securities exchanges other than government securities. In addition, violations of rules relating to transactions involving puts, calls, straddles or options are no longer required to have been effectuated "by use of any facility of a national securities exchange." Broker-dealers can be held liable for violating rules and regulations regarding endorsements or guarantees on puts, calls, straddles or options.

- *Short Sale Reforms.* The SEC will prescribe rules providing for the public disclosure of the following information on short sales of equity securities: name of the issue and title, class, CUSIP number, aggregate amount of the number of short sales of each security and any additional information that the SEC deems appropriate. At a minimum, such disclosures must be made on a monthly basis.

  Section 9 of the Exchange Act is amended to make it unlawful for any person, directly or indirectly, alone or with one or more persons, to effect a manipulative short sale of any security. The SEC is to issue rules to ensure that appropriate enforcement options and remedies are available to it.

- *Securities Lending.* Brokers and dealers must notify customers that they may elect not to allow their fully paid securities to be used in connection with short sales. If such securities are used, the broker or dealer must provide the customer with notice that the broker or dealer may receive compensation in connection with lending the customer's securities. The SEC may, by rule, prescribe the form, content, time and manner of any such notice.

- *SEC Aiding and Abetting Authority.* The Act in several ways expands the SEC's ability to bring enforcement actions in district court against aiders and abettors. First, the Act authorizes the SEC to bring district court enforcement actions against persons who aid and abet violations of the Securities Act and the Investment Company Act. Second, the Act expands the enforcement provisions of the Advisers Act by making clear that the SEC in district court can seek civil monetary penalties against persons who aid and abet Advisers Act violations. Third, in those sections, and in amendments to the existing aiding and abetting language in Section 20(e) of the Exchange Act, the Act allows the SEC to predicate a district court action against and abettors for knowingly *or recklessly* providing substantial assistance to primary violators.

- *Study on Securities Litigation.* The Comptroller General must conduct a study on the impact of allowing aiding and abetting claims in private securities actions. To the extent feasible, the study shall include, among other things, the types of lawsuits decided under the Private Securities Litigation Act of 1995. Given the parameters of this study, the Comptroller General will be reexamining the results of *Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). The report is due one year from the date of enactment of the Act.

- *SEC Cease and Desist Proceedings.* The Act amends the securities acts to give the SEC uniform authority to seek civil penalties in cease and desist proceedings.

- *Extraterritorial Jurisdiction.* Pursuant to amendments to the Securities Act, the Exchange Act and the Advisers Act, the SEC shall have jurisdiction over an action it brings (or Federal prosecutors bring) if the conduct within the United States constitutes significant steps in furtherance of the violation even if the securities transaction occurs outside the United States and involves only foreign investors or conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

- *Extraterritorial Private Rights of Action.* The SEC shall solicit public comment and conduct a study to determine the extent to which private rights of action under the antifraud provisions of the Exchange Act should be extended to cover conduct within the United States that constitutes a significant step in the furtherance of the violation even if

the securities transaction occurs outside the United States, and conduct occurring outside the United States has a foreseeable substantial effect within the United States.

- *Custody Recordkeeping Relating to Investment Companies and Investment Advisers.* The Investment Company Act is revised to require each person having custody or use of assets of a registered investment company to maintain and preserve records for such period as the SEC may prescribe and subject such custodians to reasonable periodic, special or other SEC examinations. The Advisers Act is amended to provide that a custodian having custody or use of client assets also is subject to SEC examination. A custodian that is subject to regulation by a Federal financial institution regulatory agency may satisfy the SEC's examination request by providing a detailed written list of the assets within its custody or use.
- *Deadline for Completing Examinations, Inspections and Enforcement Actions.* The Act requires the SEC to file an enforcement action no later than 180 days after it has provided any person with a written "Wells" notification. The SEC must inform the subject, in writing, of any examination that the SEC has concluded, has concluded without findings or that the staff requests the entity to undertake corrective action within 180 days after the SEC staff completes its on-site portion of the examination or receives all records requested of the examinee (whichever is later). The enforcement and examination timing may be extended by an additional 180 days in complex matters.

Subtitle C – Improvements to the Regulation of Credit Rating Agencies

- The Act will subject nationally recognized statistical rating organizations ("NRSROs") to greater oversight by the SEC.
    - NRSROs will be required to submit an annual internal controls report, attested to by the CEO, to the SEC describing the responsibility of management in establishing and maintaining an effective internal control structure for determining credit ratings and assessing that structure.
    - NRSRO compliance officers will have to write annual reports (and certify to the accuracy of such reports) that would be submitted to NRSRO management and filed with the SEC. Such reports will have to describe any material changes to the code of ethics and conflict of interest policies.
    - The SEC must issue rules to prevent sales and marketing considerations of an NRSRO from influencing the production of ratings although the SEC could make exceptions for small NRSROs.
    - An NRSRO must report to the SEC when it knows or can reasonably be expected to know where a person associated with the NRSRO within the last five years obtains employment with an obligor, issuer, underwriter or sponsor of a security or money market instrument for which the NRSRO issued a credit rating during the preceding one year period, if such employee was a senior officer, participated in determining the credit rating or supervised a person who participated in determining the credit rating. The SEC will make any such report available to the public.
- *Sanctions of Associated Persons of NRSROs and NRSRO Suspension or Revocation for a Particular Class of Securities.* The SEC will be able to censure or place limitations on the activities of a person who is associated with, or is seeking to become associated with, or who at the time of any misconduct was associated with an NRSRO. Sanctions can include a one-year suspension or a bar from association with an NRSRO. The SEC also has the authority to sanction persons who fail to reasonably supervise an associated person with the view to preventing a violation of the securities laws.

  The SEC may temporarily suspend or permanently revoke the registration of a NRSRO with respect to a particular class or subclass of securities if the SEC finds that the NRSRO does not have adequate financial and managerial resources to consistently produce credit ratings with integrity.

- *Look-Back Requirements Relating to Employment.* Each NRSRO must establish, maintain and enforce policies and procedures reasonably designed to address conflicts of interest when an NRSRO former employee works for a person subject to the NRSRO's credit ratings, or an issuer, underwriter or sponsor of a security or money market instrument. Such look-backs must occur when the former NRSRO employee participated in determining the credit rating during the preceding year.
- *Office of Credit Ratings.* The SEC is required to establish an Office of Credit Ratings to administer the SEC's rules relating to NRSROs, to promote accuracy in NRSRO credit ratings and to ensure that ratings are not unduly influenced by conflicts of interest. The Office will conduct at least annual examinations of each NRSRO and will examine, among other things, whether each NRSRO acts in accordance with its policies and procedures and how conflicts of interest are managed. The SEC will make public the essential findings of examinations as well as any NRSRO responses to findings of material regulatory deficiencies.
- *Transparency.* NRSROs will have to increase the transparency of ratings, under rules to be promulgated by the SEC, by providing disclosures that would allow users of credit ratings to compare performance of credit ratings across NRSROs and for a variety of types of credit ratings, including for credit ratings that are withdrawn. Such disclosures would be available on each NRSRO website and in writing. Each NRSRO must include an attestation with any credit rating it issues affirming that no part of the rating was influenced by any other business activities, that the rating was based solely upon the merits of the instrument being rated and that such rating was an independent evaluation of the risks and merits of the instrument.
- *Disclosures.* The SEC would prescribe rules that would require each NRSRO to ensure that credit ratings are determined using procedures and methodologies, including qualitative and quantitative data and models, approved by each NRSRO's board. SEC rules further would require that, when there are material changes to credit rating procedures and methodologies, such changes are applied consistently and quickly and that the reason for the change is publicly disclosed. NRSROs would be required to notify users of credit ratings when a material change is made, when a significant error is identified in a procedure or methodology, and the likelihood of a material change resulting in a change to current credit ratings. NRSROs also would have to disclose information relating to assumptions, the data that was relied upon to determine the rating, how (if applicable) the NRSRO used servicer or remittance reports to conduct surveillance of credit ratings, the potential limitation of the credit ratings, the types of risks that were not evaluated in establishing the rating, information on the uncertainty of the credit rating, a statement of the overall assessment of the quality of information available and considered in producing a rating, an explanation or measure of the potential volatility of a rating, and information relating to conflicts of interest. The SEC will require most of these matters to be disclosed on a form accompanying the publication of each credit rating.
    - NRSROs will have to disclose whether and to what extent third-party due diligence services were used by the NRSRO, a description of the information reviewed by such service, and a description of the service's findings.
- *Due Diligence Services for Asset-Backed Securities*. The Act requires the issuer or underwriter of an asset-backed security to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter, and if a third-party due diligence service is employed by an NRSRO, an issuer or an underwriter, the person providing the due diligence service must provide to any NRSRO that produces a rating to which such services relate, a written certification in a form established by the SEC to ensure that providers of due diligence services have conducted a thorough review of data, documentation and other relevant information necessary for an NRSRO to provide an accurate rating. The SEC must also adopt rules requiring an NRSRO, at the time at which it rates the security, to disclose publicly the certification such that the public can determine the adequacy and level of due diligence services provided by the third party.
- *Credit Rating Agency Statements and State of Mind in Private Rights of Action*. The enforcement and penalty provisions of the Exchange Act would apply to statements made by a credit rating agency - not just an NRSRO - in the same

manner and to the same extent as apply to statements made by a registered public accounting firm or a securities analyst under the securities laws. In addition, the Act rescinds Rule 436(g) of the Securities Act, known as the "expert exemption." As a result, NRSROs may be liable under Sections 11 and 12 of the Securities Act if an NRSRO were to 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 the registration statement.

