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MORE THAN JUST FINANCIAL REFORM: ANALYSIS AND OBSERVATIONS ON THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

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INTRODUCTION

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The result of a year-long effort to transform financial supervision in response to the financial crisis, the sweeping legislation affects not only banks and other financial institutions but also has far-reaching consequences for all corporations doing business in the United States. Although Congress has attempted to lay the foundation for long-term financial stability, most of the actual details and implementation of many key provisions of the Act are reserved for regulators to divine in the coming months—the Act explicitly calls for more than 240 rulemaking efforts and nearly 70 studies by 11 regulatory bodies. The Act is essentially a 2,300-page introduction to an eventual new financial regulatory environment—an incomplete roadmap for the regulatory financial future of the United States. Notwithstanding the incomplete character of the Act, the Act will have a significant and immediate impact on all businesses. The Act:

- Devotes much of its detail to addressing public anger over the "bailout" rather than to the actual causes of the financial crisis.
- Delegates most detail and authority to regulatory agencies.
- Goes well beyond traditional financial institutions by mandating changes to corporate governance provisions that negatively affect all public companies.
- Imposes a significantly increased compliance burden on banks and other financial institutions that is likely to further industry consolidation.
- Creates a public market for derivatives that increases the cost of doing business for most corporations.
- Is likely to continue to limit access to capital by causing banks and other financial institutions to lend less to comply with enhanced regulatory requirements.

Despite its shortcomings and the delegation of much of the detail to rulemaking agencies, financial institutions and all other companies must begin to plan for the historic changes to U.S. banking, derivatives trading, corporate governance, consumer financial protection, executive compensation, and securities dealing. It is no secret that adapting to the emerging body of rules will be a challenge for all, but opportunities will appear for those institutions capable of internalizing the Act's most important principles and adjusting to rulemaking and regulatory implementation.

During this uncertain rulemaking period, market participants will distinguish themselves from their competitors not through passivity, but by anticipating the judgment of policymakers and the reaction of markets. To this end, the following analysis is designed to help our clients navigate the Act's substantial ambiguities, understand its complexities, and prepare effective strategies for adapting to this new regulatory environment.

This White Paper analyzes the major topics addressed in the Act. The Sections in this White Paper are as follows:

- **The Financial Stability Oversight Council.** Describes the membership and powers of this new council of regulators, which is tasked with overseeing the entirety of the financial system, focusing on gaps in the regulatory framework and emerging threats to financial stability.
- **Enhanced Bank Regulatory Provisions.** Outlines the major themes of depository institution and holding company regulation, including provisions related to capital and liquidity, regulatory supervision, enhanced supervisory requirements for mergers and acquisitions, enhanced regulation of financial institutions with consolidated assets of at least $50 billion, the Collins Amendment, and the Volcker Rule.
- **Orderly Liquidation Authority.** Analyzes the resolution and liquidation provisions, highlighting the differences between those provisions and the Bankruptcy Code, and examining the potential impact that the new legislation would have on various parties in interest.

- **Hedge Fund, Private Equity, and Other Advisers.** Describes how the Act will affect many investment advisers to hedge funds, private equity funds, and real estate funds by significantly expanding the requirement for investment advisers to register with the Securities and Exchange Commission (the "SEC").
- **Federal Insurance Office.** Discusses the creation of the Federal Insurance Office, which will collect information and monitor developments in the state regulation of insurance, but has no authority to regulate or supervise insurance companies.
- **Derivatives.** Analyzes the Act's bifurcated jurisdictional framework, which submits virtually all swaps to regulation by either the SEC or the Commodity Futures Trading Commission. This section also describes the clearinghouse requirement for swaps, highlighting certain limited exemptions, and explains new regulations and requirements on entities engaging in swap transactions.
- **Corporate Governance and Executive Compensation.** Discusses the trend toward short-termism resulting from new rules governing corporate America, including say-on-pay voting, shareholder approval of golden parachutes, the prohibition of broker voting in certain instances; the requirement of clawback provisions for exchange-traded companies, requirements for disclosing hedging policies and compensation ratios, and proposed changes to proxy access.
- **Investor Protection and Enforcement Provisions.** Analyzes enforcement provisions aimed at improving securities laws and strengthening investor protections, which include: adding new whistleblower protections and incentives; establishing aiding and abetting liability in SEC enforcement actions; providing the SEC with the authority to issue industry-wide collateral bars; disqualifying certain "bad actors" from Regulation D offerings; restricting mandatory predispute arbitration provisions; and establishing a deadline for the SEC to file an enforcement action after providing an individual with a Wells Notice.
- **Credit Rating Agencies.** Describes the increased regulation of credit rating agencies, which include: enhancing the SEC's powers to oversee and regulate certain rating agencies; requiring the adoption of specified internal controls; expanding regulations intended to address conflicts of interest; expanding disclosure obligations to increase competition and add transparency to the ratings process; and exposing credit rating agencies to greater potential liability to SEC enforcement actions, as well as private actions under the securities laws.
- **Asset-Backed Securities.** Analyzes a number of material changes for the structured finance market, including credit risk retention requirements, which obligates originators/securitizers to retain credit exposure to their securitized assets, and other provisions focused on increased disclosure and reporting requirements.
- **Preemption.** Discusses new standards and procedural requirements affecting federal preemption of state consumer laws, focusing on the adoption of the legal standard for preemption set forth by the U.S. Supreme Court in *Barnett Bank v. Nelson*.
- **Consumer Protection.** Discusses the establishment of the new Consumer Financial Protection Bureau and new mortgage lending standards.

THE FINANCIAL STABILITY OVERSIGHT COUNCIL

The Act creates the Financial Stability Oversight Council (the "Council") to identify risks to the financial stability of the United States (the "U.S.") that could arise from the material financial distress, failure, or by ongoing activities of large, interconnected bank holding companies[1] or nonbank financial companies,[2] or that could arise outside the financial services marketplace.[3] To facilitate this objective, the Council will promote market discipline by attempting to eliminate expectations that the U.S. government will shield them from losses in the event of failure. The Council is also given powers that will allow it to identify and respond to emerging threats to the stability of the U.S. financial system.

Membership of the Council is divided between voting members and nonvoting members. Voting members each have one vote, and include the following 10 individuals: the Secretary (the "Secretary") of the United States Department of Treasury (the "Treasury"), as Chairperson of the Council; the Chairperson of the Board of Governors of the Federal Reserve System (the "Board of Governors" or "Federal Reserve"); the Comptroller of the Currency; the Director of the Bureau of Consumer Financial Protection; the Chairperson of the Securities and Exchange Commission; the Chairperson of the Federal Deposit Insurance Corporation (the "FDIC"); the Chairperson of the Commodity Futures Trading Commission; the Director of the Federal Housing Finance Agency; the Chairperson of the National Credit Union Administration Board; and an independent member with insurance expertise who is appointed by the President of the United States (the "President") for a six-year term, with the advice and consent of the Senate.[4]

The Council's nonvoting members, who will serve in an advisory capacity for a two-year term, include the following five individuals: the Director of the Office of Financial Research (the "OFR"); the Director of the Federal Insurance Office (the "FIO"); a state insurance commissioner, to be designated by a process determined by the State insurance commissioners; a state banking supervisor, to be designated by a process determined by the state banking supervisors; and a state securities commissioner (or officer performing like functions), to be designated by a process determined by the state securities commissioners.[5]

Unless otherwise stated in the Act, action by the Council requires a majority vote.[6] Actions requiring a two-thirds vote include the determination to subject a nonbank financial company to enhanced supervision,[7] the decision to rescind such determination,[8] resolving jurisdictional disputes amongst Member Agencies,[9] causing certain companies to take measures that mitigate risk to the financial system (discussed below),[10] and recommending that the Secretary appoint the FDIC as receiver of a financial company.[11]

In order to monitor the financial services marketplace to identify potential risks to the financial stability of the U.S., the Act permits the Council to collect information from Member Agencies, other federal and state financial regulatory agencies, the FIO, bank holding companies, and nonbank financial companies.[12] With respect to bank holding companies and nonbank financial companies, the Council, through the OFR, may require the submission of reports for the purpose of assessing the extent to which such company, financial activity or financial market in which such company's participation poses a threat to the financial stability of the U.S.[13]

1 Bank holding companies are defined by reference to section 2 of the Bank Holding Company Act of 1956. H.R. 4173, § 101(a)(1). This Act defines a "bank holding company" as any company that has control over any bank or over any company that is or becomes a bank holding company. 12 U.S.C. § 1841.

2 A company is a "nonbank financial company" if 85 percent of its gross revenues or consolidated assets are related to activities that are financial in nature. H.R. 4173, § 102(a). Notably, "financial in nature" is defined in accordance with section 4(k) of the Bank Holding Company Act (12 U.S.C. § 1843(k)). Under that act, the Board of Governors (defined below), in consultation with the Secretary (defined below), is authorized to determine what activities are financial in nature. 12 U.S.C. § 1843(k). The act itself declares a wide-range of activities financial in nature, including lending, financial and investment advisory services, insurance agency activities, issuing, underwriting and dealing in securities, and other common banking activities.

3 H.R. 4173, § 112. The concepts of "material financial distress" and "to the financial stability of the United States" are not defined in the Act. Similarly, the Act does not define "large, interconnected bank holding company," although provisions regarding enhanced supervision automatically apply to bank holding companies with at least $50 billion in consolidated assets (discussed in more detail below).

4 H.R. 4173, § 111(b)(1).
5 H.R. 4173, § 111(b)(2).
6 H.R. 4173, § 111(f).
7 H.R. 4173, § 113(a).
8 H.R. 4173, § 113(d).
9 H.R. 4173, § 119. A "Member Agency" means any agency represented by a voting member of the Council. H.R. 4173, § 102(a)(3).
10 H.R. 4173, § 121.
11 H.R. 4173, § 203(a).
12 H.R. 4173, § 112(a).
13 H.R. 4173, § 112(d)(3)(A).

However, prior to requiring submission of these reports, the Council is instructed to rely, to the extent possible, on information available from the financial regulatory agency responsible for regulating such company.[14]

If the Council is unable to determine whether the financial activities of a nonbank financial company pose a threat to financial stability based on these reports, discussions with management, and publicly available information, the Council may request the Board of Governors, and the Board of Governors is authorized, to conduct an examination of the nonbank financial company for the sole purpose of determining whether such company should be subject to enhanced supervision.[15]

Once the Council decides to place a company under the enhanced supervision of the Board of Governors, acting through the OFR it may require reports to keep the Council informed as to: the financial condition of the company; systems for monitoring and controlling financial, operating and other risks; transactions with any subsidiary that is a depository institution; and the extent to which the activities and operations of the company and any subsidiary thereof, could, under adverse circumstances, have the potential to disrupt financial markets or affect the overall financial stability of the U.S.[16]

The Council, the OFR, and the other Member Agencies must maintain the confidentiality of any data, information, and reports submitted under this Act. The submission of any nonpublicly available data or information will not constitute a waiver of, or otherwise affect, any privilege arising under federal or state law to which the data or information is otherwise subject.[17]

ENHANCED SUPERVISION AND PRUDENTIAL STANDARDS

Nonbank Financial Companies. If the Council determines that the material financial distress of a nonbank financial company poses a threat to the financial stability of the U.S., it is authorized to subject such company to enhanced supervision by the Board of Governors.[18] The procedures established under the Act require the Council to: (1) pass a "proposed determination," by two-thirds majority; (2) provide notice to such company of the determination, including an explanation of the basis for the determination; and (3) allow the company an opportunity for a hearing before the Council to contest the determination.[19] The Council has 60 days after such hearing to issue a "final determination." The Act provides a nonexclusive list of factors that the Council will consider prior to making a final determination including, among others: the extent of leverage of the company; off-balance-sheet exposure; relationships with other significant financial companies; the importance of the company as a source of credit; and the nature, scope and interconnectedness of the activities of the company.[20]

If the Council makes the final determination, a nonbank financial company has 30 days from receipt of notice to seek judicial review in the U.S. District Court for the District of Columbia (the "D.C. District Court") or the judicial district in which the home office of such nonbank financial company is located.[21] Review of the Council's final determination is limited to whether such determination was "arbitrary and capricious."

