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# The Dodd-Frank Act, the Changing EU Regulatory Regime and Basel III: Consequences of a New Regulatory Environment

**John M. Casanova, Partner, London**

**Connie M. Friesen, Partner, New York**

**Leonard Ng, Partner, London**

**London/New York**

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# Agenda

I. Introduction – Broad Themes

II. Changes in Supervisory Structure

III. Regulatory Capital Framework

IV. Regulatory Oversight – Key Initiatives

V. Conclusions/Implications



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# I. Introduction – Broad Themes

# Broad Themes for Today

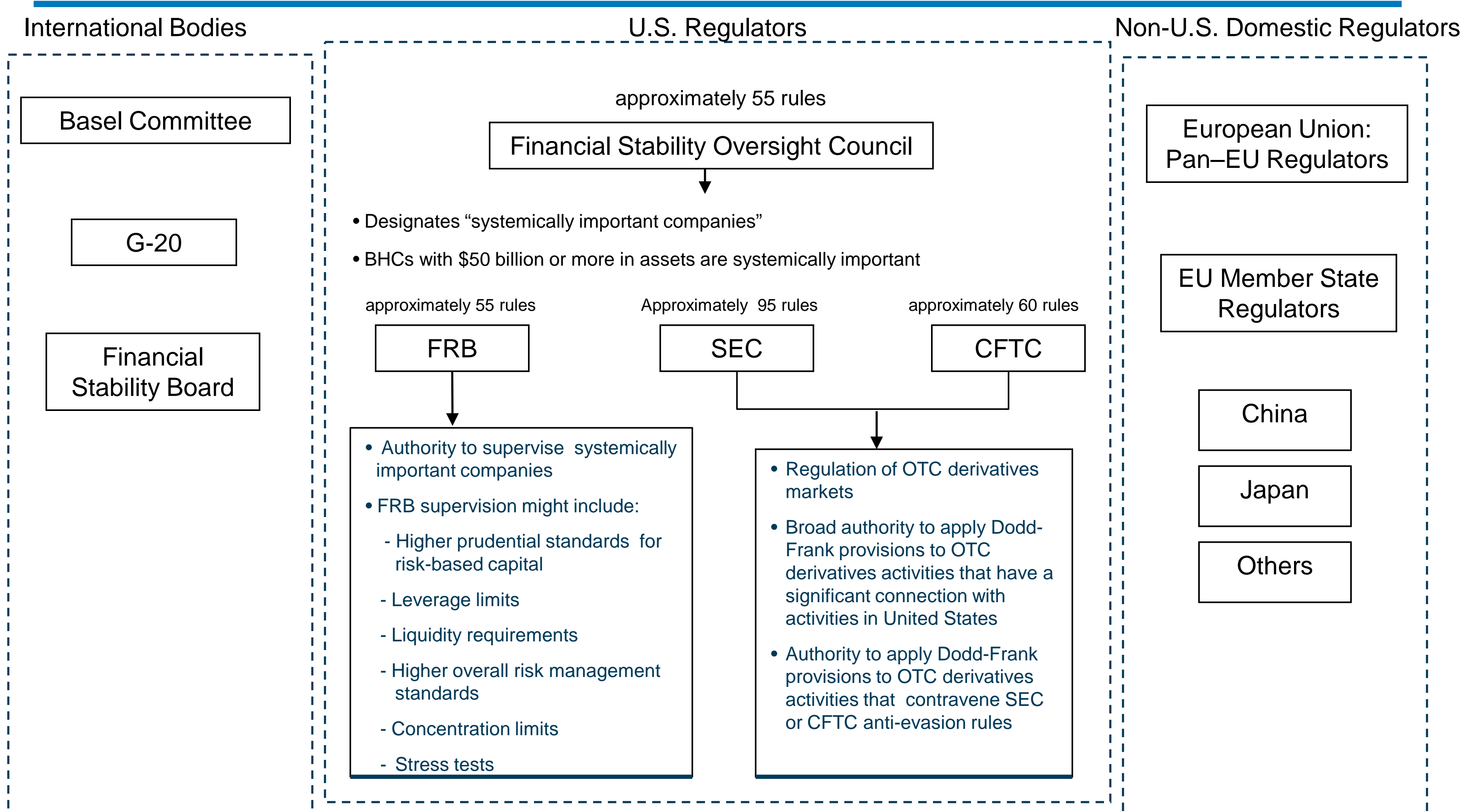
- The credit crisis that began three years ago has changed the way we think about the business and regulation of banking.
- The provisions of the Dodd-Frank Act, various EU regulatory initiatives and Basel III reflect the heightened supervisory oversight and enhanced standards that are characteristic of the new approach.
- The new rules and regulations that will implement the Dodd-Frank Act, the EU initiatives and Basel III will focus on common themes such as:
  - Enhancing Supervision
  - Strengthening Prudential Standards and Crisis Prevention
  - Raising Corporate Governance Expectations
  - Enhancing Transparency
  - Harmonizing Regulatory Standards Across Borders

# II. Changes in Supervisory Structure

# Changes in Supervisory Structure

- Changes in U.S., EU and UK Supervisory Regimes
- Centralization of authority
- Internationalization of standards
- Future developments