Statements by credit rating agencies would not be deemed forward-looking statements for the Exchange Act's Section 21E Safe Harbor.

For purposes of pleading a requisite state of mind for litigation against a credit rating agency – not just an NRSRO – it would be sufficient to state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to: (1) conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk or (2) obtain reasonable verification of such factual elements from other sources independent of the issuer and underwriter that the credit rating agency considered to be competent.

- *Referring Tips to Law Enforcement or Regulatory Authorities*. Each NRSRO must inform law enforcement or regulatory authorities of any information that the NRSRO receives from a third party and finds credible that alleges that an issuer of securities rated by the NRSRO committed or is committing a material violation of law. An NRSRO would not be required to verify the accuracy of such information.
- *Removal of References to Credit Ratings from Laws Governing Securities and Banking*. The Act removes references to credit ratings from, among other things, the FDIA, the Federal Housing Enterprises Financial Safety and Soundness Act, the Investment Company Act and the Exchange Act. Moreover, each Federal Agency must, within one year of enactment of the Act, substitute any references to credit ratings in regulations with other standards of credit-worthiness.
- *Regulation FD*. Within 90 days of enactment, the SEC must revise Regulation FD to remove the exemption for entities whose primary business is the issuance of credit ratings. The effect of this removal may only be that rating agencies will have to agree that they will maintain disclosed material nonpublic information in confidence.
- *Study and Rulemaking on Assigned Credit Ratings for Structured Finance Products*. 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. The SEC must consider the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine the credit ratings of structured finance products and alternative means for compensating NRSROs that would create incentives for accurate ratings. The SEC must submit its report and recommendations to Congress not later than 24 months after enactment of the Act. Following the study, the SEC will issue rules, as the SEC determines is necessary or appropriate in the public interest or for the protection of investors, creating a self-regulatory organization to assign NRSROs (including potentially through a lottery or rotating assignment system) unless it determines that an alternative mechanism would better serve the public interest and investor protection. This provision is the result of the amendment that was proposed by Senator Al Franken (D-Minn.).
- *Additional Studies*. The SEC must conduct a study of the independence of NRSROs and how their independence affects their ratings. The SEC must consider the management of conflicts of interest raised by NRSROs providing other services and the potential impact of rules prohibiting an NRSRO that provides a rating to an issuer from providing other services to the issuer. A report of the study must be submitted to Congress within three years of enactment of the Act. The Comptroller General must conduct a study on alternative means for compensating NRSROs within 18 months of enactment of the Act and the GAO must conduct a study on the feasibility and merits of creating an independent professional organization for rating analysts employed by NRSROs. The GAO study is due one year from the date of enactment of the Act.

Subtitle D — Improvements to the Asset-Backed Securitization Process

The Act's provisions related to securitization (the "ABS Provisions") effect a number of significant changes to securitization transactions. In addition to these changes, in April, the SEC released proposed rules (the "SEC proposed rules") that would significantly modify and expand the regulations governing structured finance securities and, in May, the FDIC issued a Notice of Proposed Rulemaking that proposes a number of securitization reforms (including risk retention and asset-level disclosure) (the "FDIC proposed rules") as part of proposed changes to its securitization conservatorship and receivership safe harbor rule for FDIC-insured depository institutions.[4]

Securitization Risk Retention Requirement

- The applicable regulators must jointly adopt regulations:
    - Requiring securitizers to retain an unhedged economic interest in a portion of the credit risk on the assets they transfer, sell or convey through the issuance of asset-backed securities, subject to the exemptions and exceptions discussed below. An "asset-backed security" is broadly defined and is not limited to an "asset-backed security" as defined under the SEC's Regulation AB. A "securitizer" is defined as an issuer of an asset-backed security or a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.
    - Providing for the allocation, as the Federal banking agencies and the SEC jointly determine to be appropriate, of the risk retention obligation between a securitizer and an originator if the securitizer purchases assets from an originator. An "originator" is defined as a person who creates a financial asset (through the extension of credit or otherwise) that collateralizes an asset-backed security and who sells that asset directly or indirectly to a securitizer.
        - The FDIC proposed rules on risk retention would apply only to a sponsor in a securitization that seeks to qualify for the FDIC's safe harbor for securitizations and the SEC proposed rules would apply only to sponsors in shelf-registered asset-backed securities transactions. Neither the FDIC proposed rules nor the SEC proposed rules provide for allocation of the risk retention requirement between the sponsor and other entities.
    - Setting the minimum level of risk retention at not less than 5% of the credit risk or, if the originator of the assets meets certain prescribed underwriting standards, less than 5% of the credit risk. The underwriting standards are to be established by the Federal banking agencies and must specify the loan terms, conditions and characteristics that indicate a low credit risk with respect to loans within each asset class for which the applicable regulators have established separate rules.
- Additionally, under regulations to be jointly adopted by the Federal banking agencies, the SEC, the Secretary of Housing and Urban Development and the Director of the FHFA, securitizations of "qualified residential mortgages" will be exempt from the risk retention requirement if the issuer certifies to the SEC that it has evaluated the effectiveness of its internal supervisory controls with respect to the process for ensuring that all assets that collateralize the asset-backed securities are qualified residential mortgages. The exemption does not apply to asset-backed securities collateralized by other asset-backed securities (such as CDOs or other re-securitizations of RMBS with underlying qualified residential mortgages) or asset-backed securities collateralized by a combination of qualified residential mortgages and other assets, such as a pool of prime and Alt-A mortgage loans.

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[4] *See* "Summary of SEC Proposals Regarding Asset-Backed Securities and Other Structured Finance Securities," Sidley client update (April 19, 2010), *available at* http://www.sidley.com/sidleyupdates/Detail.aspx?news=4394 and "FDIC Proposes Revised Safe Harbor for Securitizations," Sidley client update (May 17, 2010), *available at* http://www.sidley.com/sidleyupdates/Detail.aspx?news=4426.

- The term "qualified residential mortgage" will be defined jointly by the regulators taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as documentation and verification of financial resources, standards with respect to debt-to-income ratio and limits on features (*e.g.*, negative amortization or interest-only mortgage loans). The adopted definition can be no broader than the definition of "qualified mortgage" adopted under Title XIV of the Act. See "Title XIV—Mortgage Reform and Anti-Predatory Lending Act—Minimum Standards for Mortgages—Ability to Repay."
- The regulations to be adopted by the applicable regulators are required to prohibit a securitizer from directly or indirectly hedging (or otherwise transferring) the retained risk.
    - The FDIC proposed rules would not permit a sponsor to directly or indirectly hedge its risk.
    - Under the SEC proposed rules, hedge positions not directly related to the securities or exposures taken by the sponsor or affiliate would not be counted against the sponsor's risk retention requirement.
- The regulations to be adopted by the applicable regulators also are required to:
    - Establish appropriate standards for retention of an economic interest with respect to CDOs, securities collateralized by CDOs and similar instruments collateralized by other asset-backed securities.
    - With respect to commercial mortgages, specify the permissible types, forms and amounts of risk retention that would meet the risk retention requirement, which in the determination of the Federal banking agencies and the SEC may include:
        - retention of a specified amount or percentage of the total credit risk of the asset;
        - retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first-loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before the issuance of the asset-backed securities and meets the same standards for risk retention as the Federal banking agencies and the SEC require of the securitizer;
        - a determination by the Federal banking agencies and the SEC that the underwriting standards and controls for the asset are adequate; and
        - provision of adequate representations and warranties and related enforcement mechanisms.
- In addition, the applicable regulators must adopt regulations that provide for a total or partial exemption from the risk retention requirements:
    - for any securitization, as may be appropriate in the public interest and for the protection of investors;
    - for any securitization where the assets securitized are assets issued or guaranteed by the United States or an agency of the United States (other than Fannie Mae or Freddie Mac) as determined by the Federal banking agencies and the SEC to be appropriate in the public interest and for the protection of investors; or
    - for any securitization where the asset-backed security is issued or guaranteed by any State (or political subdivision or public instrumentality thereof) and is exempt from the registration requirements of the Securities Act pursuant to Section 3(a)(2), or is a security defined as a qualified scholarship funding bond under the Internal Revenue Code of 1986, as amended, as may be appropriate in the public interest and for the protection of investors.
- Additionally, the Federal banking agencies and the SEC may jointly adopt or issue exemptions, exceptions or adjustments for classes of institutions or assets with respect to the risk retention requirement and the prohibition on hedging. The Act specifically exempts any loan or other financial asset made, insured, guaranteed or purchased by any institution that is subject to the supervision of the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation, from the risk retention requirement. Any residential, multi-family or health

care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, which is insured or guaranteed by the United States or an agency of the United States (other than Fannie Mae, Freddie Mac and the Federal home loan banks), is also exempted from the risk retention requirement.