Large Bank Holding Companies. A bank holding company with greater than $50 billion[22] in consolidated assets is automatically subject to enhanced supervision by the Board of Governors.[23] Notably, this stipulation includes any entity (or successor entity) that was a bank holding company having total consolidated assets of at least $50 billion as of January 1, 2010, *and* received financial assistance under or participated in the Capital Purchase Program established under the Troubled Asset Relief Program[24] ("TARP"). The Act provides an opportunity for such bank holding company to appeal this treatment before the Council, but the decision to grant an appeal is to be made by the Council and requires a two-thirds

14 H.R. 4173, § 112(d)(3)(B).
15 H.R. 4173, § 112(d)(4). This provision applies only to U.S. nonbank financial companies.
16 H.R. 4173, § 116.
17 H.R. 4173, § 112(d)(5).

18 H.R. 4173, § 113(a)(1)-(2); H.R. 4173, § 113(b)(1)-(2).
19 H.R. 4173, § 113(e). If a nonbank financial company does not make a timely request for a hearing, the Council will notify such company, in writing, of the final determination of the Council not later than 10 days after the date by which the company may request a hearing. H.R. 4173, § 113(e)(4).
20 H.R. 4173, §§ 113(a)(2), (b)(2).
21 H.R. 4173, § 113(h).
22 The Board, pursuant to a recommendation by the Council, may establish a threshold above $50 billion. H.R. 4173, § 165(a)(2)(B).
23 H.R. 4173, § 165(a)(1), (a)(2).
24 H.R. 4173, § 117.

vote in favor of granting an appeal.[25] If the Council denies an appeal, it must reevaluate that decision at least annually.

Anti-Evasion. In order to avoid evasion of enhanced supervision and prudential standards, the Act includes an umbrella provision applicable to any company that poses a threat to the financial stability of the U.S., based on the factors to be considered for subjecting a nonbank financial company to supervision by the Board of Governors. To apply the anti-evasion provision, the Council must make a determination, by two-thirds majority including an affirmative vote by the Chairperson of the Council, that:

- The company poses a threat to the financial stability of the U.S., based on consideration of the above mentioned factors;
- The company is organized or operates in such a manner as to evade the application of this title of the Act; and
- Such financial activities of the company will be supervised by the Board of Governors and subject to prudential standards in accordance with the title of the Act.[26]

Companies subject to the Act's anti-evasion provision are entitled the same opportunity for review as described above for the decision to subject a nonbank financial company to enhanced supervision by the Board of Governors. Upon making such a determination, the Council must submit a report to the "appropriate committees of Congress" detailing the reasons for making such determination. In order to facilitate supervision, the Board of Governors may require such company to establish an intermediate holding company for purposes of conducting the company's activities that are financial in nature or incidental thereto.[27]

25 H.R. 4173, § 117(c).
26 H.R. 4173, § 113(c).
27 H.R. 4173, § 113(c)(3).

MITIGATION OF RISKS TO FINANCIAL STABILITY

Along with the aforementioned powers over bank holding companies with consolidated assets of at least $50 billion and nonbank financial companies supervised by the Board of Governors, the Board of Governors is also given the authority to impose on such companies extraordinary measures to mitigate risk. The Board of Governors, in consultation with the Council, must first provide such a company written notice that it is being considered for mitigatory action pursuant to this section of the Act, including an explanation of the basis for, and description of, the proposed mitigatory action. Such company will be given an opportunity for a hearing before the Board of Governors. Subsequent to the hearing, the Board of Governors must notify the company within 60 days of its final decision, including the results of the vote by the Council. Upon an affirmative vote by two-thirds of the Council, the Board of Governors can impose the following measures on such company:

- Limit the ability of the company to merge with, acquire, consolidate with, or otherwise become affiliated with another company;
- Restrict the company's ability to offer a financial product or products;
- Terminate one or more activities;
- Impose conditions on the manner in which the company conducts one or more activities; and
- Sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities, if the Board of Governors determines that such other actions are inadequate to mitigate a threat to the financial stability of the U.S.[28]

28 H.R. 4173, § 121.

OBSERVATIONS

The Council possesses significant power to intervene in the U.S. economy in the event it determines an institution poses a threat to the overall economy. This power includes the ability to order an examination of any bank or nonbank financial company, subject them to enhanced supervision, and, under certain circumstances, order the entity to cease doing business or sell itself. It can also apply to the financial activities of any other company to the extent the Council determines they pose a threat to the U.S. financial system. This situation could have a significant impact on the way investors and other entities interact with certain banks or other companies they feel might be at risk to being subject to scrutiny by the Council, and it is compounded by the treatment of certain unsecured creditors under the liquidation authority in the event the Council orders a liquidation of an institution. (This topic is discussed in more detail under the "Orderly Liquidation Authority Section.") Further, it is difficult to believe that the Council would be able to successfully identify risks to the financial system and effectively eliminate these risks before it was too late without creating some degree of panic just by virtue of the fact that it was taking action.

CHANGES IN THE REGULATION OF DEPOSITORY INSTITUTIONS AND THEIR HOLDING COMPANIES

The Act greatly changes the regulation of depository institutions. Many provisions affect depository institution holding companies and bring other nonbank financial companies under the Federal Reserve's supervision and regulation for the first time. This section outlines the major themes of depository institution and holding company regulation contained in the Act in which the regulatory elements are incorporated throughout. These include provisions related to:

- Capital and liquidity;
- Regulatory supervision;
- Enhanced supervisory requirements for mergers and acquisitions;
- Enhanced regulation of financial institutions with $50 billion or more in assets;
- Limits on concentration in the industry;
- Greater fees upon larger institutions; and
- Numerous studies and rulemaking.

Capital and Liquidity. Section 171 of the Act, the Collins Amendment (the "Amendment") changes depository institution holding company capital to that permitted for Tier 1 capital for depository institutions, limiting the types of instruments that may count as capital for depository institution holding companies.

In addition, there are numerous other provisions in the Act that change capital and liquidity requirements. The Council will have an expanded role in the regulatory oversight of capital liquidity. One of its tasks under Section 112 of the Act is to make recommendations to the Federal Reserve regarding heightened prudential standards for risk-based capital, leverage, liquidity, "contingent capital," resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for large interconnected bank holding companies and nonbank financial companies supervised by the Federal Reserve. Similarly, counter-cyclical capital is required of large depository institutions and the appropriate federal bank agencies are required to set capital standards accordingly.

The Basel Committee on Banking Supervision (the "Basel Committee") and the federal banking agencies are already working on enhanced capital and liquidity standards, and will have to take the Act into account in their rulemaking. The Basel Committee issued a release on July 26, 2010 concerning its agreement on capital and liquidity reform.

Source of Strength. The Act amends the Federal Deposit Insurance Act (the "FDI Act") to add a new Section 38A, which requires both depository institution holding companies and other companies that control insured depository institutions to serve as a source of financial strength for any subsidiary. This compares to the Federal Reserve's longstanding requirement under the Bank Holding Company Act of 1956 (the "BHC Act") that bank holding companies serve as a source of financial and managerial strength to their subsidiaries. Subsidiaries of controlling companies, including bank and thrift holding companies, may now be required by their primary federal bank supervisor to report periodically on the ability of their parent companies to comply with the source of strength doctrine and for such regulators to enforce compliance with this new mandate. New rules are required within one year from the transfer date of the Office of Thrift Supervision' ("OTS") authorities to the other federal bank regulators, and joint federal bank agency rules are required to carry out the new source of strength requirements.

The source of financial strength will include the ability of a company that, directly or indirectly, owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of its financial distress. This Section is effective immediately.

Contingent Capital. Contingent capital is derived from debt or hybrid instruments that would become capital upon a financial company, including a bank or thrift holding company, becoming distressed. The Council is directed to study the feasibility, benefits, costs, and structure of a contingent capital requirement for supervised nonbank financial companies and large bank holding companies ($50 billion or more in assets) and make recommendations for implementing regulations. This is required within two years of the date of enactment upon which the Council may make recommendations to the Federal Reserve to require a minimum amount of contingent capital convertible into equity in times of financial stress. The Chairman of the Council is also required to carry out a study of the economic effects of regulatory limitations intended to reduce systemic risk under Section 123 of the Act. Implementing this would have been much more feasible, less costly, and less burdensome to the regulators and the industry without the Amendment regarding hybrid instruments.

Stress Tests. In determining capital adequacy, the Federal Reserve, in conjunction with the other bank regulatory agencies and the FIO, must conduct annual stress tests under baseline, adverse, and severely adverse conditions with respect to any company with consolidated assets of $50 billion or more. All bank holding companies or other financial companies with consolidated assets of $10 billion or more that are regulated by a primary federal financial regulatory agency also must conduct annual stress tests and report the results to the Federal Reserve and its primary federal regulatory agency. Regulations are to be developed by the regulatory agencies. It would not be surprising to see regulators also requiring stress testing of smaller institutions.

Leverage Limits. Bank holding companies with consolidated assets of $50 billion or more, and Federal Reserve supervised nonbank financial companies, may maintain a debt to equity ratio of no more than 15 to 1 upon a determination by the Council that the company poses a grave threat to the financial stability of the United States, and that such a requirement is necessary to mitigate the risks to the country's financial stability.

Short-Term Debt. The Federal Reserve may prescribe regulations limiting the amount of short term debt, including off-balance-sheet exposures, that may be accumulated by any bank holding company with consolidated assets of $50 billion or more and any supervised nonbank financial company. The Federal Reserve may impose regulations and issue exemptions under this provision.

Off-Balance-Sheet Exposures. Section 165(k) requires bank holding companies with assets of $50 billion or more and Federal Reserve supervised nonbank financial companies to have capital that takes into account off-balance-sheet activities. Off-balance-sheet activities include direct credit substitutes, irrevocable letters of credit, risk participations in bankers acceptances, purchase agreements, asset sales with recourse against the seller, interest rate and credit swaps, commodities and forward contracts, securities contracts, and other activities or transactions that the federal banking agencies may define by rule. However, it is unclear why this provision is needed when it could be covered by risk-based capital rules.

Prudential Standards. For bank holding companies with more than $50 billion in assets and certain nonbank financial companies, the Federal Reserve must establish risk-based capital requirements and leverage limits, unless it determines, in consultation with the Council, that such requirements are inappropriate. Further, the Federal Reserve is required to impose liquidity requirements, overall risk requirements, resolution plan, and credit exposure requirements and concentration limits.