# Changes to Supervisory Structure – U.S.



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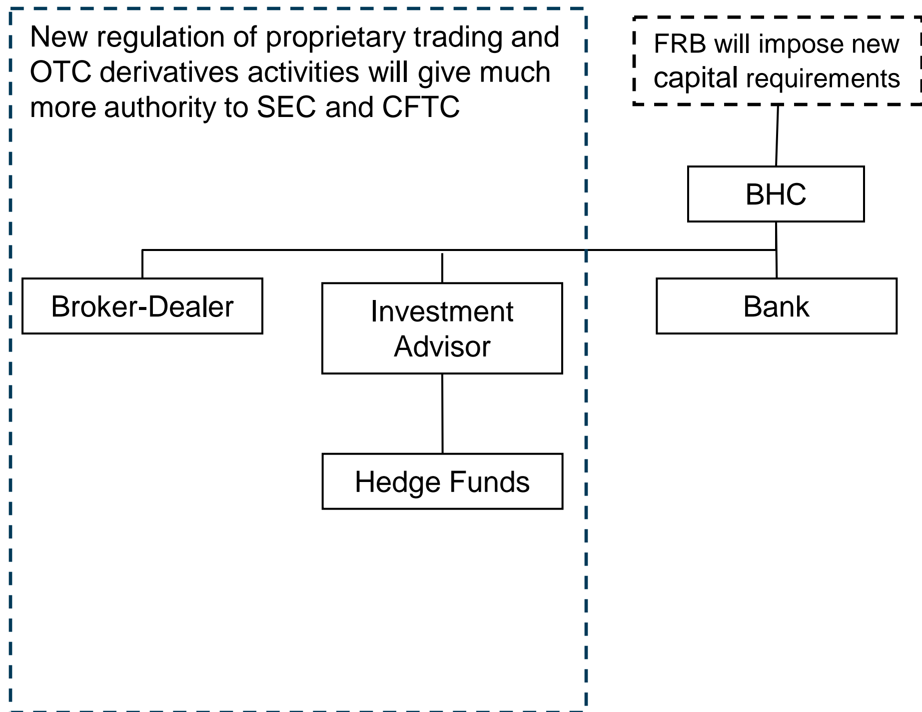
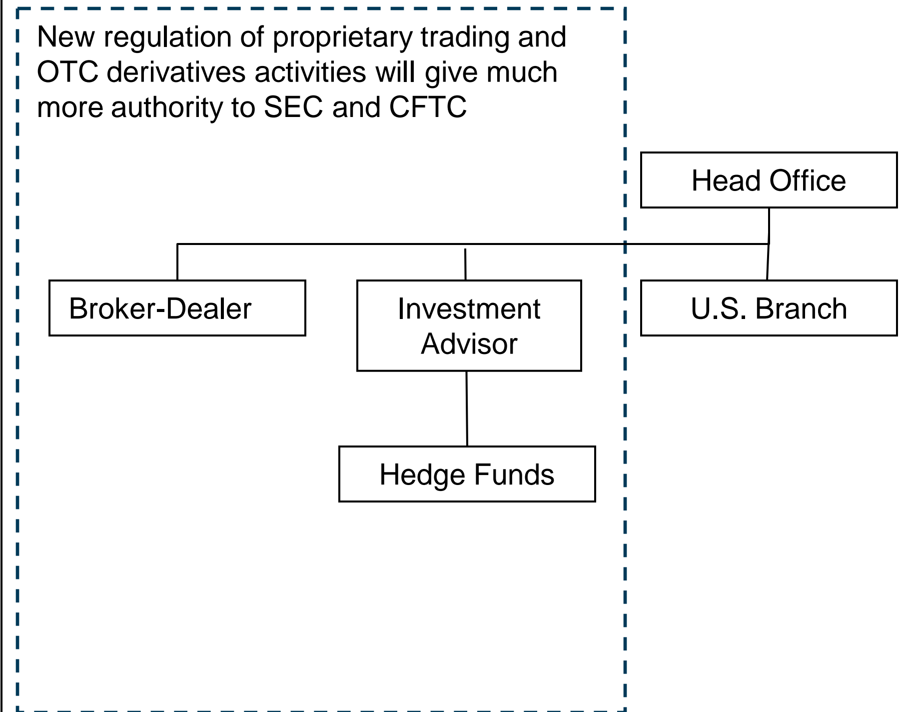
# Changes in Supervisory Structure – U.S.



# Changes in U.S. Bank Supervisory Relationships

| Type of Financial Institution | Supervisor under current law | Supervisor under Dodd-Frank Act |
|---|---|---|
| National Bank | OCC | OCC |
| State Bank | State & FDIC & FRB (if member bank) | State, FDIC & FRB (if member bank) |
| Savings & Loan (“S&L”) | OTS | OCC (Federal “S&L”)<br>FDIC (State “S&L”) |
| “Systemically Important” Non-bank Entities | N/A | FRB |

OCC: Office of the Comptroller of the Currency
FDIC: Federal Deposit Insurance Corporation
OTS: Office of Thrift Supervision
Member Bank: Bank that is a member of the Federal Reserve System