- In contrast to the Act, neither the SEC proposed rules nor the FDIC proposed rules would provide any type of exemption or exceptions with respect to the risk retention requirements or any reduction of the risk retention amount below 5%.
- The Act leaves the determination as to permissible forms of risk retention and the minimum duration of the risk retention requirement to the applicable regulators.
  - The SEC proposed rules would require the sponsor (or an affiliate) in a shelf-registered issuance of securities to retain a vertical slice of 5% of each tranche of securities issued in the transaction (or, in the case of a master trust transaction, a 5% originator's interest) net of any directly related hedge positions so long as an unaffiliated entity owns securities issued in the transaction.
  - The FDIC proposed rules would require that 5% of each of the credit tranches sold or transferred to investors (or, that a "representative sample" of the securitized assets equal to not less than 5% of the principal amount of the financial assets at transfer) be retained for the life of the transaction.
- The regulations to be adopted by the applicable regulators must also establish asset classes with separate rules for securitizers of different asset classes, including residential mortgages, commercial mortgages, commercial loans, auto loans and any other class of assets that the Federal banking agencies and the SEC deem appropriate.
  - The FDIC proposed rules would distinguish securitizations of residential mortgage loans from other asset types and, in securitizations of residential mortgage loans, would require, in addition to the 5% risk retention requirement, establishment of a reserve fund equal to at least 5% of the cash proceeds of the securitization payable to the sponsor to cover, during the first year of the securitization, repurchase of any of the securitized assets required for breach of representations and warranties.
  - The SEC risk retention proposal does not vary by asset class (although the SEC proposed rules would distinguish between asset classes with respect to disclosure and reporting obligations).
- The Act also requires a study and report (within 180 days of the Act's enactment) by the Chairperson of the Oversight Council on the macroeconomic effects of the risk retention requirements (with particular emphasis placed on the potential beneficial effects with respect to stabilizing the real estate market), and an analysis on the feasibility of minimizing real estate price bubbles by proactively adjusting the risk retention requirements and mortgage origination requirements. In addition, the ABS Provisions require a study and report within 90 days of the Act's enactment by the Federal Reserve Board (in consultation with the Comptroller of the Currency, the Director of the OTS, the Chairperson of the FDIC and the SEC) on the combined impact of the ABS Provisions' risk retention requirements, including the effect credit risk retention requirements have on increasing the market for Federally-subsidized loans, and Statement of Financial Accounting Standards Nos. 166 and 167. The report must include recommendations for eliminating any negative impacts on the continued viability of the securitization markets and on the availability of credit for new lending.

Effective Date of Regulations

- The Act requires the risk retention regulations to be adopted within 270 days of the Act's passage and to become effective one year, in the case of securities backed by residential mortgages, or two years, for all other asset-backed securities, after the date of publication of the final regulations in the Federal Register. The Chairperson of the Oversight Council will coordinate all joint rulemaking required under the ABS Provisions.

Increased Disclosure and Reporting by Issuers; New Asset Review

- The ABS Provisions exclude all publicly-registered asset-backed securities from the automatic reporting suspension provisions of Section 15(d) of the Exchange Act and the SEC is authorized to adopt new suspension or termination schemes for different classes of publicly-registered asset-backed securities under terms and conditions as it deems necessary or appropriate in the public interest or for the protection of investors. The SEC proposed rules would impose ongoing reporting obligations equivalent to Exchange Act reporting on issuers using shelf registration (independent of the ability to suspend reporting under Section 15(d)) as well as issuers relying on the Rule 144, Rule 144A or Rule 506 Safe Harbors.
- The SEC is required to:
  - Impose registration statement disclosure requirements on asset-backed securities issuers with respect to asset-level information, including loan-level data, if such data are necessary for investors to independently perform due diligence. The SEC proposed rules contain extensive new disclosure requirements for asset-backed securities that would appear to address these requirements.
  - Adopt rules requiring an issuer of registered asset-backed securities to perform a review of the assets underlying the asset-backed securities and to disclose the nature of the review in the issuer's registration statement.
- While the FDIC proposed rules would require a third-party diligence report on compliance with applicable statutory and regulatory standards for the origination of mortgage loans and compliance with representations and warranties in residential mortgage-backed transactions, there is no corollary in the SEC proposed rules.

Representations and Warranties; Repurchase Requests; Repeal of the Securities Act Section 4(5) Exemption

- The SEC is required to adopt regulations requiring:
  - A description and comparison of the representations, warranties and enforcement mechanisms available to investors to be included in a report accompanying each rating of an asset-backed security.
  - A securitizer to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer. This is similar to the SEC's proposal to require sponsors and originators that have originated more than 20% of the pool assets to disclose the number of repurchase or replacement demands the entity has received in the last three years and the percentage of those where it did not repurchase or replace the asset.
- The Act repeals the transactional exemption from the Securities Act's registration and prospectus delivery requirements, contained in Section 4(5) thereof, for the sale of certain promissory notes secured by first liens on residential and commercial real estate and participation interests therein.

Securitization Conflicts of Interest

- Under Title VI of the Act, underwriters, placement agents, initial purchasers and sponsors (and their affiliates and subsidiaries) of asset-backed securities, as defined in the Act, and synthetic asset-backed securities are prohibited 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. The SEC is required to issue final rules, within 270 days of the Act's passage, to implement this prohibition.
  - This prohibition does not apply to risk-mitigating hedging activities in connection with positions or holdings arising out of such activities if they are designed to reduce specific risks associated with those positions or holdings arising out of such activities, or to purchases or sales of asset-backed securities or synthetic asset-

backed securities made pursuant to and consistent with commitments to provide liquidity for such securities or bona fide market-making activities.

Credit Ratings of Structured Finance Securities

- Among the provisions that affect NRSROs, the Act contains a number of changes relevant for structured finance securities, including a provision to make due diligence reports publicly available, commissioning a two-year study to evaluate ratings for structured finance products, removing certain statutory references to NRSROs and repealing Rule 436(g) under the Securities Act. *See* "—Subtitle C—Improvements to the Regulation of Credit Rating Agencies."

Amendments to the Truth in Lending Act of 1968 ("TILA")

- The Act's amendments to TILA include restrictions on the origination of residential mortgage loans and on prepayment penalties, which could have a significant effect on the secondary mortgage loan market and on residential mortgage securitization transactions and sellers into these transactions. *See* "Title XIV—Mortgage Reform and Anti-Predatory Lending Act."

Covered Bonds

- The Act does not include the comprehensive framework for covered bonds proposed by Representative Scott Garrett (R-NJ). Although offered by the House, the Senate rejected the proposal because the Treasury Department and the FDIC were said to have expressed concerns about the framework. Senator Christopher Dodd (D-Conn.) promised to hold a hearing in the coming months to further explore covered bonds and Representative Barney Frank (D-Mass.) promised to hold a mark-up of Garrett's covered bond bill in July.

Subtitles E and G — Corporate Governance and Executive Compensation Requirements

Proxy Access

- The Act gives the SEC the authority, but not a mandate, to issue rules that allow shareholders to nominate directors by using the company's proxy solicitation materials. Under pre-existing law, there is some uncertainty as to whether the SEC has authority to adopt such rules. The Act gives the SEC the authority to exempt an issuer or a class of issuers from this requirement and directs the SEC to consider whether the requirement disproportionately burdens small issuers.

Say on Pay

- The Act requires that, at least once every three years, each company that is subject to the SEC's compensation disclosure requirements must include a separate non-binding "say on pay" vote in its proxy statement by which shareholders may approve the compensation of named executive officers as disclosed in the proxy statement. The vote will be purely advisory, and apply to the overall compensation disclosure, rather than the compensation of each executive or each program. In a separate non-binding vote held at least once every six years the shareholders will determine whether the say on pay vote is to occur every one, two or three years.
- The Act also provides that whenever an issuer seeks shareholder approval of an acquisition, merger, consolidation or sale of all or substantially all of the issuer's assets, the issuer must disclose in its proxy statement all compensation arrangements, which the statute refers to as "golden parachute compensation" with named executive officers that relate to the transaction and the amount of compensation that may be paid to them. The

shareholders are then entitled to exercise a nonbinding vote to approve the disclosed compensation arrangements, unless such arrangements previously were subject to say on pay vote.