Well-Capitalized and Well-Managed Requirements Expanded. In addition to the current requirement for their banking subsidiaries, banking and thrift holding companies are required to be "well capitalized and well managed" in order to engage in certain expanded financial activities under the BHC Act. Likewise, where a holding company proposes to acquire a bank across state lines, the target bank must be "well capitalized and well managed" under the Act, rather than just "adequately capitalized and adequately managed," as currently required. Interstate bank mergers also require the resulting entity to be "well capitalized and well managed," rather than only "adequately capitalized and adequately managed," as currently required.

Countercyclical Capital. Thrift holding companies will be subject to capital requirements for the first time under Section 616 of the Act. The Federal Reserve is required to establish countercyclical capital ratio requirements for bank and thrift holding companies that will increase capital needed in times of economic expansion and decrease capital in times of economic contraction, consistent with the safety and soundness of the company. Additionally, the Act requires bank and thrift holding companies, and other companies that control banks, to serve as "source[s] of financial strength" for their banking subsidiaries. Within two years of enactment, the respective federal banking agencies regulating these companies will issue rules to effect this requirement.

Capital Formation. Although there is much in the Act that requires capital, there is little that promotes its formation SEC is directed to change Regulation D to require that accredited investors have a minimum net worth of at least $1 million, exclusive of the value of their primary residence, net of any mortgage debt. One provision that may be helpful is contained in Section 989(G). This amends Section 404 of the Sarbanes-Oxley Act of 2002 by deleting the internal controls testing and attestation requirements with respect to any audit report prepared for filers that are not considered large accelerated or accelerated filers. This may help facilitate capital raising by smaller companies that have found Section 404 to be unduly expensive and burdensome.

ACQUISITIONS AND OTHER EXPANSION ACTIVITIES

Bank and Nonbank Expansion. Bank holding companies will find their freedom to engage in financial activities somewhat restricted. Prior Federal Reserve approval is now required of holding company acquisitions of nonbank companies whose total consolidated assets to be acquired exceed $10 billion. These acquisitions are now subject to prior Federal Reserve approval; Hart-Scott-Rodino Act notices will be required regardless of Federal Reserve approval.

BHC Act and Bank Merger Act ("BMA") transactions will now be subject to an additional statutory factor that the approving agency must consider the "risks posed to the stability of the U.S. banking or financial system" by any potential merger or acquisition of a bank or nonbank.

CONCENTRATION LIMITS ON ACQUISITIONS

The Act requires the Council to conduct a study within six months of enactment regarding the extent to which the concentration limits under new Section 14 of the BHC Act would affect the following:

- Financial stability;
- Moral hazard in the financial system;
- The efficiency and competitiveness of U.S. financial firms and financial markets; and
- The cost and availability of credit and other financial services to households and businesses in the U.S.

The study will make recommendations as to whether other concentration limits would more effectively implement Section 14, and whether a limitation on the concentration of liabilities in the context of any merger, consolidation, or acquisition would be appropriate.

The Federal Reserve is to adopt regulations within nine months of completion of the Council's study, and in accordance with the Council's recommendations. Financial companies, banks, including depository institution holding companies (such as foreign banks regulated as holding companies), and supervised nonbank financial companies (collectively, for purposes of these concentration limits, "financial companies") would be prohibited from merging with or acquiring any other financial company if the total resulting liabilities of the bank exceed 10 percent of the aggregate consolidated liabilities of all financial institutions in the U.S. as of the end of the preceding calendar year.

For purposes of the BHC Act, Section 14, liabilities are calculated differently for U.S. financial companies and foreign based financial companies. For U.S. financial companies, liabilities are the total of risk-weighted assets of the financial company under the risk-based capital rules, less the total regulatory capital of the company under such risk-based rules. For foreign institutions, liabilities are the total risk-weighted assets of the U.S. operations of the financial company as determined under the risk-based capital rules, less the total regulatory capital of the U.S. operations of the financial company as determined under such risk-based rules. Supervised nonbank financial companies and insurance companies will have their applicable liabilities determined by the pending Federal Reserve regulation.

Interstate mergers under the BMA are also restricted where the applicant, upon consummation of the transaction, would control or already controls more than 10 percent of the total amount of deposits of insured depository institutions in the U.S.

These concentration limits are tempered by exceptions in the case of acquisitions of defaulting banks, FDIC-assisted transactions, and acquiring companies that experience only a *de minimis* increase in their individual liabilities as a result of the transaction.

GOVERNANCE

The Act provides for governance of public companies, including shareholder access. Specific governance provisions are made applicable to bank holding companies, particularly the largest bank holding companies by Section 165(h). The Federal Reserve is required to issue regulations requiring each bank holding company that is publicly traded and has total consolidated assets of not less than $10 billion to establish a risk committee. Supervised nonbank financial companies are also required to establish a risk committee not later than one year after the receipt of a final determination and will be supervised as such under Section 113 of the Act. The Federal Reserve also may require each publicly traded bank holding company that has consolidated assets of less than $10 billion to establish a risk committee.

The risk committees are required to:

- Be responsible for the oversight of enterprise-wide risk management;
- Include the number of independent directors determined by the Federal Reserve as appropriate, based upon the company's nature of operations, size of assets and other appropriate criteria; and
- Include at least one risk management expert having experience and identifying, assessing, and managing risk exposures of large, complex firms.

The Federal Reserve will issue rules, which will take effect not later than 15 months after the transfer date of OTS authorities to the other federal bank regulatory agencies. The risk management expert is similar to the Sarbanes-Oxley Act "financial expert." It will be interesting to see who qualifies under the Federal Reserve's rules.

NONBANK BANKS AND TEMPORARY MORATORIUM ON FDIC APPROVALS

The Act prohibits the FDIC from approving, through July 21, 2013, deposit insurance for a credit card bank, an industrial bank, or a trust bank, as these terms are defined in the BHC Act (collectively, "nonbank banks"). Similarly, the federal banking agencies are prohibited from approving a change of control of a nonbank bank, except where the nonbank bank is in danger of default, as a result of a combination of a parent company or in connection with the acquisition of voting shares of a publicly traded parent company where the acquiring group owns less than 25 percent of any class of voting securities.

It is surprising that after the industrial bank moratorium that lasted several years and the reluctance of the FDIC to grant insurance to nonbank banks, that a further moratorium is needed. This will restrict new entrants into the markets for the services provided by these institutions, limit the availability of credit to consumers that may be available through industrial banks and credit card banks, and will hinder the ability of various participants in the credit card industry from selling their credit card banks or portfolios. Since the commencement of the credit crisis, various institutions have announced a goal of selling their credit card portfolios, especially those of private label credit cards.

The Comptroller General is also requiring a study of eliminating the nonbank bank exemptions from the BHC Act's coverage of "banks." This study must also state the consequences and desirability of applying BHC Act regulations to thrifts. This report is due not later than 18 months after the enactment of the Act.

Credit card banks that are not deemed "banks" for BHC Act purposes will be allowed to expand their permissible activities to issue credit cards to businesses eligible for SBA loans, whereas now they can only extend credit to consumers.

SECURITIES HOLDING COMPANIES

Bank holding companies will no longer be able to register to be supervised by the SEC under rules promulgated by the SEC applicable to investment bank holding companies. Instead, the Act replaces the elective investment bank holding company framework currently available under SEC rules with a "securities holding company" system that allows an investment bank holding company without a bank or a savings association affiliate to register to be supervised by the Federal Reserve. This change accommodates securities holding companies that are required by foreign regulators to be subject to comprehensive consolidated supervision. Under this regime:

- Securities holding companies are subject to capital and risk-management requirements set forth by the Federal Reserve on an individual basis;
- The Federal Reserve may examine the securities holding company and any nonbank affiliate and impose record keeping requirements; and
- Securities holding companies are subject to applicable sections of the BHC Act and certain provisions of the FDIA.

EXAMINATIONS AND REPORTING

The reporting requirements of Section 5 of the BHC Act are expanded to include compliance by bank holding companies and their nonbank subsidiaries with all other applicable provisions of federal law. The Federal Reserve's examination authority is expanded to include not only the safety and soundness of a bank holding company or any depository institution subsidiary, but also the stability of the country's financial system, as well as monitoring compliance with applicable laws other than consumer laws covered by the Bureau of Consumer Financial Protection.

The Federal Reserve is further required to provide reasonable notice to and consult with the appropriate federal banking agencies, the SEC, and the Commodity Futures Trading Commission (the "CFTC"), or state regulatory agencies with respect to holding company subsidiaries that are depository institutions or are functionally regulated subsidiaries before it commences an examination. Such examinations must be conducted in the same manner, subject to the same standards and with the same frequency as would be required if such activities were conducted in a lead insured depository institution subsidiary of the holding company.

The bank regulatory agencies' powers over holding companies are expanded dramatically. In the event that the Federal Reserve does not conduct these nonbank subsidiary examinations as required, the primary federal banking agency for the lead insured depository institution may recommend that the Federal Reserve perform the examination. However, if the Federal Reserve does not begin its examination, or does not provide an appropriate explanation or plan responding to the concerns raised, within 60 days after receiving such notice, the lead insured depository institution's regulator may examine the activities of the nonbank subsidiary as if it were a depository institution. A fee may be charged by the appropriate federal banking agency for any examination. Recommendations for enforcement action may be made as a result of such examination by another federal bank regulatory agency to the Federal Reserve. If the Federal Reserve does not take enforcement action acceptable to the federal bank regulator that made the recommendation, the bank regulatory agency may take the recommended enforcement action against the non-depository institution's subsidiary as if it were an insured depository institution.

CHARTER CONVERSIONS

Troubled banks and federal savings associations will encounter more difficulty in converting their status as state, national, or federal associations, as applicable. Banks operating under a cease and desist order or memorandum of understanding with any federal or state regulatory authority concerning any "significant supervisory matter" will not be allowed to convert their charter to change their regulator, without approvals from both the federal bank regulatory agency that would govern the resulting entity and the regulatory agency issuing the cease and desist order or memorandum of understanding.

GENERAL STUDY OF BANKING ACTIVITIES

Within 18 months of enactment, the appropriate federal banking agencies shall jointly review activities that banking entities may engage in and report to Congress. The report will cover the risks posed by various activities in which a banking entity may engage and the related risk mitigation activities undertaken by banking entities. The federal bank agencies will draw conclusions about the appropriateness of the activities and the negative effects such activities might have on the safety and soundness of the U.S. financial system, and any additional restrictions on these activities that may be necessary.

LENDING LIMITS

The Act allows insured state-chartered banks to engage in derivative transactions, only if the applicable state law takes into consideration credit exposure to derivative transactions as part of state lending. The Act expressly mentions derivatives, sales of assets under agreements to repurchase, and securities lending in the list of credit extensions to which established national bank lending limits apply. The Act also limits loans to insiders by adding credit exposure to an insider arising from a derivative transaction, securities lending or borrowing transaction, and repurchase or reverse repurchase agreement to the definition of "credit extensions" prohibited by the Federal Reserve Act.

AFFILIATE TRANSACTIONS

The Act further limits banks' transactions with their affiliates. The definition of "affiliate" under Section 23A of the Federal Reserve Act is expanded to include investment advisers, without any reference to such persons being registered under the U.S. Investment Advisers Act of 1940 (the "Investment Advisers Act"). For the sales of assets with agreements to repurchase, the lending of securities and derivative transactions are added to the list of transactions that must be fully secured by appropriate collateral at all times. The Federal Reserve is authorized to determine how a netting agreement may be taken into account when determining the amount of a covered transaction with an affiliate, and therefore whether a transaction is fully secured.