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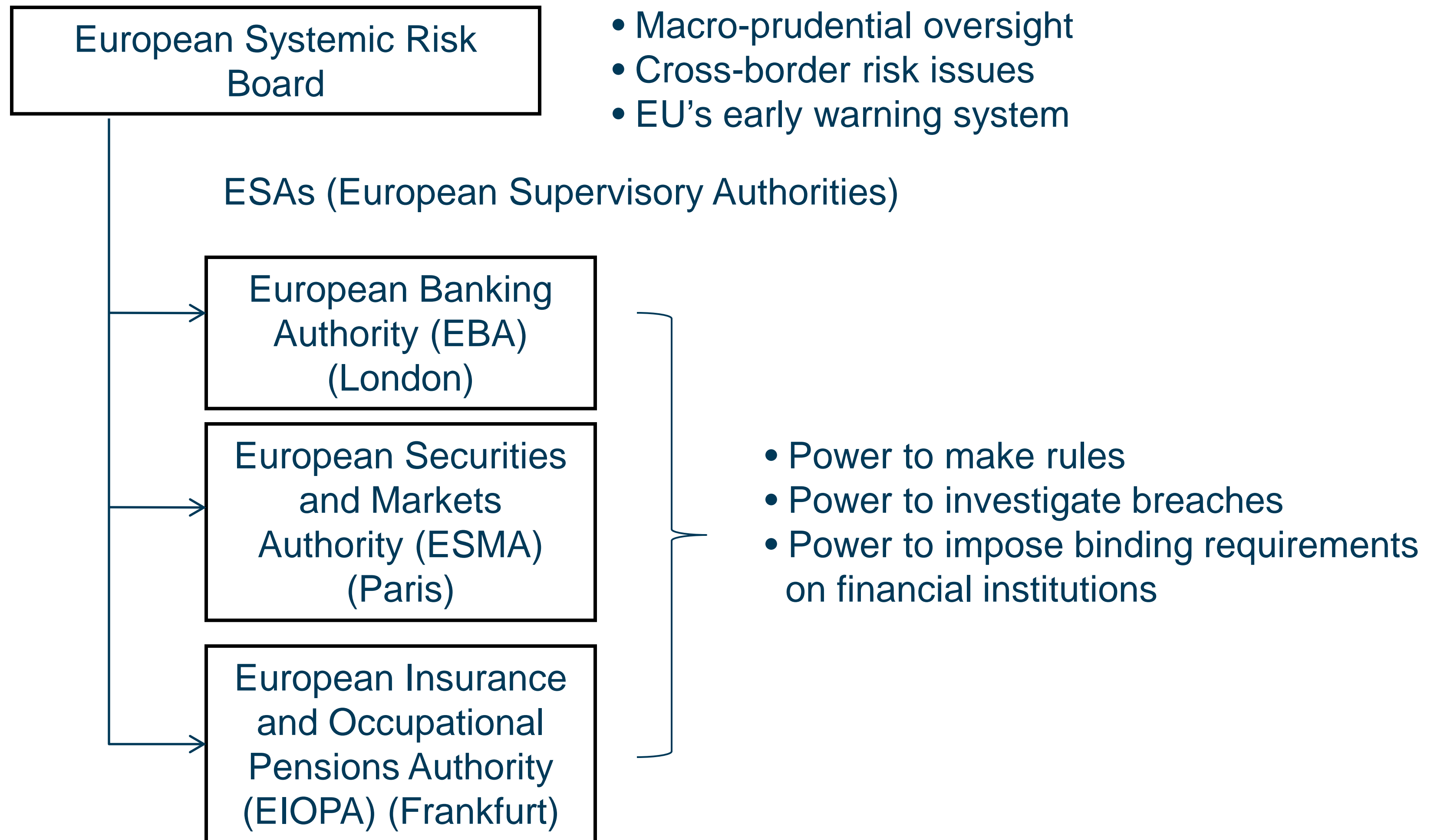
# Changes to Supervisory Structure - EU



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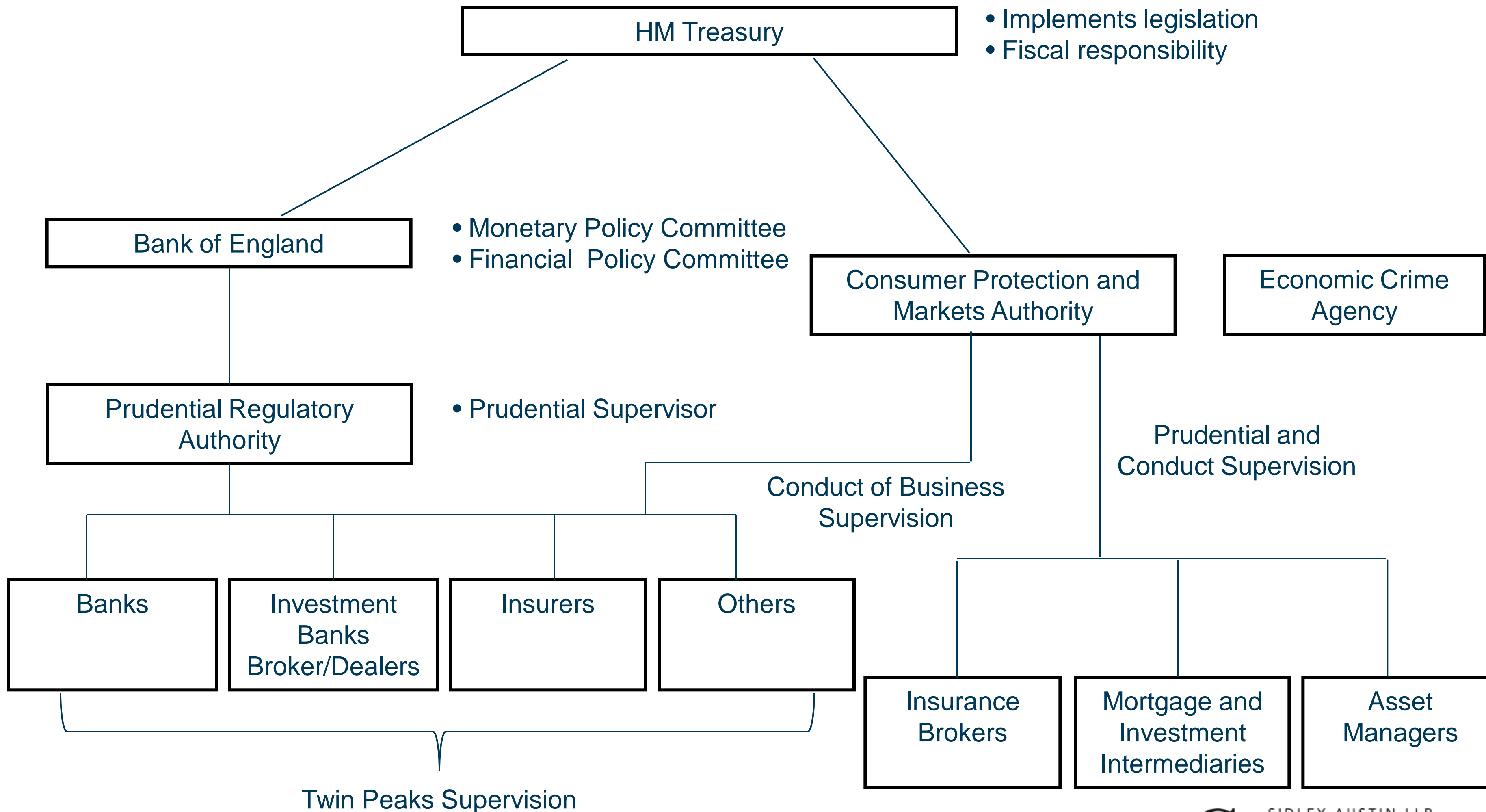
# Changes to Supervisory Structure - UK