- Institutional shareholders who are subject to Section 13(f) of the Exchange Act are required to report annually how they voted in any say on pay vote.
- The say on pay requirements take effect at the first shareholder meeting that occurs more than six months after the date of enactment. For the first shareholder meeting, shareholders will vote on two items: (1) whether to approve the current compensation of named executive officers, as disclosed in the proxy and (2) whether future say on pay votes will be held every one, two or three years.
- The SEC is authorized to exempt issuers or classes of issuers, such as small issuers, from the say on pay requirement.

Compensation Committee Independence

- The Act requires the SEC to adopt rules to direct the national stock exchanges and national securities associations to prohibit the listing of an issuer's equity securities if the issuer does not have an independent compensation committee.
- For purposes of determining independence, the SEC's rules will take into account:
    - consulting, advisory or other compensatory fees paid by the issuer to the member of the committee; and
    - whether the committee member is an affiliate of the company.
- The following entities are exempt from the independence requirement: (1) "controlled companies" that hold board of director elections in which more than 50% of the voting power is held by an individual, a group or another issuer, (2) limited partnerships, (3) companies in bankruptcy, (4) open-ended management investment companies registered under the Investment Company Act and (5) foreign private issuers that disclose to shareholders annually why they do not have an independent compensation committee.

Independent Compensation Consultants and Counsel

- The Act also requires the SEC to adopt rules that would permit an issuer's compensation committee to engage compensation consultants, counsel and other advisers only after considering their independence. The Act directs the SEC to identify factors to be considered in assessing the independence of these advisers, including other services performed for the company, the fees paid to the adviser as a percentage of total revenue, procedures for selection, business or personal relationships and any stock of the issuer owned by the adviser. These factors must be "competitively neutral" among categories of consultants, counsel and other advisers.
- The issuer's compensation committee must have the authority to retain and oversee the work of any independent compensation consultant or legal counsel, and the company must fund the engagement.
- Any proxy statement for an annual meeting of shareholders occurring on or after the one-year anniversary of enactment must disclose whether the committee retained a compensation consultant, whether there are any conflicts of interest and how they are being addressed.
- The rules relating to the use of independent advisers do not apply to "controlled companies" that hold board of director elections in which more than 50% of the voting power is held by an individual, a group or another issuer.
- The Act directs the SEC to adopt these rules relating to Compensation Committee and advisor independence within 360 days of enactment.

Expanded Clawback Requirements

- The Act requires the SEC to adopt rules to direct the national stock exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the compensation clawback requirements included in the Act. The SEC rules will require that:
    - Exchange-traded companies adopt a clawback policy covering incentive compensation paid to all executive officers.
    - The required clawback applies in the event of an accounting restatement due to material noncompliance with financial reporting requirements. If triggered, the policy would require recovery from current and former executive officers of any incentive compensation received (including options) during the three-year period preceding restatement, in excess of what otherwise would have been paid to the officer.
- In contrast, the clawback requirement found in the Sarbanes-Oxley Act of 2002 covers only a company's CEO and CFO and applies only if noncompliance results from misconduct.

Hedging Disclosure

- The Act requires the SEC to adopt rules requiring disclosure in a company's proxy statement as to whether any director or employee of a company is permitted to hedge his or her position in any equity security of the company, whether granted to the employee or director as compensation or held, directly or indirectly, by the employee or director.

Increased Compensation Disclosure

- The Act requires the SEC to adopt rules requiring additional disclosure of:
    - Information that shows the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the stock value and dividends paid. This disclosure may include a graphic representation of the information required to be disclosed.
    - Information on internal pay disparity, including:
        - the median annual total compensation of all employees, excluding the CEO,
        - the annual total compensation of the CEO; and
        - the ratio of the median non-CEO employee total compensation to that of the CEO.

Disclosures Regarding Chairman and CEO Structures

- The Act requires the SEC to adopt rules that would require an issuer to disclose in its annual proxy materials 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. The SEC already requires similar disclosure pursuant to existing Item 407(h) of Regulation S-K.

Excessive Compensation of Covered Financial Institutions

- The Act requires the various regulators of covered financial institutions to jointly establish regulations, within nine months after enactment, that:
    - require financial institutions with assets of at least $1 billion to disclose to the regulators the structures of their incentive-based compensation arrangements (but not actual individual compensation levels), and

  - prohibit any such incentive-based compensation arrangements that the regulators determine encourage inappropriate risks: (1) by providing executive officers, employees, directors or principal shareholders with excessive compensation, fees or benefits or (2) that could lead to a material financial loss to the institution.

- This requirement applies to: (1) depositary institutions or holding companies, (2) broker-dealers registered under Section 15 of the Exchange Act, (3) credit unions, (4) investment advisers, (5) Fannie Mae, (6) Freddie Mac and (7) any other institution designated by the regulators.

Broker Discretionary Voting

- The Act 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 a member of the board of directors of an issuer, executive compensation, or any other significant matter, as determined by the [SEC]." The Act expressly exempts from this requirement votes with respect to the uncontested election of a member of the board of any registered investment company. The Act's treatment of broker discretionary voting follows the amendment, in January 2010, of NYSE rules governing brokers, which prohibited broker voting in all director elections. The Act would appear to prohibit, contrary to current practice, broker discretionary voting on management say on pay proposals.

Note that there are several other provisions, not found in Subtitles E and G of Subtitle IX, that may be of relevance to public companies. These include: (1) the exemption for non-accelerated filers from the requirements of Section 404(b) of the Sarbanes-Oxley Act that is found in Title IX, Subsection H and is described below under "*SOX External Audit of Internal Controls*," (2) the changes to required whistleblower procedures that is found in Title IX, Subsection B and is described above under "*Whistleblower Protection*" and (3) the disclosure-related provisions of Title XV, which are described in the section below.

Disclosure Regarding Use of Certain Minerals

- The Act contains provisions that relate to the use of certain minerals (the "conflict minerals") that are sourced from the Democratic Republic of Congo and its adjoining countries. The conflict minerals are "columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives" and other minerals specified by the Secretary of State.

- Specifically, the Act directs the SEC, within 270 days of enactment, to promulgate regulations that would require additional reporting by companies for which the use of conflict minerals is "necessary to the functionality or production of a product manufactured by such" company. Companies for which the use of conflict minerals is necessary as described above would have to disclose annually whether the conflict minerals it uses originated in the Democratic Republic of Congo or an adjoining country. In cases in which the minerals did originate in any such country, the company would be required to submit to the SEC a report that includes a description of the measures taken by the company to "exercise due diligence on the source and chain of custody of such materials," which measures will be required to include an independent private sector audit. The report to be submitted to the SEC would also be required to include a description of a number of other items relating to the use of the conflict minerals, including a description of any such products that are "not DRC conflict-free." The term "DRC conflict-free" is defined to mean that the products "do not contain minerals that directly or indirectly finance or benefit armed groups in the Democratic Republic of Congo or an adjoining country."

- These disclosure requirements will terminate on the date, not earlier than five years from the date of enactment, on which the President determines and certifies that "no armed groups continue to be directly involved and benefitting from commercial activity involving conflict minerals."

- The Act contains several other provisions imposing obligations on the Secretary of State and the Comptroller General and the Secretary of Commerce that relate to the conflict in the Congo and the effectiveness of the new disclosure requirements.

Disclosure Applicable to Mine Operators

- The Act contains provisions that will require additional disclosure for issuers that operate, or have subsidiaries that operate, "coal or other mines." Specifically, such companies will be required to include in each periodic report a number of items relating to the company's mine-safety history.
- In addition, such companies will be required to file a Form 8-K upon the receipt of certain specified safety-related notices from regulators.
- This section of the Act, which is apparently self-effectuating, will take effect 30 days after enactment.

Disclosure Applicable to Entities Engaged in Resource Extraction

- The Act directs the SEC, within 270 days of enactment, to issue rules that require "resource extraction" issuer[s]" to include in "an annual report" of the issuer information relating to "any payment made by the resource extraction issuer, a subsidiary . . . or an entity under control of the resource extraction issuer to a foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals." The term "resource extraction issuer" is defined to mean an issuer that is required to file reports with the SEC and "engages in the commercial development of oil, natural gas, or minerals."