The Federal Reserve's authority to grant exemptions under Section 23A and 23B of the Federal Reserve Act and similar provisions of Section 11 of the Home Owners' Loan Act ("HOLA"), is limited, particularly with respect to transactions with financial subsidiaries, which are expressly prohibited. During the credit crisis, the Federal Reserve issued waivers of these provisions to many banking organizations with respect to their capital markets operations. Transactions with hedge funds and private equity funds are especially limited, as discussed more fully in the section on the Volcker Rule.

Transactions with insiders, including asset purchases and sales, are also restricted unless these are on market terms, and, if the transaction represents more than 10 percent of the capital stock and surplus of a bank, are approved by a majority of disinterested directors.

INTERMEDIATE HOLDING COMPANIES

If a grandfathered unitary thrift holding company conducts activities other than financial activities, the Federal Reserve may require such company to establish and conduct all or a portion of its financial activities in or through an intermediate holding company, which shall be a thrift holding company. Such requirement may be implemented by the Federal Reserve not later than 90 days after the transfer date of the OTS authorities to the Federal Reserve and the other appropriate bank regulatory agencies. A grandfathered unitary thrift holding company also may be required to establish an intermediate holding company, if the Federal Reserve determines that such intermediate holding company is necessary to appropriately supervise its financial activities or to ensure that Federal Reserve supervision does not extend to the non-financial activities of that entity's parent company. Internal financial activities, such as treasury, investment, and employee benefit functions, are not required to be placed in an intermediate holding company. Importantly, a grandfathered unitary thrift holding company that controls an intermediate holding company must serve as a source of strength to its subsidiary intermediate holding company, and must also be examined by, and report to, the Federal Reserve, including information needed by the Federal Reserve to assess the ability of the ultimate parent company to serve as this source of strength. The Federal Reserve retains full enforcement powers with respect to the ultimate parent company as if it were a thrift holding company and violations may be treated as violations of the FDI Act. The Federal Reserve will also establish regulations regarding the criteria for requiring an intermediate holding company and providing restrictions or limitations on transactions between an intermediate holding company or a parent of such company and its affiliates.

CONFLICTS OF INTEREST IN SECURITIZATION TRANSACTIONS

The Securities Act of 1933 (the "Securities Act") is amended to prevent underwriters, placement agents, initial purchasers, and sponsors of asset-backed securities from engaging any transaction that would result in a conflict of interest for one year after the closing of the asset-backed security sale. This prohibition will not apply to:

- Risk-mitigating hedging activities designed to reduce risk to the underwriter, placement agent, initial purchaser, or sponsor of the purchased asset-backed securities in relation to those securities;
- Purchases or sales of asset-backed securities made consistent with the underwriter's placement agent's, initial purchaser's, or sponsor's commitment to provide liquidity for the asset-backed security; or
- Purchases or sales of asset-backed securities made consistent with the underwriter, placement agent, initial purchaser, or sponsor's *bona fide* market-making with respect to the asset-backed security.

OBSERVATIONS

The changes in regulations of depository institutions and their holding companies are a surprisingly small part of the Act. Nonetheless, these will require substantial studies and rulemaking activities and considerable staff time at each of the bank regulatory agencies. Some of the thornier issues will include contingent capital and countercyclical capital, which will be difficult to implement in a practical manner. Examinations and reporting will also be more difficult and will involve increased regulatory overlap and potential conflict.

The lending limits set forth in the Act require state banks to take into account off-balance-sheet and derivative transactions that may require additional state legislation and will affect "wild card" provisions in state laws regarding lending limits. Affiliate transaction restrictions are increased under various provisions of the Act, including the Volcker Rule, and will require considerable rulemaking and interpretation.

During a time when the staffs of the various bank regulatory agencies are stretched due to the stressed nature of the system, considerable additional resources will have to be added and devoted to studies and writing regulations. We hope that these added responsibilities will not divert the regulatory staff from their already more than full-time jobs dealing with pressing issues in the banking system that have and will continue to exist regardless of the Act.

THE COLLINS AMENDMENT—NEW CAPITAL RULES UNDER THE ACT

The Collins Amendment (the "Amendment") is Section 171 of the Act. It applies bank capital standards to other financial services companies, including bank and thrift holding companies. The Amendment was promoted by the FDIC and highlighted by the FDIC press release on the passage of the Act. Although rationalized from its original form, the Amendment reduces the types of capital that count for regulatory purposes. The Amendment and the other capital provisions in the Act are among the more significant and potentially costly and disruptive provisions of the Act.

BACKGROUND

The Federal Deposit Insurance Corporation Improvements Act of 1991 ("FDICIA") added Section 38 to the FDI Act to establish a prompt corrective action ("PCA") set of rules applicable to FDIC-insured banks. The PCA authorized the applicable federal bank regulators to establish five capital categories ranging from "well capitalized" to "critically undercapitalized." As insured depositary institutions' capital fell through these categories, they became subject to ever greater restrictions in their activities. Banks that became "critically undercapitalized" and were unable to raise capital were required to be placed in FDIC receivership. Bank regulators were authorized to issue PCA directives requiring undercapitalized banks to raise capital or sell within 30 days. PCA directives are usually death sentences—most recipients are placed in receivership and many times the recipient's board of directors consents to a receivership at the time a PCA directive is received. The PCA regime reflected the sense of the Congress in FDICIA that it was less costly to the FDIC deposit insurance fund to close struggling banks sooner.

The PCA regime applies only to FDIC-insured depository institutions and not to their holding companies. The Board of Governors of the Federal Reserve System has applied capital rules to bank holding companies similar to the PCA capital standards. Bank holding companies were able to use a broader range of capital instruments than banks. Savings and loan holding companies did not have separate capital standards, nor did companies that controlled industrial banks, credit card banks, and other entities that were FDIC-insured but were not "banks" under the BHC Act, as amended. Often the Office of the Comptroller of the Currency ("OCC") or FDIC required the parents of such "nonbank banks" to enter into capital maintenance or capital and liquidity maintenance agreements ("CALMAs"), which had similar, and often more stringent, effects as bank holding company and bank capital regulations.

THE AMENDMENT

The Amendment applies the generally applicable PCA leverage and risk-based capital standards (the "generally applicable standards") on a consolidated basis to:

- Insured depository institutions;
- Depository institution holding companies ("holding companies"); and
- Nonbank financial companies supervised ("supervised financial companies") by the Federal Reserve as a result of the Act.

These standards will be established by the appropriate federal banking agency, which generally is its primary federal regulator. The generally applicable standards will be "floors" for the standards set by the regulators, and cannot be less than the current PCA standards for insured depository institutions.

EFFECTIVE DATES

The Amendment applies to any debt or equity issued by holding companies and supervised financial companies on or after May 19, 2010. For instruments issued prior to May 19, 2010, the following apply to the "deductions required by this section [171]":

- A phase-in, "incrementally over . . . 3 years" beginning January 1, 2013, generally;
- No capital deductions are required for holding companies with less than $15 billion of consolidated assets and mutual holding companies, each tested as of May 19, 2010;

- As to any holding company not supervised by the Federal Reserve as of May 19, 2010, the effective date is five years after enactment of the Act, except as to Subsections 171(b)(4)(A) and (B);
- For BHC subsidiaries of foreign banking organizations that have relied on Federal Reserve SR01-1, the effective date is five years after enactment of the Act, except for Subsection 171(b)(4)(A).

EXCEPTIONS

The Amendment does not apply to:

- Capital instruments issued to the Treasury or any other government agency prior to October 4, 2010 pursuant to TARP;
- Any Federal Home Loan Bank;
- Any small BHC subject to the Federal Reserve's Small Bank Holding Company Policy Statement (the "small BHC policy") applicable to BHCs with $500 million or less of consolidated costs; or
- Foreign organizations that own or control a U.S. holding company.

STUDIES

Section 174 of the Act directs the Comptroller General, in consultation with federal bank regulators to study and report, within 18 months of the enactment of the Act, on (i) hybrid capital instruments including trust-preferred securities ("hybrid securities") for banking institutions and "bank holding companies" (the "Hybrid Capital Study") and (ii) the capital requirements of U.S. holding companies ("intermediate holding companies") that are controlled by foreign banks (the "Intermediate HC Study").

The Hybrid Capital Study must consider many of the things already mandated by Section 171, including:

- The current use of hybrid securities as Tier 1 capital;
- Differences in capital components for banks and holding companies, and their respective benefits and risks;
- The economic effect of prohibiting hybrid instruments as Tier 1 capital;
- Reviewing the consequences of disqualifying trust-preferred securities and whether it could lead to the failures or undercapitalization of banking organizations;
- International competitive effects of prohibiting hybrid securities as Tier 1 capital;
- The availability of capital for institutions with less than $10 billion of total assets; and
- Any other effects or financial system safety and soundness and potential economic effects.

The Intermediate HC Study will consider:

- Current Federal Reserve policy regarding intermediate companies;
- National treatment and competitive opportunities for foreign banks in the U.S.;
- Foreign banks' home country capital standards compared to U.S. capital standards;
- Potential foreign regulatory effects on U.S. banking organizations operating abroad;
- Effects on the cost and availability of credit in the U.S.; and
- Other economic effects and effects on safety and soundness.

Another study is called for by Section 174 of the Act. This Section directs the Comptroller General, after consultation with the federal bank regulators, to study "smaller" (in this case, financial companies with consolidated assets of $5 billion or less) depository institutions' access to the capital markets. The report will be made to the House Financial Services Committee and the Senate Banking Committees, and will include recommendations for legislative or regulatory action that would enhance "smaller" institutions' access to capital consistent with safety and soundness.

REGULATIONS

The Federal Reserve will need to revise its holding company capital regulations in the Appendices to Regulation Y ("Reg. Y"), and implement standards for thrift holding companies when the OTS's authority over such companies is transferred to the Federal Reserve under Title III of the Act. The federal bank regulators are also required, subject to the recommendations of the Council, to develop additional capital requirements applicable to FDIC-insured institutions and their holding companies, as well as supervised financial companies. These must address the following risks to the institution and to other "public and private stakeholders in the event of adverse performance, disruption or failure of the financial institution or activity":

- Significant volumes of activity in derivatives, securitized products purchased and sold, financial guarantees purchased and sold, securities borrowing and lending, and repurchase agreements and reverse repurchase agreements;
- Concentrations in assets for which financial reports provide values based on models rather than deep and liquid two-way markets; and
- Concentrations in market share for any activity that would substantially disrupt financial markets if the institution was forced to unexpectedly cease that activity.

CONCLUSIONS AND EFFECTS

It is unfortunate that the Amendment added Section 171 mandating changes in capital requirements prior to the studies specified in Sections 174 and 171. Even if future legislation is adopted in light of the studies to reverse the Amendment, the Act prohibits certain instruments that currently count as capital and is already affecting markets for, and issuers of, such instruments, especially trust-preferred securities.