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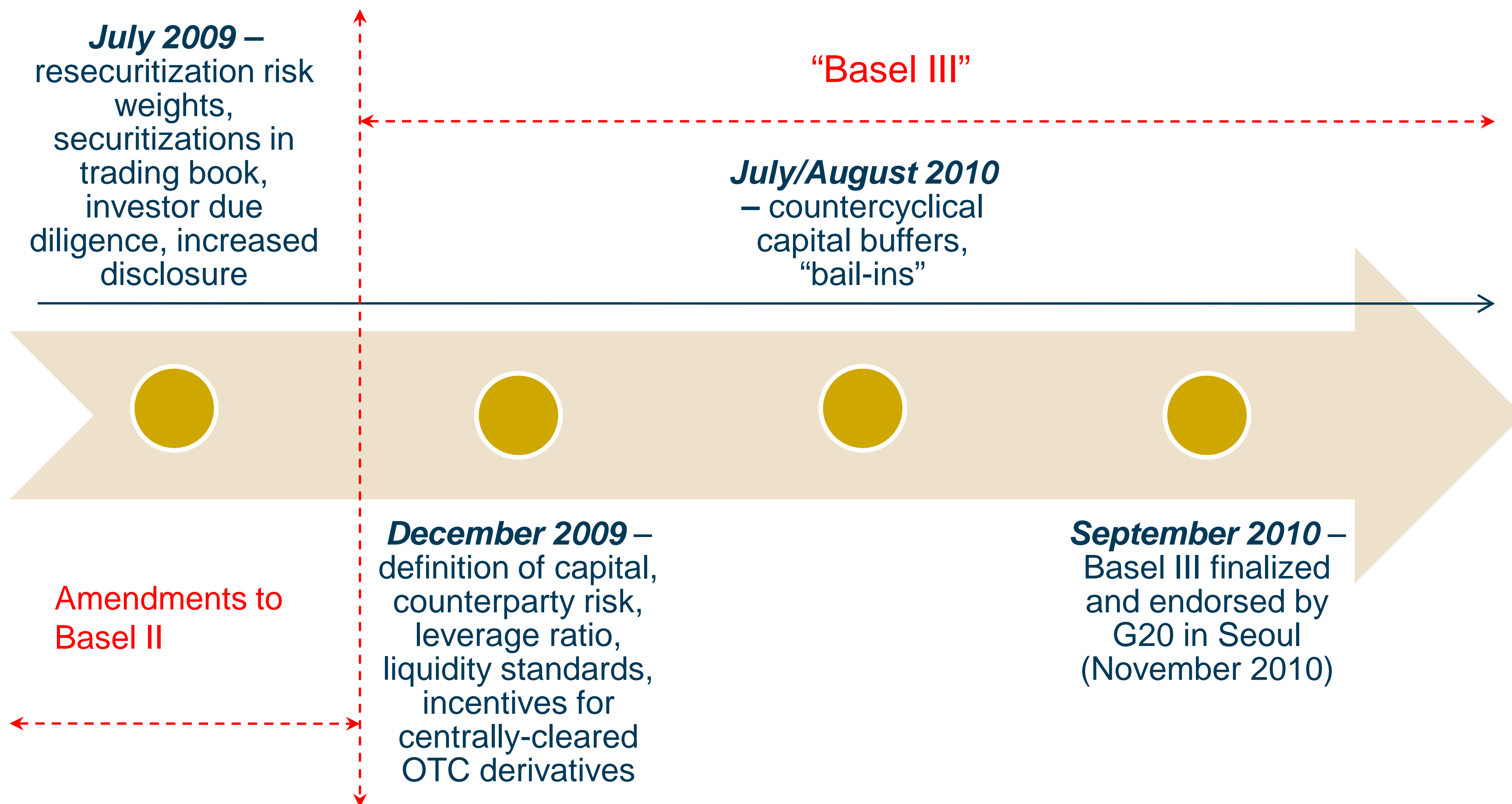
# II. Regulatory Capital Framework