Subtitle F — Improvements to the Management of the SEC

- *Report and Certification of Internal Supervisory Controls.* Not later than 60 days after the end of each fiscal year, the SEC will be required to submit a report to Congress on the SEC's conduct in examining registered entities, conducting enforcement investigations and reviewing corporate financial securities filings. Such report must assess the SEC's internal supervisory controls and the directors of the Division of Enforcement, Division of Corporate Finance and the Office of Compliance and Inspections and Examinations must certify that there are adequate internal controls.
- *Triennial Report on Personnel Management.* The Comptroller General must submit a report once every three years Congress on the quality of personnel management by the SEC. This report will evaluate the effectiveness of, among other things, supervisors in achieving the goals of the SEC, the criteria for promoting employees to supervisory positions, the competence of the SEC staff, the efficiency of communication between units of the SEC and the efforts to promote such communications, and any initiatives to increase the competence of the staff. The SEC must submit a response to the Comptroller General's report not later than 90 days after issuance.
- *Annual Financial Controls Audit.* Not later than six months after the end of each fiscal year, the SEC must publish and submit to Congress a report assessing the responsibility of SEC management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. The chairman and chief financial officer must provide attestations to such report. The Comptroller General must attest to, and report on, the SEC's assessment on annual financial controls not later than six months after the end of the first fiscal year after the date of enactment of the Act.
- *Report on Oversight of National* Securities *Associations, i.e., FINRA.* Not later than two years after enactment of the Act and every three years thereafter, the Comptroller General must submit to Congress a report evaluating the SEC's oversight of national securities associations (*i.e.,* FINRA). The report will review, among other things, the governance of FINRA (including the identification and management of conflicts), examinations conducted by FINRA (including a review of the expertise of examiners), FINRA executive compensation packages, the

cooperation provided to State securities administers and the policies regarding the employment of former FINRA employees by regulated entities.

- *SEC Organizational Study and Reform.* Not later than 90 days after enactment of the Act, the SEC shall hire an independent consultant to examine the internal operations, structure, funding and the need for comprehensive reform of the SEC as well as the SEC's relationship with, and reliance upon, self-regulatory organizations. The independent consultant must, at a minimum, consider, among other things, the possible elimination of unnecessary or redundant units at the SEC, improving the communications between SEC offices and divisions and the need to establish a clear chain of command structure (particularly for enforcement examinations and compliance inspections). The independent consultant shall issue its report to the SEC and Congress no later than 150 days after being retained. Six months after the independent consultant issues its report, and every six months for the next two year period, the SEC must issue a report to Congress describing the SEC's implementation of the regulatory and administrative recommendations made by the consultant.
- *Study on SEC Revolving Door.* The Comptroller General must conduct a study that, among other things: (1) reviews the number of SEC employees who leave the SEC to work for financial institutions regulated by the SEC, (2) determines how many employees who leave the SEC worked on cases that involved financial institutions regulated by the SEC and (3) determines if greater post-employment restrictions are necessary to prevent SEC employees from being employed by financial institutions regulated by the SEC. The Comptroller General must submit this report to Congress not later than one year after the enactment of the Act.
- *Match Funding.* Title J of the Act states that the SEC shall collect transaction fees and assessments that are designed to recover the costs to the government of the annual appropriation to the SEC by Congress.

Subtitle H — Municipal Securities

- *Municipal Advisor.* The Act creates a new category of entity – a municipal advisor – that must register with the SEC. A municipal advisor would be a person who "(i) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues; or (ii) undertakes a solicitation of a municipal entity." The Act expressly excludes a broker, dealer or municipal securities dealer serving as an underwriter, any registered investment adviser or persons associated with registered investment advisers who are providing investment advice, any commodity trading adviser who is providing advice related to swaps, attorneys providing legal advice, and engineers providing engineering advice.
- *Fiduciary Duty.* A municipal advisor and any associated person shall owe a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor, and no municipal advisor may engage in any act, practice or course of business which is not consistent with a municipal advisor's fiduciary duty.
    - The MSRB generally would have the same authority in relation to municipal advisors that it has with transactions in municipal securities effected by brokers, dealers and municipal securities dealers.
    - *"Municipal financial products"* is defined as municipal derivatives, guaranteed investment contracts, and investment strategies.
    - *"Obligated persons"* includes any person, including an issuer of municipal securities, who supports the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities.
- *FINRA Requests for Guidance.* FINRA is required to request guidance from the MSRB concerning the interpretation of MSRB rules and provide information to the MSRB about enforcement actions and examinations so that the MSRB may assist in such actions and examinations and evaluate MSRB rules.

- *SEC Office of Municipal Securities.* The Act establishes an Office of Municipal Securities to administer the SEC's rules relating to the practices of municipal securities brokers and dealers, municipal securities advisors, municipal securities investors, and municipal securities issuers as well as to coordinate with the MSRB regarding rulemaking and enforcement actions.

- *Studies.* The Comptroller General shall conduct a study of the disclosures required to be made by issuers of municipal securities within 24 months of enactment of the Act. The Comptroller General also shall conduct a study of the municipal securities markets and provide it to Congress within 18 months of enactment of the Act. The Comptroller General will consider, among other things, the mechanics for trading, quality of trade executions, market transparency and credit enhancements. Not later than 180 days after the Comptroller General's report on the municipal securities markets, the SEC shall submit a response to Congress including the actions taken by the SEC in response to the Comptroller General's findings.

Subtitle I — Public Company Accounting Oversight Board, Portfolio Margining and Other Matters

- *Foreign Oversight Authorities.* The PCAOB is authorized to share, at its discretion, documents and information prepared or received by the Board, as well as its deliberations, in connection with an inspection with foreign auditor oversight authority without the information losing its privileged status if, among other things, the PCAOB finds that sharing the information is necessary to protect investors and the foreign auditor oversight authority provides assurances of confidentiality.

- *Auditors of Broker-Dealers.* The Act gives the PCAOB the authority to inspect registered public accounting firms that audit brokers and dealers. The PCAOB would be authorized to refer investigations with respect to an audit of a broker or dealer to that broker's or dealer's self-regulatory association.

- *Securities Lending.* Within two years of enactment, the SEC shall issue rules to increase the transparency of information available to brokers, dealers and investors with respect to the loan or borrowing of securities.

- *GAO Study on Proprietary Trading.* The Comptroller General must conduct a study of the risks and conflicts associated with proprietary trading by insured depository institutions, affiliates of insured depository institutions, bank holding companies, financial holding companies, or subsidiaries of bank holding companies and financial holding companies. The study is to evaluate whether proprietary trading presents: (1) a material systemic risk to the stability of the financial system, (2) a material risk to the safety and soundness of such entities and (3) material conflicts of interests between such entities and clients. The study also is to evaluate whether adequate disclosure is provided to depositors, trading and asset management clients, and investors in such entities as well as whether banking, securities, and commodities regulators have adequate systems and controls to monitor and contain any risks and conflicts of interest relating to proprietary trading. The Comptroller General must submit his findings to Congress not later than 15 months after enactment of the Act.

- *SOX External Audit of Internal Controls.* The Act exempts issuers that are neither "large accelerated filers" nor "accelerated filers" from the Sarbanes-Oxley Act's external audit of internal control requirement. The SEC is to conduct a study to determine how it could reduce the burden of complying with Section 404(b) of the Sarbanes-Oxley Act for companies whose market capitalization is between $75 million and $250 million. The Comptroller General further is to conduct a study on whether issuers that are exempt from Section 404(b) requirements have fewer or more restatements of published accounting statements.

- *Equity Indexed Annuities.* The Act states that certain indexed annuities will be treated as exempt securities under the Securities Act. This provision, in effect, nullifies much of Securities Act Rule 151A. To qualify for the exemption: (1) the value of the annuity may not vary based on the performance of a separate account, (2) the annuity contract must satisfy standard nonforfeiture laws and (3) the insurer implements or is subject to minimum suitability requirements for the sale of such products.

Title X — Bureau of Consumer Financial Protection

- **The Bureau.** The Act creates the Consumer Protection Bureau within the Federal Reserve; the Act prohibits the Federal Reserve Board from interfering with the Bureau's operations.
- **Single Director.** The Consumer Protection Bureau will be led by a sole Director appointed by the President with the advice and consent of the Senate.
- **Transfer of Powers.** The Act transfers to the Consumer Protection Bureau the consumer financial protection functions (including rule-making and enforcement authority) of other Federal agencies under various consumer protection laws. However, the Chairperson of the Council (the Treasury Secretary) has the authority to temporarily stay regulations issued by the Bureau, and the Council, upon a two-thirds vote of its members, can permanently set aside such regulations in limited circumstances.
- **Mandate and Rule-Making.** The Consumer Protection Bureau's mandate is to implement and enforce consumer financial protection laws for the purpose of ensuring that all consumers have access to markets for consumer financial products and services, and that markets for consumer financial products and services are fair, transparent and competitive. The Bureau will have broad rule-making authority to implement its mandate and objectives, as well as more specific rule-making authority under Title X and existing statutes transferred to the Bureau's jurisdiction.
- **Preemption.** The Act substantially revises the scope of preemption of State law for national banks and Federal savings banks. State consumer laws will be preempted only to the extent that they prevent or significantly impair the Federally chartered banks' exercise of their powers, and the preemption decision must be made on a case-by-case basis.
- **Effective Dates.** The Act requires the Secretary of the Treasury, in consultation with other agencies, to establish a "designated transfer date," between six and 18 months after enactment of the Act, for the transfer of consumer financial protection functions to the Consumer Protection Bureau. Most provisions of Title X become effective on that date. However, various provisions are subject to separate effective dates.