Other observations:

- No new trust-preferred securities may be issued after May 19, 2010, which are includible in Tier 1 capital except for exchanges of TARP preferred securities for trust preferred exchanges prior to October 4, 2010 and nonpublic issuances by small BHCs;
- The phase-in and phase-outs for holding companies whose subsidiaries are thrifts, credit card banks, industrial banks and other institutions that were not previously supervised by the Federal Reserve are unclear, and may be less favorable than for existing BHCs. For example, is the five-year effective time a cap that ends earlier in 2015, as opposed to the final phase-out which should end on December 31, 2015? Is the avoidance of the first two years of the incremental phase-out, with a bullet phase-out, better or worse? It is clear that these institutions may not issue more trust preferred that counts as Tier 1 capital on or after May 19, 2010.
- Similar concerns arise for intermediate HCs as to the end of the phase-out period. Intermediate HCs also cannot issue any more trust-preferred securities that count as Tier 1 capital on or after May 19, 2010.
- It may be desirable for institutions to redeem high cost trust-preferred securities by declaring a "capital event" since the legislation provides that trust-preferred securities will not be treated as Tier 1 capital. Depending upon the wording of trust-preferred securities, issuers will be required to determine, and perhaps negotiate, with trustees and investors over the timing of capital events and related redemption rights.
  - Is the passage of the Act a "capital event"?
  - Is January 1, 2013 or the fifth anniversary of the Act's enactment a separate "capital event"?
  - Is the beginning of each of the three years in the phase-out period a "capital event"?
  - Must an issuer decide on only one such date as a capital event? Since the trust preferred market has had limited public issuances since 2007, many issuers will not have to rely on a capital event to call their outstanding trust-preferred securities, which generally may be exercised at any time after five years from issuance.
- Will grandfathered trust-preferred securities of smaller institutions with less than $15 billion of assets and mutual holding companies become more valuable since, unless they are very high coupon, are less likely to be redeemed by the issuer?
- Issuers considering redeeming or repurchasing trust-preferred securities and preferred stock should remember that prior Federal Reserve approval is required consistent with Federal Reserve Supervisory Letter SR 09-4. Treasury approval also may be required for TARP recipients, and many issuers are subject to replacement capital covenants, which along with Federal Reserve requirements, will push issuers to redeem trust-preferred securities only if they can sell enough common or perpetual, noncumulative preferred stock to redeem trust-preferred securities without much dilution to existing equity holders.

- Issuers with outstanding securities that will be phased out as Tier 1 components under Section 171 may want to wait for the Studies and Federal Reserve rule changes before making a decision on redemption. The Act potentially has created multiple "capital events" that would permit redemption, if the trust-preferred securities are not otherwise redeemable.
- All organizations subject to enforcement actions and capital plans will want to update their plans early to avoid surprise and better control their destinies. The phase-out and phase-ins under Section 171 provide opportunities for better planning, although the bank regulators may become more skeptical of capital components limited by Section 171.
- Small BHCs will want to ensure that their capital structures are maintained.
- Congress should consider directing the Comptroller General to study the Act's effects upon "smaller" holding companies up to $15 billion in assets, and add an inflation adjustment to any rulemaking.
- The Act reverses the Federal Reserve's long-standing rule of allowing institutions that are not "internationally" active to issue larger amounts of trust-preferred securities as a percentage of Tier 1 capital.
- Foreign banking organizations will want to consider the capital structure of their Intermediate HCs, and whether it may be advantageous or not to allow their Intermediate HCs to raise capital and funds in the U.S. and other markets. Certain foreign organizations may determine not to remain U.S. registrants owing to the new limits on Tier 1 capital instruments available to the Intermediate HCs under the Act.

All banking and financial services companies subject to the Amendment will want to closely monitor regulatory rulemaking in their area, and plan alternative capital structures to operate best with the final decisions made under the Act, and in light of potential future rationalization of the Amendment and regulations when the Studies are due. All institutions should be especially alert to, and comment upon, any proposed regulations based upon their activities and market shares that are mandated by Section 171.

THE VOLCKER RULE: NEW SECTION 13 OF THE BANK HOLDING COMPANY ACT

On January 21, 2010, the White House announced the "Volcker Rule," named after Paul Volcker, the former Federal Reserve Chairman, who currently serves as Chairman of the President's Economic Recovery Advisory Board. The President described the Volcker Rule as follows:

> Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers. If financial firms want to trade for profit, that's something they are free to do. Indeed, doing so—responsibly—is a good thing for the markets and the economy, but these firms should not be allowed to run these hedge funds and private equity funds while running a bank backed by the American people.

The Volcker Rule went through numerous permutations, with Senators Levin and Merkeley trying to take financial institutions out of trading altogether, and Senator Cantwell, among others, calling for a return to the Depression-era Glass-Steagall Act. Many considered it a basis for separating banks from investment banking and the securities markets. Section 619 of the Act adopts a version of the Volcker Rule as new Section 13 to the BHC Act.

WHAT IS COVERED BY SECTION 13

Prohibited Activities. The Act generally prohibits any "banking entity" from:

- Engaging in proprietary trading; or
- Acquiring or retaining any equity, partnership, or other ownership interest in or controlling relationship over, or sponsorship of a hedge fund or a private equity fund.

Section 13(h)(2) defines hedge funds and private equity funds as issuers that would be an investment company, except for the exemptions provided by Sections 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"). It also includes similar funds as the appropriate federal banking agencies, the SEC or the CFTC, may by rule determine.

"Proprietary trading" is defined as:

> . . . engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the [Federal Reserve] Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract or 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 agencies, the SEC or the CFTC may determine by rule.

A "sponsor" of a hedge fund or a private equity fund means someone who:

- Serves as a general partner, managing member, or trustee of a fund;
- Has the ability to select or control or have employees, officers, or directors who are agents who constitute a majority of the directors, trustees, or management of the fund; or
- Shares the same name or a variation of the same name with a fund for corporate, marketing, promotional, or other purposes.

A "trading account" means any account used for acquiring or taking positions in the securities or financial instruments described in the term "proprietary trading" principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate federal banking agencies, the SEC and the CFTC, may determine by rule.

A hedge fund is distinguished from a private equity fund, which is defined in Section 203(m) of the Investment Advisers Act.

Limitations also are imposed on these activities conducted by "nonbank financial companies" supervised by the Board of Governors of the Federal Reserve System under Sections 161-176 of the Act, upon designation by the Council.

"Banking entities" are broadly defined in Section 619(h)(i) of the Act to include FDIC-insured institutions and their holding companies, foreign-controlled entities that are treated as bank holding companies under Section 8 of the

International Banking Act of 1978, and any of their affiliates or subsidiaries.

"Nonbank financial companies" include U.S. and foreign companies, depending on whether these are organized in the U.S. or elsewhere, which are "predominantly engaged" in financial activities. Section 102(a)(6) defines "predominantly engaged" as follows:

- Annual gross revenues of the company and all its subsidiaries' activities that are "financial in nature" (as defined in BHC Act, Section 4(k)) and from FDIC-insured institutions which it owns or controls are 85 percent or more of the company's consolidated gross revenues; or
- The consolidated assets of the company and all its subsidiaries related to activities that are financial in nature under BHC Act, Section 4(k), and related to the ownership or control of FDIC-insured institutions, is 85 percent or more of the company's consolidated assets.

The following limited exceptions are provided for FDIC-insured institutions functioning solely in a trust or fiduciary capacity, which operate with little reliance on the FDIC or Federal Reserve borrowings or services:

- All or substantially all deposits are received in a bona fide fiduciary capacity and are trust funds;
- No FDIC-insured deposits are offered or marketed by or through an affiliate;
- No demand deposits or deposits withdrawable by check or similar means to third parties or others are permitted nor commercial loans made; and
- No payment-related services are obtained from any Federal Reserve Bank, including any service referred to in Section 11(a) of the Federal Reserve Act (*i.e.*, check clearing, wire transfers, ACH services, securities safekeeping, etc.) or no discount or borrowing privileges or exercise pursuant to Section 19(b)(7) of the Federal Reserve Act.

Permitted Activities. Certain activities are deemed "permitted activities" to the extent they are permitted by any other provision of federal or state law, subject to the limitations of Section 13(d)(2) and any restrictions or limitations of the federal banking agencies, the SEC, and the CFTC. These include:

- The purchase, sale, acquisition, or disposition of obligations of the U.S. or any agency thereof and obligations, participations or other instruments of or issued by GNMA, Fannie Mae, Freddie Mac, the Federal Home Loan Banks, the Federal Agricultural Mortgage Corporation, a farm credit system institution, and obligations of any state or political subdivision.
- The purchase, sale, acquisition, or disposition of securities, derivatives, commodities futures contracts and options on such instruments, or other securities or instruments as permitted by the appropriate federal banking agency, the SEC and the CFTC under Section 13(B)(2), in connection with underwriting or market-making-related activities to the extent such activities are designed not to exceed the "reasonably expected near-term demands of clients, customers, or counterparties," or on behalf of customers.
- Risk-mitigating hedging activities in connection with and related to individual or aggregate positions, contracts, or other holdings designed to reduce the specific risk to the holder in connection with and related to such positions, contracts or other holdings.
- Investments in one or more small business investment companies ("SBICs"), investments designed primarily to promote public welfare, as permitted in 12 U.S.C. 24(11), or investments that are qualified rehabilitation expenditures with respect to qualified rehabilitated buildings, certified historic structures or similar state historic tax credit programs.
- The purchase, sale, acquisition, or disposition of securities and other proprietary trading instruments by a regulated insurance company "directly engaged in the business of insurance" of the company and by any affiliate thereof, which are:
  1. solely for the general account of the insurance company;
  2. conducted in compliance with and subject to the insurance company investment laws, regulations, and written guidance of the jurisdiction in which each such insurance company is domiciled; and
  3. the appropriate banking agencies after consultation with the Council and relevant insurance commissioners have not jointly determined that a particular law, regulation, or written guidance is insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States.
- Organizing and offering private equity or hedge funds as permitted under Section 13(d)(1)(G), as described more fully below.

- Proprietary trading conducted by a banking entity pursuant to BHC Act Section 4(c)(9) (foreign companies most of whose business is conducted outside the U.S.) or (13) (companies which do no business in the U.S., except incident to their foreign or international business) so long as the trading occurs solely outside the U.S. and the banking entity is not directly or indirectly controlled by a banking entity organized under the laws of the U.S. or any of its States.
- The acquisition or retention of any equity, partnership, or other ownership interests in or the sponsorship of hedge funds or private equity funds by a banking entity pursuant to BHC Act Section 4(c)(9) or (13) solely outside the U.S., provided that no ownership interests in such funds are offered for sale or sold to a resident of the U.S. and the banking entity is not directly or indirectly controlled by a U.S. banking entity.
- Such other activity as the appropriate federal banking agencies, the SEC, and the CFTC may determine by rule, would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

All permitted activities under Section 13(d)(1) are subject to limitations prescribed by rules, including definitions, to be adopted by the appropriate federal banking agencies, the SEC, and the CFTC, if the transaction, class of transactions or activity would:

- Involve or result in a "material conflict of interest" (to be defined by regulation) between the banking entity and its clients, customers, or counterparties;
- Result directly or indirectly in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (each to be defined by regulation);
- Pose a threat to the safety and soundness of such banking entity; or
- Pose a threat to the financial stability of the United States.

PERMISSIBLE PRIVATE EQUITY AND HEDGE FUNDS ACTIVITIES

Banking entities are permitted to organize and offer private equity funds and hedge funds under certain restrictions provided in Subsection 13(d)(G). These include:

- Serving as a general partner, managing member or trustee of the fund;
- Selecting or controlling, or having employees, officers, directors, or agents who constitute, a majority of the directors, trustees, or management of the fund; and
- Paying the necessary expenses for the foregoing.