# Basel III – Changes to the Basel Capital Framework



# Equivalent Changes to EU Capital Framework

- EU has a rolling program of changes to the Capital Requirements Directive ("CRD") taking effect in 2011/2012:
  - CRD II ( Jan 1, 2011):
    - 5% retention rule
    - Investor due diligence
    - Enhanced disclosure requirements
  - CRD III (Jan 1, 2011/2012):
    - Resecuritization risk weights
    - Trading book securitization positions
    - Remuneration
  - CRD IV
    - Will implement Basel III (same phased-in timing as Basel III)

# Basel II Changes vs. CRD II / CRD III

| | BASEL II Changes 2009 | CRD II and III |
|---|---|---|
| 5% Risk Retention | - | • |
| Transaction-specific Disclosure | - | • |
| Pillar 3 Disclosures | • | • |
| Investor Due Diligence | • | • |
| Common Approach Requirement | • | • |
| Resecuritization | • | • |
| Large Exposure Rule Changes | - | • |
| Significant Risk Transfer Definition | - | • |
| Securitization Liquidity RWs | • | • |
| Self-guaranteed Exposures | • | • |
| Trading Book Treatment | • | • |

# Basel III/CRD IV – Main Proposals and Implementation

Phase-in arrangements (shading indicates transition periods). All dates are as of January 1.

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | As of January 1, 2019 |
|---|---|---|---|---|---|---|---|---|---|
| Leverage Ratio | Supervisory monitoring | | Parallel run Jan 1, 2013 – Jan 1, 2017<br>Disclosure starts Jan 1, 2015 | | | | | Migration to Pillar 1 | |
| Minimum Common Equity Capital Ratio | | | 3.5% | 4.0% | 4.5% | 4.5% | 4.5% | 4.5% | 4.5% |
| Capital Conservation Buffer | | | | | | 0.625% | 1.25% | 1.875% | 2.50% |
| Minimum common equity plus capital conservation buffer | | | 3.5% | 4.0% | 4.5% | 5.125% | 5.75% | 6.375% | 7.0% |
| Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials) | | | | 20% | 40% | 60% | 80% | 100% | 100% |
| Minimum Tier 1 Capital | | | 4.5% | 5.5% | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| Minimum Total Capital | | | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| Minimum Total Capital plus conservation buffer | | | 8.0% | 8.0% | 8.0% | 8.625% | 9.25% | 9.875% | 10.5% |
| Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital | | | Phased out over 10 year horizon beginning 2013 | | | | | | |
| | | | | | | | | | |
| Liquidity coverage ratio | Observation period begins | | | | Introduce minimum standard | | | | |
| Net stable funding ratio | | Observation period begins | | | | | | Introduce minimum standard | |



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# Implementation of Basel III in the U.S.

- U.S. Treasury Department has committed to implement Basel III capital, liquidity and leverage standards beginning in 2013.
- In a joint press release on September 12, 2010, the U.S. federal banking regulators endorsed the phase-in periods and arrangements agreed to by the Basel Committee.
- In a recent speech, FRB Governor Daniel Tarullo expressed support for Basel III and noted that Basel III's phase-in period of 2013-2019 can readily be met in the U.S.
- The U.S. seems committed to following Basel III guidelines requiring that the Tier 1 common equity ratio be increased to 4.5%.
- The U.S. has also expressed support for a capital conservation buffer of 2.5%, thereby endorsing the Basel III requirement that banks have common equity capital of 7% (4.5% common equity plus 2.5% capital conservation buffer).

# Implementation of Basel III in the U.S.

- The U.S. concepts of “adequately capitalized” and “well capitalized” will need to be reconciled with Basel III requirements. Basel III raises the minimum Tier 1 capital ratio to 6% (by January 1, 2015).
- The higher minimum imposed by Basel III means that U.S. regulators are likely to require a level higher than 6% for entities required to be well-capitalized. This is important because Dodd-Frank applies the “well-capitalized” requirement to FHCs and certain thrift holding companies, as well as to acquiring bank holding companies and resulting insured depository institutions in interstate bank mergers.
- The new capital conservation buffer introduced by Basel III will be treated as a separate requirement to be added on to the 6% requirement.
- Certain capital instruments that will not qualify as Tier 1 capital (including U.S. trust preferred securities and cumulative perpetual preferred stock) will be phased out.

# Basel III and Dodd-Frank: Some Possible Areas of Disagreement

William Dudley (FRBNY): "Basel III achieves an appropriate balance between raising minimum capital and liquidity requirements and does so in a way that recognizes current state of global economy."

Timothy Geithner (Treasury): "Basel III must be implemented in a transparent and consistent manner by supervisors in different countries."

Spencer Bachus (House Financial Services Committee): "Basel III will make the financial system more uncertain without making it significantly safer. We do not know how much capital banks will need to raise or how many businesses and consumers will be denied credit so that banks can comply with Basel III. We are still trying to figure out how the Administration will interpret the new standards and how these standards will interact with Dodd-Frank."

# Challenges in Reconciling the Dodd-Frank Act and Basel III in the U.S.

- Basel III calls for the Basel Committee and the Financial Stability Board to develop a higher "loss absorption" capital charge for "systemically important banks." The Dodd-Frank Act calls for the U.S. Financial Stability Oversight Council to designate certain firms as systemically important.
- The standards required by the Dodd-Frank Act for systemically important institutions are in some respects more stringent than those contemplated by the Basel Committee and the Financial Stability Board.
- The transition to stricter asset risk weightings contemplated by Basel III for trading, derivatives and securitization activities (which rely in part on external ratings) will need to be reconciled with the Dodd-Frank Act requirement to remove external credit ratings from capital adequacy standards.