Creation and Organization of the Consumer Protection Bureau

- The Act creates the Consumer Protection Bureau within the Federal Reserve, with jurisdiction over credit, savings, payment and other consumer financial products and services. Financial products or services include the "catch-all" category of those that the Consumer Protection Bureau determines: (1) are permissible for a bank or financial holding company to offer and (2) have, or likely will have, a material impact on consumers.
- The Act does not give the Consumer Protection Bureau responsibility for mutual funds or other investment products, which remain with the SEC and CFTC, and the Bureau does not have authority over insurance products.
- Although the Consumer Protection Bureau is part of the Federal Reserve, the Federal Reserve Board is prohibited from intervening in matters before the Consumer Protection Bureau, appointing or removing officers or employees of the Consumer Protection Bureau or merging or consolidating the Consumer Protection Bureau or any of its functions with any other division or office of the Federal Reserve. The Bureau's budget will be principally funded by the Federal Reserve.
- The Consumer Protection Bureau's authority extends to all entities engaged in providing financial products within its jurisdiction, as well as entities covered by any of the "consumer protection" statutes that will be transferred to the Consumer Protection Bureau under the Act. The Act also extends the Consumer Protection Bureau's jurisdiction to include affiliates of covered persons which act as a service provider to the covered person, thus

subjecting a wide range of companies to the Consumer Protection Bureau's jurisdiction. There are a number of exceptions to the Bureau's authority, discussed below.

- The Consumer Protection Bureau will be led by a Director appointed by the President with the advice and consent of the Senate; the Director will serve a five-year term, and can be removed by the President for cause.
- Offices of Fair Lending, Financial Education, Service Member Affairs and Financial Protection of Older Americans will be created within the Consumer Protection Bureau, and an ombudsman for private education loans will be designated. A Consumer Advisory Board will also be created.

Authority of the Consumer Protection Bureau

- The Consumer Protection Bureau's mandate is to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent and competitive. The Act broadly defines the Bureau's objectives and functions.
  - In addition to general rule-making authority to implement Federal consumer financial law, the Act gives the Consumer Protection Bureau the authority to prescribe: (1) rules and regulations applicable to covered persons or service providers identifying unlawful, unfair, deceptive or abusive acts or practices in connection with consumer transactions for a consumer financial product or service, (2) consumer disclosure requirements for financial products and services, including model disclosures that would provide a safe harbor for covered persons and (3) rules requiring a covered person to make available to a consumer, upon request, information concerning the consumer financial product or service obtained from such covered person.
  - The Consumer Protection Bureau has exclusive authority to issue and interpret regulations under a broad array of existing laws (such as the Truth in Lending Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act and the Real Estate Settlement Procedures Act). Other agencies which currently have rule-making authority under these statutes will lose that authority; however, the Act provides that the Federal Trade Commission ("FTC") retains its authority under the FTC Act and any other law, other than its authority under the enumerated consumer finance laws which are transferred to the Consumer Protection Bureau.
  - Prior to proposing a regulation, the Consumer Protection Bureau must consult with appropriate prudential regulators and other Federal agencies; if a prudential regulator provides the Consumer Protection Bureau with a written objection to a proposed regulation, the Consumer Protection Bureau must include a description of the objection, and of the Consumer Protection Bureau's decision regarding the objection, in the adopting release for the proposed regulation.
  - When proposing a regulation, the Consumer Protection Bureau must consider the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services that will result from the rule, and the impact on consumers in rural areas and very large banks.
  - The Council may permanently set aside regulations issued by the Consumer Protection Bureau if two-thirds of the Council members agree that the regulation would put the safety and soundness of the U.S. banking system or the stability of the U.S. financial system at risk; the Chairperson of the Council (the Treasury Secretary) may stay the effectiveness of a regulation issued by the Consumer Protection Bureau for up to 90 days upon receipt of a petition by a member of the Council to have the regulation set aside, so that the Council may consider the petition.

  - The Consumer Protection Bureau is authorized to prohibit or restrict the use of mandatory predispute arbitration provisions; however, the Consumer Protection Bureau must first conduct a study of the use of such provisions and provide a report to Congress.
  - The Act requires the Consumer Protection Bureau to conduct a study on reverse mortgage transactions, which must be completed within one year after the designated transfer date. If the Consumer Protection Bureau determines based on the study that conditions or limitations on reverse mortgage transactions are necessary or appropriate to protect borrowers, it may issue regulations imposing such conditions and limitations, including regulations identifying unfair, deceptive or abusive practices or establishing disclosure requirements and model disclosure forms.

- The Consumer Protection Bureau will assume the role of examining very large banks for compliance with consumer financial laws and regulations, and will have primary authority to enforce consumer financial laws with respect to such institutions.
  - Very large banks are insured depository institutions and insured credit unions with total assets of more than $10 billion, and their affiliates.
  - The Consumer Protection Bureau is required to coordinate its supervisory activities with those conducted by prudential regulators and State bank supervisors; if supervisory determinations by the Consumer Protection Bureau conflict with those of a prudential regulator, the conflicts are to be resolved by a panel consisting of a representative of the Consumer Protection Bureau, a representative of the prudential regulator and a representative of another banking agency.
- The Consumer Protection Bureau also may require depository institutions other than very large banks to provide reports to the Consumer Protection Bureau, and may participate in examinations of such institutions that are performed by prudential regulators.
- The Act gives the Consumer Protection Bureau supervisory authority over mortgage brokers, lenders and servicers, private education loan lenders, payday loan lenders, other large nondepository institutions that offer consumer financial products or services and service providers to all of the foregoing. Other nondepository institutions will be subject to supervision principally at the State level, and in many cases by the FTC.
- The Act gives the Consumer Protection Bureau broad authority to investigate potential violations of consumer protection laws, including the power to conduct hearings, subpoena records and the testimony of witnesses and issue civil investigative demands for records and oral testimony. The Act also includes protections for whistleblowers at covered entities.
- The Act provides that the Consumer Protection Bureau will not have any rule-making, supervisory, enforcement or other authority over: (1) many merchants, retailers or other sellers of nonfinancial goods and services, except if they are covered by one of the transferred consumer protection laws (such as the Truth in Lending Act) or significantly engaged in providing consumer financial products or services, (2) licensed real estate brokers, (3) a person who acts as an agent or broker for a buyer or seller, or otherwise facilitates the purchase by a consumer of a manufactured home or modular home, (4) accountants and tax preparers, (5) activities of attorneys as part of the practice of law, (6) persons regulated by State insurance regulators, State securities commissions, the SEC, the CFTC or the Farm Credit Administration, (7) employee benefit and compensation plans or (8) activities relating to charitable contributions to tax-exempt organizations.
- The Act also generally exempts from the Consumer Protection Bureau's authority automobile dealers which are predominantly engaged in the sale and servicing of motor vehicles and/or the leasing and servicing of motor vehicles. However, automobile dealers will be subject to the Bureau's authority if they engage in mortgage-related

activities, if they finance automobile loans or leases without selling the paper to third parties or if they engage in other financial products or services not related to automobile finance.

Preemption/State Authority

- The bills that passed the House in December and the Senate in May both significantly changed the scope of preemption of State laws applicable to national banks, under the National Bank Act, and Federal savings banks, under the Home Owners' Loan Act. The Senate Bill, in a compromise measure adopted near the end of the debate on the bill, expressly incorporated the Supreme Court's decision in *Barnett Bank of Marion County, N.A.* v. *Nelson*, 517 U.S. 25 (1996), as the standard for preemption. The House Bill, rather than incorporating *Barnett Bank* expressly, used language drawn from the decision to define the scope of preemption. The final Act substantially follows the Senate Bill's compromise, however, it refers to *Barnett Bank* only as a guidepost and defines the preemption standard by drawing language out of that opinion, similar to the House Bill. Under the Act, preemption may apply if, "in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in *Barnett Bank of Marion County, N. A.* v. *Nelson, Florida Insurance Commissioner, et al.*, 517 U.S. 25 (1996), the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers."
- Preemption determinations may only be made on a case-by-case basis, must follow procedural rules and be reviewed on a regular basis and may be made only by the Comptroller of the Currency rather than any designee.
- Preemption under the National Bank Act and Home Owners' Loan Act no longer applies to any non-bank operating subsidiaries of national banks and Federal savings bank.
- The Act confirms that Federal preemption of State interest rate limits (the "exportation" doctrine for banks) is preserved.
- The new Consumer Financial Protection Act (Title X) itself does not preempt State law unless the State law is inconsistent with Federal law. A State law providing additional consumer protection is not considered an inconsistency.
- The Act follows the Senate Bill compromise in defining the enforcement powers of the States. State attorneys-general may bring actions in a court in that attorney-general's own State to enforce the Act or its regulations, although the State officials must consult with the Consumer Protection Bureau before initiating such an action, and the Consumer Protection Bureau would have the power to intervene. With respect to enforcement of the new Act against Federal chartered banks, however, State attorneys-general are only permitted to bring actions to enforce specific regulations adopted by the Bureau under Title X. As to enforcement actions more generally, the Act adopts the Supreme Court's decision in *Cuomo* v. *Clearing House Ass'n*, 129 S. Ct. 2710 (2009), under which State attorneys-general are authorized to bring, in courts of appropriate jurisdiction, litigation to enforce non-preempted law.
- The Consumer Protection Bureau is required to commence a rule-making if a majority of the States enact resolutions calling for regulation of a particular matter.