These are permitted basically for customers only under the following requirements:

- The banking entity provides *bona fide* trust, fiduciary, or investment advisory services;
- The fund is organized and offered only in connection with the provision of such *bona fide* trusts, fiduciary or investment services and only to persons that are customers of such services of the banking entity;
- The banking entity does not acquire or retain any equity or ownership interest in the funds except for *de minimis* investments and the provisions of Subsection 13(f) are complied with;
- The banking entity cannot directly or indirectly guarantee, assume, or otherwise ensure the obligations or performance of the fund or any of the private equity funds or hedge funds in which it invests;
- The banking entity and the hedge fund or private equity fund do not share for corporate, marketing, promotional, or other purposes, the same name or variation of the same name;
- No director or employee of the banking entity takes or retains an equity or other ownership interest in the fund, except for persons who are directly engaged in providing investment, advisory, or other services to the fund;
- The banking entity discloses to actual and potential investors in writing that any loses of the fund are borne solely by the investors and not by the banking entity; and
- The fund complies with any additional rules of the federal banking agencies, the SEC, or the CFTC designed to ensure that losses in such funds are borne solely by investors in the fund and not by the banking entity.

Investment Limitations. A banking entity can retain investments in funds that the banking entity organizes and offers for purposes of establishing the fund with sufficient initial equity or "seed" capital to permit the fund to attract unaffiliated investors or for purposes of making a *de minimis* investment.

In order to take advantage of these provisions, the banking entity must "actively seek" unaffiliated investors to reduce or dilute the banking entities' investment to the amounts permitted. Not later than one year after the establishment of the fund, the banking entity's investment must be reduced through redemptions, sales or dilution to an amount that is not more than 3 percent of the total ownership interest in the fund *and* must be immaterial to the banking entity, as defined by rule. In no case may the aggregate of all interest the banking entity and all private equity and hedge funds exceeds 3 percent of the banking entity's Tier 1 capital.

Permissible Services and Limitations on Relationships With Funds. Banking entities that directly or indirectly serve as the investment manager, investment adviser or sponsor of a private equity or hedge fund, or that organize or offer such funds as permitted under the Act, as well as their affiliates, may not enter into transactions with the fund or any other fund that is controlled by such fund, that would be a covered transaction under Section 23A of the Federal Reserve Act. For this purpose, the banking entity and its affiliates are deemed member banks and the private equity or hedge funds are deemed "affiliates." Similar treatment is provided under Section 23B, which is made applicable to the banking entity and its affiliates as if they were member banks and the funds were "affiliates."

The Federal Reserve may permit a banking entity or non-bank or a Federal Reserve supervised nonbank financial company to enter into "prime brokerage transactions" with any private equity or hedge fund that it manages, sponsors, or advises or has an ownership interest, if such supervised entity is in compliance with each of the limitations under Section 13(d)(1)(G) with respect to the fund, the CEO of the banking entity, or supervised nonbank financial company certifies in writing annually that there are no guarantees by the banking entity with respect to the fund, and the Federal Reserve has determined that such transaction is consistent with the "safe and sound" operation and condition of the banking entity or supervised nonbanking financial company. Similarly, such prime brokerage transactions are subject to Section 23B of the Federal Reserve Act.

Divestitures. Impermissible activities and investments have to be discontinued and divested following the effective date of Section 13. Generally, Section 13 becomes effective on the *earlier* of 12 months after the date of issuance of final rules under Section 13(b) and two years after the date of enactment. Banking entities and supervised nonbank financial companies must bring their activities and investments into compliance with Section 13 not later than two years after the effective date of the requirements or two years after the entity or company becomes a nonbank financial company supervised by the Federal Reserve. The Federal Reserve may extend this two-year period by not more than one year at a time, if the extension is consistent with the purposes of this Section and would not be detrimental to the public interest. In no event may the extensions exceed three years, bringing the maximum discontinuance period to five years.

The divestiture period for ownership interests in "illiquid" private equity and hedge funds is extended "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010." The Federal Reserve may only grant one extension of this divestiture period, which may not exceed five years. Except for activities permitted by Section 13(d)(1)(G), banking entities may not engage in any private equity or hedge fund activity prohibited by Section 13 after the earlier of (i) the date on which the contractual obligation to divest the illiquid fund terminates, and (ii) the date of any extensions granted by the Federal Reserve expire. Notwithstanding the transition period, additional capital requirements and other restrictions may be imposed by rulemaking on the ownership or sponsorship of private equity funds or hedge funds by banking entities.

CAPITAL

In addition to the increased capital requirements and restrictions on ownership interest in and sponsorship of private equity and hedge funds during the divestiture period provided under Section 13(c)(5), other capital requirements may be imposed. Section 13(d)(3) provides that the appropriate federal banking agencies, the SEC, and the CFTC shall adopt rules imposing additional capital requirements and quantitative limitations, including diversification requirements with respect to activities permitted under Section 13, if such agencies determine that these are appropriate to protect the safety and soundness of the banking entities engaged in such activities. In addition, with respect to *de minimis* investments in private equity and hedge funds, the outstanding investment in such funds that is permitted shall be deducted by the assets and tangible equity of the banking entity and the amount of the deduction shall increase "commensurate with the leverage of the hedge fund or private equity fund." Implementation of this will require rule-making and further definition. This deduction from equity failed to take into account amendments to this Section before passage that replaced tangible equity as the base for *de minimis* investments with Tier 1 capital.

EFFECTIVE DATE

Except for the permitted divestitures and the transition period for preexisting investments or commitments to illiquid funds, the effective date of the Section 13 will be 12 months after the date of issuance of final rules under Section 13(b) or two years after the date of enactment, whichever is earlier.

STUDIES

Within six months of enactment, the Council is required to study and make recommendations on implementing Section 13 to:

- Promote and enhance the safety and soundness of banking entities;
- Protect taxpayers and consumers and enhance financial stability by minimizing the risk that banking entities will engage in unsafe and unsound activities;
- "Limit the inappropriate transfer of federal subsidiaries from institutions that benefit from deposit insurance and liquidity facilities of the federal government to unregulated entities";
- Reduce conflicts of interest between bank entities and supervised nonbank financial companies;
- Limit activities that have caused undue risk or loss in banking entities and supervised nonbank financial companies or that might be expected to create undue risk or loss in such entities;
- Appropriately accommodate the business of insurance in compliance with insurance company investment laws, while protecting the safety and soundness of any banking entity with which the insurance company is affiliated and the U.S. financial system; and
- Appropriately time the divestiture of illiquid assets that are affected by the prohibitions of Section 13.

Section 620 of the Act requires an additional study not later than 18 months after enactment by the appropriate federal banking agencies regarding the activities that banking entities may engage in under federal and state law. This report is required to consider:

- The type of activities or investments;
- Any financial, operational, managerial, or reputational risk associated with or presented as a result of the activities or investments by the banking entities; and
- Risk mitigation activities undertaken by the banking entities with regard to such risk.

This report shall be made to the Council and to Congress and shall include recommendations regarding:

- Whether each activity or investment has or could have a negative effect on the safety and soundness of a banking entity or the United States financial system;
- The appropriateness and the conduct of each activity or type of investment; and
- Additional restrictions as may be necessary to address risk of the safety and soundness arising from the activities or types of investments.

A further study is mandated by Section 989, which shall be conducted by the Comptroller General, regarding the risks and conflicts associated with proprietary trading, including:

- Whether proprietary trading presents a material systemic risk;
- Whether proprietary trading presents a material risk to the safety and soundness of banking entities;
- Whether proprietary trading presents material conflicts of interest between covered entities that engage in proprietary trading and the clients who use the banking entity to execute trades will rely on the firm to manage assets;
- Whether adequate disclosures regarding the risks and conflicts of proprietary trading are provided to the depositors trading in asset management clients, as well as investors of the banking entities; and
- Whether the banking, securities, and commodities regulators have adequate systems and controls to monitor

and contain risk and conflicts of interest related to proprietary trading.

Among other things, the Comptroller General must consider the advisability of a complete ban on proprietary trading, limitations on the scope of proprietary trading by banking entities, the advisability of additional capital requirements, enhanced restrictions on transactions between affiliates, enhanced accounting and public disclosure regarding proprietary trading and other options.

RULEMAKING

The Volcker Rule will require substantial rulemaking. Section 13(b) requires, not later than nine months after the completion of the study specified in Section 13(b), the federal banking agencies, the SEC, and the CFTC to consider the findings of this study and adopt rules on a coordinated basis. The manner of adopting these rules results in overlapping jurisdiction and required consultation. In general, the appropriate federal banking agencies are required to jointly act with respect to insured depository institutions. The Federal Reserve is authorized to adopt rules with respect to any company that controls an insured depository institution or is treated as a bank holding company under Section 8 of the International Banking Act, and any nonbank financial company supervised by the Federal Reserve and any of their respective subsidiaries, except where otherwise supervised or as provided under Section 13. The CFTC and the SEC are designated as the primary federal regulatory agency as provided in Section 2(12) of the Act.

The bank regulatory agencies, the SEC and the CFTC are required to consult and coordinate with each other, "as appropriate," to assure that such regulations are comparable and provide for consistent application and implementation to avoid providing advantages or imposing disadvantages to the companies affected by this regulation and to protect the safety and soundness of banking entities and nonbank financial companies. The Council is responsible for coordinating the regulations issued under this Section. Therefore, any rulemaking will be subject to at least the three federal bank regulatory agencies, the SEC, the CFTC, the Council, and the Secretary coordinating and agreeing.

Various provisions of Section 13 specify other rulemaking, including the following:

- Although the regulations are required to be adopted by the appropriate agencies, under Subsection 13(c)(5), on the date on which the SEC issues rules under Subsection 13(d)(2), the banking regulators, the SEC, and the CFTC shall issue rules that require additional capital requirements and other restrictions on any ownership interest in or sponsorship of a hedge fund or a private equity fund;
- Not later than six months after enactment, the Federal Reserve is required to issue rules for conformance and divestiture of fund activities and investments. The amount of such private equity and hedge fund investments must be defined by rule and cannot exceed 3 percent of Tier 1 capital of the banking entity. This will depend in part upon the definition of Tier 1 capital, as well as the Tier 1 capital changes implemented by the Amendment contained in Section 171 of the Act, and other capital changes under the Act.
- The rules adopted under Section 13(d) must also specify internal controls and recordkeeping requirements pursuant to Section 13(e).
- Section 13(f) will require new Federal Reserve rules as part of Regulation W to implement the new application of Sections 23A and 23B of the Federal Reserve Act to relationships between banking entities and private equity and hedge funds including permissible prime brokerage transactions.
- Although seemingly covered in multiple Sections, Subsection 13(f)(4) requires the appropriate federal banking agencies, the SEC, and the CFTC to adopt rules imposing additional capital charges or other restrictions for supervised nonbank financial companies to address risks to and conflicts of interest.

In the rulemaking, the regulators will take into account the rules of construction contained in Section 13(g). These include:

- "Notwithstanding any other provision of law," the restrictions and prohibitions apply . . . "even if such activities are authorized by a banking entity or nonbank financial company supervised by the Federal Reserve."
- Nothing in Section 13 is to limit or restrict the ability of a banking entity or supervised nonbank financial company to sell or securitize loans in a manner otherwise permitted by law.

- Nothing in this Section shall be construed to limit the inherent authority of any federal agency or state regulatory authority under otherwise applicable provisions of law.