# U.S. Approach to Securitization Risk Retention

- Dodd-Frank Act requires securitizers of asset-backed securities to maintain 5% of the credit risk in assets that are transferred, sold or otherwise conveyed through issuance of asset-backed securities.
- In contrast to EU approach in Article 122a (under CRD II) where obligation to impose retention is placed on investor, the U.S. places obligation on “securitizers” and “originators.”

# Liquidity and Leverage Requirements in the U.S.

- Dodd-Frank Act imposes the leverage standards that currently apply to FDIC-insured depository institutions on U.S. bank holding companies, including U.S. intermediate holding companies of foreign banking organizations.
- It is not yet certain that the Basel III concepts of a global liquidity coverage ratio ("LCR") and a net stable funding ratio will be fully implemented by U.S. regulators.
- Dodd-Frank Act includes provisions designed to ensure systemic liquidity in times of crisis. Emergency lending programs are required to provide liquidity to the financial system as a whole and not to a single or specific entity.
- It is likely that there will be some implementation differences between Basel III liquidity and leverage requirements and Dodd-Frank liquidity and leverage requirements.

# Systemically Important Financial Institutions (“SIFIs”)

- Financial Stability Board (“FSB”) views global SIFIs as “institutions of such size, market importance and global interconnectedness that their distress or failure would cause significant dislocation of the global financial system and adverse economic consequences across a range of countries”.
- G20 Seoul Summit (November 2010) endorsed FSB’s view.
- Basel Committee will develop by end-2010 a provisional methodology regarding quantitative and qualitative indicators for SIFIs and complete a study by mid-2011 of additional loss absorbency requirements for SIFIs.

# Systemically Important Financial Institutions – U.S.

- Dodd-Frank Act establishes the Financial Stability Oversight Council ("FSOC") that is to designate companies that pose a threat to the financial stability of the United States. Such "systemically important" companies are to be subject to Federal Reserve supervision and prudential oversight.
- Bank holding companies with $50 billion or more in assets will be automatically designated as "systemically important."
- The definition of large bank holding companies that might be deemed to be systemically important does not specifically include or exclude foreign banking organizations ("FBOs"). The prevailing view is that FBOs will be included if they have $50 billion or more in assets in the U.S. that relate to certain U.S. – based banking and trading activities.

# Implications and Consequences of Basel III

- New prudential standards may reduce profits significantly at the biggest U.S. banks.
- Higher capital ratios will likely constrain growth of:
  - lending
  - bank businesses and balance sheets
  - bank profits, dividends and bonuses
  - the economy
- Regulators want smaller and more “boring” banks.

# Implications and Consequences of Basel III

- Capital conservation to be paramount.
- Banks should be structured for their safety and long-term success, not for tax, regulatory arbitrage or any other short-term purposes.
- But new regime will create strong incentives for innovative regulatory arbitrage and balance sheet “management”.

# IV. Regulatory Oversight

# Regulatory Oversight – Key Initiatives

- Remuneration
- Short Selling
- Volcker Rule
- OTC Derivatives Reform
- Investment Advisors / Asset Managers

# Remuneration – U.S.
# Dodd-Frank Act

- Does not impose precise limits and prohibitions on compensation. Principles-based provisions will be implemented by regulation. Dodd-Frank Act gives regulators the authority to set rules for compensation of senior employees of financial institutions but does not mandate regulation of pay levels.
- Requires federal regulators to issue rules requiring companies to disclose the relationship between executive compensation and the company's financial performance.
- Requires federal regulators to issue regulations that will (i) require reporting of the structure of all incentive-based compensation arrangements, and (ii) prohibit incentive-based compensation arrangements that encourage inappropriate risks.
- Requires SEC to issue rules directing national securities exchanges to require that all members of a listed company's compensation committee be independent.
- On June 21, 2010, the FRB, the OCC and the FDIC issued a final guidance on compensation that emphasized balance between risk and financial results.

# Remuneration – EU/UK

- **EU rules** (part of CRD III, effective **January 1, 2011**)
  - Upfront cash bonuses to be capped at 30% of total bonus (20% if the bonus is “particularly large”)
  - 40%-60% of the bonus must be deferred for at least three years
  - At least 50% of the bonus to be paid as “contingent capital” (*i.e.* to be clawed back in case of bank difficulties) and shares
- **UK**
  - Proposed new rules implement the EU requirements
  - New rules will apply to all banks, CAD firms and branches of non-EEA firms
  - Applicable to “Code Staff” (*e.g.* senior management and people with significant influence); firms are required to identify such staff
  - *De minimis* concession: if the total remuneration is under £500,000 and bonus is less than 33% (currently 25%) of the total remuneration, the new rules on remuneration structures will not apply.
  - Final rules are expected December 2010 following publication of CEBS guidelines.
  - Consulting on reporting requirements.

# Short Selling – U.S.

- Dodd-Frank Act characterizes manipulative short-selling as an unlawful activity.
- Dodd-Frank Act authorizes SEC to address manipulative short-selling through the adoption of rules that include enforcement options.
- SEC is required by Dodd-Frank Act to adopt rules for public disclosure (on a monthly basis) of short sales by investment managers who are subject to Section 13(f) of the Securities Exchange Act of 1934.
- Brokers must notify customers that they may elect not to allow their securities to be used in connection with short sales and brokers must disclose that they may receive compensation for lending their customers' securities.
- Dodd-Frank Act requires the SEC to promulgate rules designed to increase the transparency of information available with respect to the lending or borrowing of securities.