Private Right of Action

- The Act does not expressly create a private right of action for consumers.
- The Act provides that it is "unlawful" to "offer or provide to a consumer any financial product or service" that is "not in conformity with" Federal consumer financial law, or otherwise "commit any act or omission" in violation of a Federal consumer financial law. This provision of the Act is substantially different from the versions passed

by both the House and Senate, which also made it unlawful to "enforce" or "attempt to enforce" contracts not in compliance with the Act.

Other Provisions

- The Act amends TILA to increase the caps on credit transactions and consumer leases that are subject to TILA from $25,000 to $50,000, and to permit the Consumer Protection Bureau to adjust such caps annually based on increases in the Consumer Price Index for Urban Wage Earners and Clerical Workers.
- The Act amends the Electronic Fund Transfer Act to allow the Federal Reserve to issue regulations governing interchange for debit and certain prepaid card transactions. This provision was modified substantially from the version included in the Senate Bill, and now: refers only to the interchange received by issuers (rather than network fees); permits a rule-making procedure to adjust interchange amounts based on fraud costs; and exempts small issuers, government-sponsored programs and many reloadable prepaid card programs. The provision restricts issuers' and networks' ability to impose requirements for routing transactions. The provision also precludes networks from prohibiting merchants from offering discounts based on the method of payment, as long as the discounts do not discriminate between debit or credit cards based on the issuer, and are offered and disclosed in compliance with other legal requirements. Finally, networks may not prohibit merchants from setting a minimum credit card transaction amount of $10 or less, and may not prohibit institutions of higher education and government entities from setting a maximum transaction amount.
- The Act provides for increased disclosures and other regulations relating to remittance transfers.
- The Act amends the Fair Credit Reporting Act to require a person which takes adverse action against a consumer on the basis of a consumer report to disclose to the consumer his or her credit score and information concerning the model used to generate the credit score. In a final Conference Committee change, the effective date for this provision was moved from the day after enactment of the Act to the designated transfer date, providing substantial additional time for affected entities to comply.
- The Act requires the Treasury Secretary to conduct a study of, and develop recommendations regarding, the options for ending the current conservatorship of Fannie Mae and Freddie Mac and the role of the Federal government in the U.S. housing finance system, and submit the recommendations to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Financial Services of the House by not later than January 31, 2011.
- The Act requires a number of additional studies and reports, including in relation to private education loans, the use of credit scores and tax-deferred exchange facilitation services.
- The Act directs the United States Sentencing Commission to review and, if appropriate, amend its guidelines and policy statements concerning sentences for securities fraud and financial institution fraud based on a number of specified factors including the seriousness of the offenses and the need for deterrence. The Act also revises the statutes of limitations for certain securities fraud and other violations.
- The Act also provides a six year statute of limitations for criminal prosecutions for violations of 18 U.S.C. § 1348 (the Federal criminal code for securities fraud), the Exchange Act, the Securities Act, the Advisers Act, the Investment Company Act and the Trust Indenture Act of 1939.

Title XI — Federal Reserve System Provisions

- **Federal Reserve Emergency Lending Procedures.** The Act directs the Federal Reserve to establish policies and procedures governing emergency lending.
- **GAO Audits of Emergency Lending and Federal Reserve Governance.** The Act authorizes the GAO to conduct audits of emergency credit facilities and covered transactions and the governance of the Federal Reserve bank system.
- **FDIC Debt Guarantee Program.** The Act establishes procedures and requirements for the establishment of a debt guarantee program by the FDIC if a liquidity event is determined to exist.

Federal Reserve Emergency Lending Authority

- *Emergency Lending Policies and Procedures.* The Act requires the Federal Reserve, in consultation with the Treasury Department, to establish policies and procedures governing emergency lending under Section 13(3) of the Federal Reserve Act 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 requires that such procedures prohibit borrowing from programs and facilities by insolvent borrowers.
- *Treasury Approval.* Programs and facilities may not be established under Section 13(3) without prior approval of the Treasury Secretary.
- *Reporting Requirements.* The Act requires the Federal Reserve to provide initial and periodic reports to Congress on programs or facilities created under Section 13(3).
- *GAO Audit Authority.* The Act authorizes the GAO to conduct audits of credit facilities established under Section 13(3) and certain open market transactions or discount window advances ("covered transactions").
  - The scope of such audits is limited to assessing:
    - the operational integrity, accounting, financial reporting and internal controls of the programs, facilities or covered transactions;
    - the effectiveness of the security and collateral policies for the facility or covered transaction in mitigating risk to the Federal Reserve bank and the taxpayers;
    - whether the credit facility or the conduct of a covered transaction favors participants over other eligible institutions; and
    - the policies governing the use, selection or payment of third-party contractors for any credit facility or covered transaction.
  - The GAO must report to Congress the results of such audits and recommendations for legislative or administrative action.
- *Public Disclosure.*
  - The Act requires the Federal Reserve to publish on its Website certain information, including GAO audit reports of Section 13(3) programs, facilities or covered transactions, annual financial statements prepared by an independent auditor and reports to Congress on Section 13(3) programs, facilities or covered transactions.

  - The Act requires the Federal Reserve to disclose the names and identifying details of each borrower, participant or counterparty in any credit facility or covered transaction, the amount borrowed or transferred, the interest rate or discount paid and information identifying the types and amounts of collateral pledged or assets transferred in connection with participation in the credit facility or covered transaction. Such disclosures shall take place one year following termination of a credit facility and on the last day of the eighth quarter following the quarter in which a covered transaction was conducted.

One-Time GAO Audit of Pre-enactment Federal Reserve Assistance and Federal Reserve Governance

- *GAO Audit of Emergency Lending.* The Act directs the GAO to conduct a one-time audit of all loans and other financial assistance provided by the Federal Reserve beginning December 1, 2007 through the date of enactment of the Act through the emergency programs created under Section 13(3) of the Federal Reserve Act (*e.g.,* TALF) to assess the same factors identified in the GAO Audit described above (*GAO Audit Authority*).
- *Public Disclosure of Certain Loans and Financial Assistance.* The Act directs the Federal Reserve to publish on its Website information on all loans and financial assistance provided from December 1, 2007 through the date of enactment pursuant to emergency programs created under Section 13(3) of the Federal Reserve Act.
- *GAO Audit of Federal Reserve Bank Governance.* The Act requires the GAO to complete an audit of the governance of the Federal Reserve bank system, including the appointment and election of Federal Reserve bank directors and establishment and operation of the loan and financial assistance facilities described above. Such audit must be completed within one year after the date of enactment.

FDIC Debt Guarantee

- *Establishment of Debt Guarantee Program.* If, upon the request of the Treasury Secretary two-thirds of the members of each of the FDIC and the Federal Reserve Board determine that a liquidity event exists to warrant the use of the debt guarantee program, then upon the written consent of the Secretary, the FDIC shall create a widely available program to guarantee the obligations of solvent insured depository institutions or solvent depository institution holding companies (including any affiliates thereof) during times of severe economic distress. A liquidity event is defined as: (1) an exceptional and broad reduction in the general ability of financial participants to sell financial assets without an unusual and significant discount, or to borrow using financial assets as collateral without an unusual and significant increase in margin or (2) an unusual and significant reduction in the ability of financial market participants to obtain unsecured credit.
- *Restrictions on Debt Guarantee Program.* The Act directs the FDIC, in consultation with and with the concurrence of the Secretary, to establish policies and procedures governing the issuance of debt guarantees.
  - The guarantee of obligations may not include the provision of equity in any form.
  - The policies and procedures may include a requirement of collateral as a condition of any such guarantee.
  - The Secretary, in consultation with the President, must establish a maximum amount of debt that the FDIC may guarantee under a debt guarantee program, which must be approved by a joint resolution of Congress under statutorily prescribed procedures.
  - A guarantee of a deposit is not treated as a debit guarantee program.
- *Funding of a Debit Guarantee Program.* The Act directs the FDIC to charge fees and other assessments to participants in the debt guarantee program in such amounts as are necessary to offset projected losses and administrative amounts, including amounts borrowed from the Treasury Department to carry out a debt guarantee program. The

Act permits the FDIC to borrow funds from the Treasury Department to carry out a debt guarantee program, but prohibits the FDIC from borrowing from the Deposit Insurance Fund for such purpose.