OBSERVATIONS

Section 13 is broad in scope, but also detailed and complex. Its effect is yet to be determined. Much of the effect will be determined by the studies and the related rulemaking. Unfortunately, the studies authorized by the Act assume the correctness of the provisions of Section 13 as enacted, without an empirical study of the concerns motivating Section 13, or the consequences of Section 13, including the affects upon the economy as well as financial stability. Whether Section 13 and the related rules will contribute to the financial stability or economic growth is unclear.

Among other things, the following should be considered:

- Section 13 is not the Glass-Steagall Act, although various amendments and iterations of the Volcker Rule proposed during Congressional debates sought to restore the Glass-Steagall Act.
- Unlike Section 13, the Glass-Steagall Act did not try to regulate investment banks, except to the extent they were affiliated with commercial banks.
- Proprietary trading, derivatives, and investment banking have been strong sources of revenues and profits for banking entities. Since the credit crisis began in the fall of 2007, most major investment banks are parts of bank holding companies regulated and supervised by the Federal Reserve.
- Even if they wanted to avoid regulation under the BHC Act and Section 13, the Federal Reserve's expanded supervision of nonbank financial companies and the provisions of Sections 113 through 117 under Title 1 of the Act will make it difficult for such entities to exit the supervision of the Federal Reserve or the application of Section 13.
- The jurisdiction of the federal banking agencies, the SEC, and the CFTC are less than clear and there are likely to be issues of regulatory overlap and differences of opinion related to the types of entities each regulates and their ability to impose rules that are consistently applied across organizational type.
- Will reducing proprietary trading reduce the liquidity and depth of the capital markets? Proprietary trading and market making are risk functions by their very nature. The markets and economic stability and growth depend upon orderly, liquid, and deep markets. This has been a hallmark of the U.S. financial system, which has provided a competitive advantage domestically and internationally.
- How the provisions will affect underwriting activities and subsequent market making is also uncertain. No underwriters will be as receptive to capital raising where they are limited in terms of warehousing underwritten offerings to amounts of securities or other instruments that do not exceed the "reasonably expected near term demands of clients, customers, or counterparties." The implementation of rules under Section 13(d)(1)(B) will be critical.
- The determination of risk mitigating hedging activities and the scope of other permissible activities, much of which will be determined by rulemaking, may further constrain the ability of the industry to serve the economic needs of the country, which also promotes financial stability.
- The rule will affect the international competitiveness of U.S. banking organizations and appears to restrict the ability to move many of these activities offshore and to serve solely foreign persons.
- The inability to sponsor, and the limitations on investments in, private equity funds may reduce the availability of capital in the economy.
- The application of the Act to supervised nonbank financial companies and to foreign entities operating within the United States may further restrict foreign entrants to U.S. markets, reduce competition, limit the availability of capital and the liquidity of our markets.

The studies and the rulemaking in this area are critical. It would have been preferable to have the studies before the Act to focus on whether legislation or rulemaking under existing laws could be effected to promote safety, soundness, and stability, while permitting appropriate risk-taking, market-making, and capital investment. These studies might have resulted in rules or practices better focused on managing and reporting risks.

ARE THE REPORTS OF TARP'S DEATH EXAGGERATED?

On June 25, 2010, the Senate-House Conference Committee agreed on the Act. The initial Conference Report included Title XIII, the "Pay It Back Act," to pay for the legislation in an attempt to be PayGo compliant. The Conference Committee Report's Pay It Back Act included various fees/taxes on the financial services industry and raised a storm of protests and jeopardized the votes needed for passage. As a result, the House of Representatives amended this Title before Congress's July 4, 2010 recess. As finally passed by Congress, the final provisions slim TARP down but do not end it.

The Act amends the Emergency Economic Stabilization Act of 2008 ("EESA") to:

- Reduce the maximum amount of funds authorized under TARP from $700 billion to $475 billion, but deletes the further limitation of "outstanding at any one time";
- Ban any new TARP programs; and
- Require generally that TARP repayments be used to reduce the national debt.

The Secretary's authority is not reduced by:

- Any repayments of TARP principal received before, on, or after the enactment of the Pay it Bank Act;
- Any amounts committed to guarantees that have or will become uncommitted; or
- Any losses realized by the Secretary.

However, no obligations can be incurred for a program or initiative that was not initiated prior to June 25, 2010.

DEFICIT REDUCTIONS

The Pay It Back Act requires the Treasury to deposit in its General Fund any amounts received upon the sale of obligations and securities previously purchased from Fannie Mae, Freddie Mac, and any Federal Home Loan Bank and fees paid by Fannie Mae and Freddie Mac as a result of economic recovery programs. Such funds are dedicated for the sole purpose of deficit reduction.

Additionally, any American Recovery and Reinvestment Act of 2009 ("ARRA" or the "Stimulus Act") funds provided to any state that are not accepted by that state or are withdrawn by the head of any executive agency, then such funds are returned to the General Fund and dedicated for the sole purpose of deficit reduction. Unobligated funds withdrawn or recaptured by any agency shall be placed in the General Fund for deficit reduction. Further, any discretionary appropriations that have not been obligated as of December 31, 2012, also shall be deposited in the General Fund, unless the "President determines it is not in the best interest of the Nation to rescind specific unobligated amounts after December 31, 2012." The head of any federal executive agency may make such a request.

FEDERAL HOUSING FINANCE AGENCY REPORT AND GSEs

The Act requires the Director of the Federal Housing Finance Agency to report to Congress on the Agency's plans to support the housing industry while not inflicting further losses on taxpayers.

There are no solutions for resolving and ending the conservatorships of Fannie Mae or Freddie Mac included in the Act. According to *The Wall Street Journal* in May 2010, the United States had funded approximately $136 billion of Fannie Mae's and Freddie Mac's losses since these government sponsored enterprises ("GSEs") were placed in conservatorship. In addition, the Federal Reserve has been an active purchaser of mortgage-backed securities in the markets. At the end of 2009, the Treasury elected to remove the ceiling on federal aid to these GSEs from the initial cap of $200 billion each. Fannie Mae and Freddie Mac collectively are the largest recipients of U.S. aid during the credit crisis.

OBSERVATIONS

The Treasury and the President have considerable flexibility to continue spending monies from TARP. Although TARP is practically toxic in the banking industry and politically, Congress continues to work on legislation (H.R. 5297) to establish a small business lending fund following the passage of the Act, using TARP for banks with less than $10 billion in assets pursuant to a plan by the Obama administration announced in February 2010. This bill has passed the House and was due for a vote in the Senate the last week of July.

ORDERLY LIQUIDATION AUTHORITY

A significant portion of the Act is designed to provide a framework for an orderly resolution and liquidation of large financial companies that pose a significant risk to the financial stability of the U.S.[29] This section offers a discussion of the resolution and liquidation provisions in the Act, highlighting the differences between those provisions and Title 11 of the United States Code (the "Bankruptcy Code"), and examining the potential impact that the new legislation would have on various parties in interest.

According to the Act, the purpose of the liquidation provisions is to provide the necessary authority to address failing companies "in a manner that mitigates such risks and minimizes moral hazard."[30] To effectuate this goal, the Act would allow the Secretary to appoint the FDIC as receiver of a covered financial company,[31] upon the recommendation of a two-thirds vote by the board of directors of the FDIC and the Board of Governors and after consultation with the President. This power would give the FDIC authority to manage the covered financial company to mitigate the risk and impact on the economy that could potentially result from the failure of that company.[32]

Notably, while the resolution and liquidation provisions in the Act and the Bankruptcy Code contain a few similarities, the legislation would displace the Bankruptcy Code as the statutory framework for dealing with the failure of large financial companies that the Secretary, FDIC, and Board of Governors believe pose a risk to the financial stability of the U.S.[33] Indeed, upon the appointment of the FDIC as receiver for a covered financial company, any case or proceeding commenced with respect to the covered financial company under the Bankruptcy Code shall be dismissed after notice to the Bankruptcy Court and no such case or proceeding may be commenced at any time while the orderly liquidation is pending.[34] If, however, the Secretary or requisite number of the board of directors of the FDIC or Board of Governors decline to make the financial company a covered financial company, it will not be subject to the legislation, allowing liquidation or reorganization to proceed under the Bankruptcy Code, if applicable.

Additionally, the Act limits the role of the courts during the liquidation process. While there is some judicial oversight in determining what entities qualify to proceed under the Act's liquidation provisions, most of that judicial oversight recedes once the actual liquidation process begins. Generally, "no court may take any action to restrain or affect the exercise of powers or functions of the [FDIC]," unless specifically provided in the Act.[35]

In comparison, under the Bankruptcy Code, nearly all aspects of a bankruptcy case are subject to judicial and creditor scrutiny in some form or fashion. For example, creditors have a voice and the Bankruptcy Court is the ultimate decision-maker with respect to how a trustee or debtor in possession administers its bankruptcy case. The lack of judicial oversight and creditor involvement in liquidations under the Act would create a significant measure of uncertainty as to how a creditor's rights would be impacted in the event a financial company falls within the ambit of the legislation and is resolved in accordance with its provisions. Moreover, because the Act provides the FDIC with broad authority to effectuate many aspects of the liquidation, the procedures in the Act are near punitive to creditors and other parties in interest.

29 The authority provided under the Act to liquidate financial companies must be exercised in a manner that best fulfills this purpose, such that:
(1) creditors and shareholders will bear the losses of the financial company;
(2) management responsible for the condition of the financial company will not be retained; and
(3) the FDIC and other appropriate agencies will take all steps necessary and appropriate to ensure that all parties, including management and third parties, having responsibility for the condition of the financial company bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility.

30 H.R. 4173, § 204(a).

31 The term "covered financial company" means a financial company for which a determination has been made pursuant to, and in accordance with, the Act that the company is on the verge of failure and such failure poses a systemic risk to the economy, requiring that the covered financial company be placed into receivership.