# Short Selling - EU

- Status and Timing
  - September 15, 2010, European Commission published a proposal for Regulation on Short Selling and Credit Default Swaps following consultation (unlike Directive, Regulation will be directly applicable)
  - Proposed to apply from **July 1, 2012**.
- Main Proposals
  - All MiFID financial instruments, sovereign debt and related derivatives, traded on an EU "trading venue" (*i.e.* regulated market/MTF) are caught.
  - Disclosure either to national regulators or the market when net short position exceeds certain thresholds (no public disclosure required for sovereign debt and uncovered CDS relating to a sovereign).
  - Naked short sales: investor must have either: (i) borrowed the instruments concerned; (ii) entered into an agreement to borrow them; or (iii) had an arrangement with a third party who has located and "reserved" them so that they are delivered by the settlement date.
  - No ban on naked CDS, but regulators have right to obtain information and impose restrictions.
  - Member State regulators are given various emergency powers (*e.g.* temporary ban on short selling of all financial instruments).

# U.S. Volcker Rule - Proprietary Trading

- Prohibits a “banking entity” from engaging in proprietary trading, subject to certain exceptions.
- Banking entities must dispose of prohibited investments within two years after the Volcker Rule requirements become effective, subject to up to three possible one-year extensions.
- “Banking entity” is defined as:
  - any insured depository institution;
  - any company that controls an insured depository institution;
  - any company treated as a bank holding company under Section 8 of the International Banking Act of 1978; and
  - any affiliate or subsidiary of such entity.

# U.S. Volcker Rule - Proprietary Trading

- "Proprietary trading" is defined as engaging as a principal for a banking entity's trading account in any transaction to purchase or sell, or acquire or dispose of, any security, derivative, contract of sale of a commodity for future delivery, any option on a security, derivative or contract, or other security or financial instrument determined by regulation.
- Proprietary trading includes only trading for the "trading book" – banking book not affected.
- The prohibition on proprietary trading does not appear to apply to trading conducted through or at the Head Office of a foreign banking organization. However, we cannot be certain until the final implementing regulations are adopted.

# U.S. Volcker Rule - Sponsoring or Investing in Hedge Funds and Private Equity Funds

- Prohibits banking entities from sponsoring or investing in a hedge fund or private equity fund, subject to certain exceptions.
- The “funds” include any investment company that is exempt from registration under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 or similar funds as determined by the regulators.
- “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 as the fund.

# U.S. Volcker Rule - Sponsoring or Investing in Hedge Funds and Private Equity Funds

- The prohibition does not apply to certain activities including in connection with trust or investment advisory service.
- A banking entity may make and retain an initial investment in such a private equity or hedge fund if, within one year of the establishment of the fund, the investment is reduced to 3% or less of total ownership interests <u>and</u> the maximum of all such investments by the banking entity is 3% or less of the banking entity's Tier 1 capital.
- One important exception to the Volcker Rule is for activities conducted by a foreign company solely outside the U.S., provided that no interest in a hedge fund or private equity fund in which the company invests or sponsors is offered for sale to a U.S. resident.

# OTC Derivatives Reform - EU

- Status and Timing
  - Sept 15, 2010, European Commission published a proposal for Regulation on OTC Derivatives, Central Counterparties and Trade Repositories.
  - Proposed to apply from **end-2012**.
- Main Proposals
  - All standardized OTC derivatives should be cleared through central counterparties.
  - All non-centrally cleared OTC derivatives should be reported to trade repositories.
  - All financial firms and certain non-financial firms (*e.g.* corporate entities) must clear eligible OTC derivatives through CCPs.
  - CCPs need to comply with relevant standards (*e.g.* segregation of assets and portability).
  - Bespoke/illiquid derivative contracts continue to be bilaterally traded with possible higher collateral and margining requirements.

# OTC Derivatives Reform – U.S.
# Dodd-Frank Act

- Brings comprehensive regulation to the U.S. OTC derivatives markets and eliminates exemptions for OTC derivatives transactions provided by the Commodity Futures Modernization Act of 2000 (“CFMA”).
- Provides for central clearing and exchange trading requirements for most types of swaps.
- Gives the SEC jurisdiction over security-based swaps, the CFTC jurisdiction over non-security-based swaps. SEC and CFTC will share jurisdiction over mixed swaps.
- Extraterritorial Effect.
- “Spin-out” provision.

# OTC Derivatives Reform – U.S.
# Central Clearing and Exchange Trading

- All swaps that CFTC or SEC has determined should be cleared must be submitted to a central clearinghouse.
- All swaps that are subject to the clearing requirement must be executed on an exchange or through a "swap execution facility."
- There will be new regulation of market participants including swap dealers, security-based swap dealers, major swap participants and major security-based swap participants.
- Exclusions for certain products.

# Investment Advisors / Asset Managers – EU

- Directive on Alternative Investment Fund Managers (“**AIFMD**”)
  - Nov 11, 2010, the European Parliament voted to adopt the AIFMD.
  - AIFMD expected to be published / come into effect during the first or second quarter of 2011.
  - Member States are then obliged to implement within two years, *i.e.* by 2013.
- Scope
  - AIFMD regulates alternative investment fund managers (“AIFMs”), not alternative investment funds (“AIFs”) directly, within the EU.
  - Non-EU AIFMs managing an AIF domiciled in the EU or marketing an AIF (EU or non-EU) to investors in the EU will also be caught.

# Investment Advisors / Asset Managers – EU

- Marketing AIFs
  - Reverse enquiries by investors will not be caught, *i.e.* passive marketing by AIFMs would not be "marketing" under the Directive.
  - Dual marketing regime: AIFMs can market AIFs (EU or non-EU) into (i) individual Member States either under a national private placement regime, or (ii) into all Member States under the EU-wide "passport" regime.
  - Note national private placement regime quite likely to be abolished around five years after implementation (*i.e.* around mid-2018).
- Other requirements
  - AIFMs will be subject to regulatory capital requirements, conduct of business requirements, remuneration requirements, depositary requirements, disclosure requirements and leverage limits.