- *Default under an FDIC Guarantee.* If a participant in an FDIC debt guarantee program defaults on an obligation guaranteed by the FDIC, the Act requires the FDIC to appoint itself as receiver for an insured depository institution participant; and, for participants that are not insured depository institutions, the Act requires consideration of whether the company should be resolved under Section 203 of the Act and file a petition for bankruptcy or file a petition for involuntary bankruptcy of the company.

Title XII — Improving Access to Mainstream Financial Institutions

- The Treasury Secretary is authorized to establish a program to expand access to mainstream depository institutions.
- The Treasury Secretary is authorized to establish a program to provide alternatives to payday loans.

Expanded Access to Mainstream Financial Institutions

- 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.

Low-Cost Alternatives to Payday Loans

- 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.

Title XIII — Pay It Back Act

- TARP authorization reduced to $475 billion.
- Proceeds from the sale of GSE obligations currently held by the Treasury Department will be used for deficit reduction.

- 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 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.

Title XIV — Mortgage Reform and Anti-Predatory Lending Act

- **Mortgage Loan Origination and Minimum Standards for Mortgages.** The Act imposes restrictions on residential mortgage loan origination, including limits on originator compensation, a prohibition on certain prepayment penalties and a requirement that a creditor make a reasonable and good faith determination, based on verified and documented financial information of the consumer, that the consumer has a reasonable ability to repay a residential mortgage loan.
- **Other Provisions.** 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.
- **Effective Date of Amendments**. The regulations to implement the new requirements must be in final form within 18 months of the date designated for transfer of functions to the Consumer Protection Bureau in accordance with the Act and the related amendments will take effect on the date the final regulations take effect (which must be within one year of the date the regulations are issued in final form).

Residential Mortgage Loan Origination Standards

- *Compensation.* Intending to prohibit "yield-spread premiums," the Act prohibits a mortgage originator from receiving compensation that varies based on the terms of the residential mortgage loan (other than the principal amount). The Act also prohibits an originator from receiving any origination fee or charge from any person other than the consumer except where:
  - no compensation is received directly from the consumer; and
  - unless otherwise waived or exempted by the Federal Reserve Board, the consumer does not make an upfront payment of discount points, origination points or fees (other than bona fide third-party charges not retained by the mortgage originator or creditor or any affiliate of either).
- Under regulations to be adopted by the Federal Reserve Board, mortgage originators will be prohibited from steering a consumer to residential mortgage loans that a creditor is prohibited from making as described below under "—Minimum Standards for Mortgages—Ability to Repay" or that have predatory characteristics or effects.

Minimum Standards for Mortgages

- *Ability to Repay.* The Federal Reserve Board must adopt regulations prohibiting a creditor from making residential mortgage loans (other than reverse mortgages and bridge loans) unless it reasonably and in good faith determines, based on verified and documented information of the consumer's financial resources (other than the equity in the property), that at the time the loan is consummated the consumer has a reasonable ability to repay the loan according to its terms, as well as all applicable taxes, insurance (including mortgage guarantee insurance) and assessments.
  - The creditor's determination must be made using a payment schedule that fully amortizes the residential mortgage loan over the term of the loan.
  - If the creditor knows, or has reason to know, that one or more residential mortgage loans secured by the same property will be made to the consumer, it must make the determination with respect to the combined amount owed.

- A creditor of a residential mortgage loan, and any assignee of the loan subject to liability under TILA, is presumed to have met the ability to repay determination requirement if the loan is a "qualified mortgage." For this purpose, a "qualified mortgage" includes a residential mortgage loan that is fully amortizing, limits the terms of balloon loans and deferred principal payments, requires verification of financial resources, limits points and fees charged and complies with thresholds with respect to debt-to-income level.
- The Act also includes standards for determining a consumer's ability to repay under "nonstandard loans" including variable rate, interest-only and negative amortization loans.
- The Department of Housing and Urban Development, the Department of Veterans Affairs, the Department of Agriculture and the Rural Housing Service may exempt a refinancing of a loan made, guaranteed or insured by it under certain circumstances.

- *Foreclosure Defense.* Violations of the origination and repayment verification standards set forth in Title XIV can be asserted as a defense to foreclosure by recoupment or set-off without regard for the time limit on a private action for damages.
- *Additional Standards and Requirements.* The Act prohibits prepayment penalties on residential mortgage loans other than "qualified mortgages."
  - Qualified mortgages for this purpose exclude residential mortgage loans with an adjustable interest rate or with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction (as of the date the interest rate is set) by prescribed amounts.
  - Prepayment penalties are prohibited on qualified mortgages after year three of the loan and, prior to year three, a prepayment penalty on a qualified mortgage loan cannot exceed 3% of the outstanding balance of the loan in year one, 2% in year two and 1% in year three.
  - The Act requires creditors offering a consumer a residential mortgage loan with a prepayment penalty to offer the consumer the option of a residential mortgage loan without a prepayment penalty.
  - The Act also:
    - imposes limits on creditors financing (in connection with any residential mortgage loan) any credit life, credit disability, credit unemployment or credit property insurance, or any other accident, loss-of-income, life or health insurance, or any payments directly or indirectly for any debt cancellation or suspension agreements or contracts;
    - prohibits residential mortgage loans from containing mandatory arbitration provisions;
    - imposes disclosure requirements with respect to: a creditor's policies with respect to partial payments; negative amortization loans; residential mortgage loans subject to protection under any State anti-deficiency law; and other disclosure and periodic reporting requirements with respect to residential mortgage loans, and imposes notice requirements with respect to resets of hybrid adjustable rate mortgages;
    - increases the civil money penalties available in TILA litigation, including an increase from $500,000 to $1 million for the maximum civil money penalty in a class action; and
    - requires a study by the GAO to determine the effect of the amendments on availability and affordability of credit, and the effect of the credit risk retention provisions with respect to non-qualified mortgages on the capital reserves and funding of lenders.

Other Provisions

- The Act also:
  - expands the definition of a "high-cost mortgage" under TILA and imposes new requirements on high-cost mortgages, including with respect to origination practices and loan terms;
  - adds a provision to TILA regarding escrow accounts, imposing substantive requirements as well as new disclosure rules;
  - amends TILA to address appraisal practices, and amends the Equal Credit Opportunity Act to expand the requirement to provide copies of appraisals to loan applicants;
  - requires that payments be credited promptly, and that payoff statements be provided promptly; and
  - establishes the Office of Housing Counseling to provide homeownership and rental housing counseling.
- While the Act does not include any specific provisions with respect to ending the conservatorship of Fannie Mae and Freddie Mac, the Act does state Congress' sense that efforts to enhance credit and practices related to credit through regulation of residential mortgage credit terms would be incomplete without enactment of meaningful structural reforms of Fannie Mae and Freddie Mac.

Effective Date of Regulations and Amendments

- The regulations to implement the new requirements must be in final form within 18 months of the date designated for transfer of functions to the Consumer Protection Bureau in accordance with the Act and the related amendments will take effect on the date the final regulations take effect (which must be within one year of the date the regulations are issued in final form). If regulations are not issued in final form in accordance with the preceding sentence, the amendments will take effect 18 months after the designated transfer date.

Title XV — Miscellaneous Provisions

- The U.S. Executive Director of the IMF is instructed to evaluate loans to foreign governments and oppose those not likely to be repaid in full.
- The Disclosure related provisions of Title XV are discussed under Title IX, Subtitles E and G above.

Restrictions on the Use of U.S. Funds for Foreign Governments

- The Act amends the Bretton Woods Agreements Act to require the Treasury Secretary to instruct the U.S. Executive Director of the International Monetary Fund ("the Fund") to evaluate any proposal submitted to the Fund to make a loan to a country if the amount of public debt of the country exceeds its gross domestic product and the country is not eligible for assistance from the International Development Association. If the evaluation indicates that the proposed loan is not likely to be repaid in full, the Treasury Secretary is required to instruct the U.S. Executive Director to oppose the proposal. If the proposed loan is approved by the Fund over the U.S. opposition, the Treasury Secretary is required to report annually to Congress assessing the likelihood that the loan will be paid.

Disclosure Related Provisions

- For information on the disclosure related provisions of Title XV, please see "Title IX—Investor Protections and Improvements to the Regulation of Securities," Subtitles E and G, above.

Title XVI — Section 1256 Contracts

- The Act clarifies that certain swaps are not treated as Section 1256 Contracts.

- Clarification That Certain Swaps Are Not Treated as Section 1256 Contracts. Section 1603 of the Act amends Section 1256 of the Internal Revenue Code to exclude from the definition of a Section 1256 contract "any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement." See "Title VII—Over-the-Counter Derivatives," above.

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