# Investment Advisers / Asset Managers – U.S.

- On November 19, 2010, SEC issued a proposal to increase the statutory threshold for investment adviser registration with the SEC; the threshold will now be $100 million for most U.S. advisers.
- Under the proposal, there is a second threshold of $25 million for advisers that would (i) not be subject to registration and examination in the state where they maintain principal offices or (ii) be required to register in 15 or more states.
- A second November 19, 2010 SEC release proposed a new rule that would (i) exempt from registration certain private fund advisers with less than $150 million in assets under management in the U.S. and (ii) define "venture capital fund" for purposes of the Dodd-Frank Act's new exemption from the Advisers Act for advisers to venture capital funds.

# IV. Conclusions/Implications

# Conclusions/Implications

- What to expect going forward?
- What should financial institutions do now?
- What transactions will become more important?

# What to expect going forward?

- There will be increased emphasis on robust capital requirements, liquidity regulation, activities restrictions and more effective supervision.
- There will be more regulatory scrutiny of operational risk issues and concerns.
- In the U.S., because of the mid-term election results, there is likely to be increased focus on refining the Dodd-Frank Act's implementing regulations and limiting their scope.
- There will be stricter enforcement and examination regimes.

# What should financial institutions do now?

- Assess carefully the likely impact of the Dodd-Frank Act, Basel III and EU Directives/Regulations on your institution.
- Engage in appropriate contingency planning.
- Strengthen corporate governance.

# What transactions will become more important?

- Covered Bonds
- Liquidity-based initiatives, such as expansion of commercial paper programs; medium-term note programs
- Capital-raising initiatives

**John Casanova**
***jcasanova@sidley.com***
Sidley Austin LLP
Woolgate Exchange
25 Basinghall Street
London, EC2V 5HA
United Kingdom
T: +44 (0)20 7360 3739
www.sidley.com

**Connie M. Friesen**
***cfriesen@sidley.com***
Sidley Austin LLP
787 Seventh Avenue
New York, New York 10019
United States of America
T: (212) 839 5507
www.sidley.com

**Leonard Ng**
***lng@sidley.com***
Sidley Austin LLP
Woolgate Exchange
25 Basinghall Street
London, EC2V 5HA
United Kingdom
T: +44 (0)20 7360 3667
www.sidley.com

# V. Comments / Questions / Discussion

BEIJING BRUSSELS CHICAGO DALLAS FRANKFURT GENEVA HONG KONG LONDON LOS ANGELES NEW YORK PALO ALTO SAN FRANCISCO SHANGHAI SINGAPORE SYDNEY TOKYO WASHINGTON, D.C.

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# The Dodd-Frank Act, the Changing EU Regulatory Regime and Basel III: Consequences of a New Regulatory Environment

**RELEVANT SIDLEY AUSTIN LLP CLIENT UPDATES**

The following Sidley Austin LLP client updates are available at www.sidley.com

**U.S.**

1. **FEDERAL RESERVE BOARD ISSUES PROPOSED RULE TO IMPLEMENT THE CONFORMANCE PERIOD UNDER THE VOLCKER RULE"**

   December 1, 2010

   http://www.sidley.com/sidleyupdates/Detail.aspx?news=4626

2. **PROPOSED FDIC RULEMAKING REGARDING ORDERLY LIQUIDATION OF COVERED FINANCIAL COMPANIES**

   October 18, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4590

3. **CFTC AND SEC RELEASE TEMPORARY RULES ON REPORTING OF PRE-ENACTMENT SWAPS**

   October 15, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4585

4. **FINANCIAL STABILITY OVERSIGHT COUNCIL RULEMAKING REGARDING SYSTEMICALLY IMPORTANT NONBANK FINANCIAL COMPANIES AND THE VOLCKER RULE**

   October 8, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4578

5. **FinCEN Proposes Requirement for Certain Financial Institutions to Report Cross-Border Electronic Fund Transmittals**

   October 5, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4572

6. **FDIC Adopts Final Securitization Safe Harbor Rule**

   October 4, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4574

7. **Certain Banks, Broker-Dealers and Other Institutions Must Register as Municipal Advisors by October 1, 2010**

   September 13, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4552

8. **President Signs into Law the Dodd-Frank Wall Street Reform and Consumer Protection Act**

   July 21, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4500

**EU/UK**

1. **AIFM DIRECTIVE FINALLY ADOPTED – AN ANALYSIS OF THE FINAL POSITION**

   November 12, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4609

2. **BASEL COMMITTEE ON BANKING SUPERVISION ISSUES PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE**

   October 19, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4589

3. **ANALYSIS OF THE EUROPEAN COMMISSION'S PROPOSED REGULATION OF OTC DERIVATIVES**

   September 27, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4566

4. **PROPOSAL FOR EU REGULATION ON SHORT SELLING AND CREDIT DEFAULT SWAPS**

   September 22, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4563

5. **FSA CONSULTATION ON THE REMUNERATION CODE: KEY ISSUES FOR UK REGULATED FIRMS**

   September 16, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4554

6. **UK GOVERNMENT ANNOUNCES ABOLITION OF FSA AS PART OF SWEEPING FINANCIAL SERVICES REGULATORY REFORM PROPOSAL**

   June 22, 2010

   www.sidley.com/sidleyupdates/Detail.aspx?news=4468