32 H.R. 4173, § 203(b).

33 H.R. 4173, § 203.

34 H.R. 4173, § 208.

35 H.R. 4173, § 210(e).

AUTHORITY TO SET PRUDENTIAL STANDARDS

Under the Act, the Board of Governors is given authority to establish prudential standards, which are enhanced supervision and regulatory standards as to certain issues. The Board of Governors can establish prudential standards either on its own or pursuant to recommendations by the Council[36] and would do so to address the following:[37]

- Risk-based capital requirements;
- Leverage limits;
- Liquidity requirements;
- Resolution plan and credit exposure report requirements;[38] and
- Concentration limits by order or regulation.[39]

The Board of Governors may establish prudential standards to address issues in certain other areas as well, including: contingent capital requirements; enhanced public disclosures; and overall risk management requirements.[40]

Importantly, the established prudential standards apply to any nonbank financial company that the Council (by a two-thirds vote, including an affirmative vote by the Secretary as chairperson of the Council) determines to place under the supervision of the Board of Governors.[41] A company is a nonbank financial company if 85 percent of its gross revenues or consolidated assets are related to activities that are financial in nature.[42] The Council will make such a determination if the material financial distress at the nonbank financial company would pose a threat to the financial stability of the U.S.[43] The concepts of "material financial distress" and "to the financial stability of the United States" are not defined in the Act, thus making unclear the level of distress and required impact on the U.S. economy necessary for the Council to determine to subject a nonbank financial company to prudential standards.[44]

Under the Act, upon making a determination that a nonbank financial company should be placed under the supervision of the Board of Governors, the Council must first provide notice to the nonbank financial company of the Council's determination, including an explanation of the basis for the determination.[45] The Act also provides the nonbank financial company an opportunity for a hearing before the Council to contest the determination. The Council then has 60 days after such hearing to issue a final determination. If the Council makes the final determination, a nonbank financial company has 30 days from receipt of notice to seek judicial review in the D.C. District Court or the judicial district in which the home office of such nonbank financial company is located.[46]

In addition to nonbank financial companies, a bank holding company with greater than $50 billion[47] in consolidated assets is automatically subject to prudential standards.[48]

36 H.R. 4173, § 111. Council's voting members are: (i) the Secretary, as Chairperson of the Council; (ii) the Chairman of the Board of Governors; (iii) the Comptroller of the Currency; (iv) the Director of the Bureau of Consumer Financial Protection; (v) the Chairman of the SEC); (vi) the Chairperson of the FDIC; (vii) the Chairperson of the Commodity Futures Trading Commission; (viii) the Director of the Federal Housing Finance Agency; (ix) an independent member having insurance expertise (appointed by the President, with the advice and consent of the Senate); and (x) the Chairman of the National Credit Union Administrative Board. The Council's nonvoting members, who will serve in an advisory capacity, include: (i) the Director of the Office of Financial Research; (ii) the Director of the Federal Insurance Office; (iii) a state insurance commissioner, to be designated by a process determined by the state insurance commissioners; (iv) a state banking supervisor, to be designated by a process determined by the state banking supervisors; and (v) a state securities commissioner (or officer performing like functions), to be designated by a process determined by the state securities commissioners. H.R. 4173, § 111(b).

37 H.R. 4173, §§ 115 and 165.

38 The Council may make a recommendation to the Board of Governors that a nonbank financial company or a bank holding company with assets of $50 billion or more maintain a resolution plan that contains "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure." H.R. 4173, § 115(d)(1).

39 H.R. 4173, § 165(b)(1). Pursuant to the Council's recommendation, or upon its own initiative, the Board of Governors *must* establish prudential standards set forth above.

40 H.R. 4173, § 165(b)(1).

41 H.R. 4173, § 113(a).

42 H.R. 4173, § 102(a). Notably, "financial in nature" is defined in accordance with section 4(k) of the BHC Act (12 U.S.C. § 1843(k)). Under that act, the Board of Governors, in consultation with the Secretary, is authorized to determine what activities are financial in nature. 12 U.S.C. § 1843(k). The BHC Act declares a wide-range of activities financial in nature, including lending, financial and investment advisory services, insurance agency activities, issuing, underwriting and dealing in securities, and other common banking activities.

43 H.R. 4173, § 113(a)(1)-(2); H.R. 4173, § 113(b)(1)-(2).

44 *See* H.R. 4173, §§ 113(a)(2), (b)(2). The Act provides a nonexclusive list of factors that the Council shall consider prior to making a final determination, including, among others: (i) the extent of leverage of the company; (ii) off-balance sheet exposures; (iii) relationships with other significant financial companies; (iv) the importance of the company as a source of credit; and (v) the nature, scope, and interconnectedness of the activities of the company.

45 H.R. 4173, § 113(e).

46 H.R. 4173, § 113(h). Review of the Council's determination is limited to whether such determination was "arbitrary and capricious."

47 The Board, pursuant to a recommendation by the Council, may establish a threshold above $50 billion. H.R. 4173, § 165(a)(2)(B).

48 H.R. 4173, § 165(a)(1), (a)(2).

Bank holding companies are defined by reference to Section 2 of the BHC Act of 1956, [49] which states that a "bank holding company" means any company that has control over any bank or over any company that is or becomes a bank holding company.[50]

The ability to set prudential standards and the extensive scope of nonbank financial companies classification will give the Board of Governors and the Council broad authority to regulate many entities that did not previously fall under the supervision of the Board of Governors.

AUTHORITY TO PLACE A COMPANY INTO RECEIVERSHIP AND ENTITIES SUBJECT TO RECEIVERSHIP

In addition to placing certain financial companies under the supervision of the Board of Governors, the Act subjects certain financial companies to a new liquidation regime.[51] For a financial company to be a subject of this new regime, the Act first requires written recommendations from both the board of directors of the FDIC[52] and the Board of Governors, pursuant to an affirmative two-thirds vote by each,[53] after which the Secretary may place a financial company into receivership upon consultation with the President.[54]

Significantly, the Act does not make supervision by the Board of Governors a prerequisite to liquidation. The new liquidation regime applies to any "financial company," which includes a company that is incorporated or organized under the laws of the U.S. or any state and that is a bank holding company, a nonbank financial company supervised by the Board of Governors, a company predominantly engaged in activities that are financial in nature, or a subsidiary of any of these companies.[55] The ability of the FDIC to liquidate a company "predominantly engaged in activities that are financial in nature" introduces an element of unpredictability and uncertainty for parties dealing with any company that has significant financial operations.

As discussed above, in order to place a financial company in receivership, the Secretary, after consultation with the President and upon receipt of the written recommendations from both the board of directors of the FDIC (or the members of the SEC in the case of a broker or dealer, or the FIO Director in the case of an insurance company) and the Board of Governors, must determine each of the following:

- The financial company is in default or in danger of default.
- The failure of the financial company and its resolution under otherwise applicable federal or state law would have serious adverse effects on financial stability in the U.S.
- No viable private sector alternative is available to prevent the default of the financial company.
- Any effect on the claims or interests of creditors, counterparties, and shareholders of the financial company and other market participants as a result of actions to be taken under this title is appropriate, given the impact that any action taken under this title would have on financial stability in the U.S.
- Any action under liquidation would avoid or mitigate such adverse effects.
- A federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order.
- The company satisfies the definition of a financial company.[56]

The written recommendation and Secretary's determination is made on a confidential basis and without public disclosure.[57]

49 H.R. 4173, § 101(a)(1).
50 12 U.S.C. § 1841.
51 Although the scope of this discussion is limited generally to financial companies, we note that the Act makes certain exceptions for brokers and dealers and insurance companies.
52 The FDIC is not, however, involved in making all systemic risk determinations and recommendations that a company be placed in receivership. In the case of brokers or dealers, members of the SEC, along with the Board of Governors, must recommend the broker or dealer be placed in receivership. Further, in the case of insurance companies, the Director of the Federal Insurance Office (the "FIO Director"), along with the Board of Governors, must recommend the insurance company be placed in receivership. H.R. 4173, § 203(a)(1)(B), (C).
53 The vote for a receivership recommendation may be made upon the FDIC's (or the members of the SEC in the case of a broker or dealer, or the FIO Director in the case of an insurance company) and Board of Governors' own initiative or upon request from the Secretary.
54 H.R. 4173, § 203(b).
55 H.R. 4173, § 201(a)(5) and (11). H.R. 4173, § 201(b) ("Predominantly engaged in activities that are financial in nature" means that at least 85 percent of consolidated revenue from a financial company is derived from activities financial in nature or incidental thereto).
56 H.R. 4173, § 203(b).
57 H.R. 4173, § 202(a).

If the factors listed above are met, the board of directors of the company may consent or acquiesce to the appointment of the FDIC as the receiver.[58] If the board of directors does not consent or acquiesce to the receivership, the Secretary must petition the D.C. District Court for authorization to allow the Secretary to appoint the FDIC as receiver for the particular financial company. If a company contests the Secretary's recommendation and the Secretary petitions the D.C. District Court, the D.C. District Court must assess whether the Secretary's determination was "arbitrary and capricious" with respect to its findings that the covered financial company (i) is in "default or danger of default" and (ii) satisfies the definition of "financial company" under the Act. If the D.C. District Court concludes that the Secretary's determination was not arbitrary and capricious, the court must issue an order immediately authorizing the commencement of the liquidation process and the appointment of the FDIC as receiver for the covered financial company.[59] If, however, the D.C. District Court finds that the Secretary's determination was, in fact, arbitrary and capricious, then the D.C. District Court must immediately provide to the Secretary a written statement of each reason supporting its determination, and afford the Secretary an immediate opportunity to amend and refile the petition.[60] The Act does not make clear if there is any limit to the number of times the Secretary can amend and refile a petition.

According to the Act, a company is in danger of default if the "assets of the company are, or are likely to be, less than its obligations to creditors and others" or "the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business."[61] The Act's definition of "danger of default" is broad and subjective and, thus, it may prove to be difficult for the D.C. District Court to disagree with the Secretary's determination that the financial company is in "danger of default" as defined by the Act. Large institutions that fall into the definition of "financial company" under the Act may find themselves subject to the liquidation regime with very little real recourse in the event they believe the Secretary's action was not truly warranted or necessary to protect the economy at large.

ORDERLY LIQUIDATION FUND

To fund the liquidation of a covered financial company, the Act establishes, within the Treasury, an orderly liquidation fund (the "liquidation fund").[62] Prior to using any funds from the liquidation fund, the FDIC must first provide the Secretary with an orderly liquidation plan and a repayment plan, which demonstrate that the income received from the liquidation and any assessments (as discussed below) will be sufficient to repay the funds in accordance with the repayment schedule.[63]

Under the Act, the FDIC would issue debt obligations to the Secretary and use the proceeds for the initial funding of the liquidation fund.[64] During the first 30 days after the FDIC is appointed receiver, the FDIC's debt obligations in connection with the liquidation of a covered financial company may not exceed 10 percent of the total consolidated assets of the covered financial company. Thereafter, the FDIC may become obligated for 90 percent of the fair value of the covered financial company's total consolidated assets available for repayment.[65]

58 In the case of a broker or dealer, the FDIC must appoint the Securities Investor Protection Corporation ("SIPC") to act as trustee for the liquidation under the Securities Investor Protection Act of 1970 ("SIPA"), 15 U.S.C. 78aaa et. seq. Under the Act, SIPC has all powers and duties provided by SIPA, except that it will have no powers or duties with respect to assets and liabilities transferred by the FDIC from the broker or dealer to any bridge financial company as defined below). H.R. 4173, § 205. Notably, the SIPC will not be able to impair the FDIC's ability to, among other things, (i) establish a bridge company; (ii) transfer assets and liabilities; (iii) enforce or repudiate contracts; and (iv) determine claims. H.R. 4173, § 205(b).

If an insurance company is a covered financial company, or a subsidiary or affiliate of a covered financial company, the liquidation or rehabilitation of the insurance company is to be conducted under state law. This exception does not apply to a subsidiary or affiliate of an insurance company that is not itself an insurance company. If the appropriate regulator does not file the appropriate state court action within 60 days from the determination made under § 202(a) (described below) with respect to the insurance company, the FDIC is authorized to stand in the place of such regulator and file the appropriate action in the appropriate state court to place the insurance company into orderly liquidation. H.R. 4173, § 203(e).

59 H.R. 4173, § 202(a)(1). The company may also appeal the Court's decision to the Court of Appeals for the District of Columbia and ultimately to the Supreme Court. H.R. 4173, § 292(a)(2).

60 H.R. 4173, § 202(a)(1).

61 H.R. 4173, § 203(c)(4).

62 H.R. 4173, § 210(n).

63 H.R. 4173, § 210(n)(9).

64 The Secretary may use the issuance of this debt as a public debt transaction and sell the debt obligations as securities to the public. H.R. 4173, § 210(n)(5).

65 H.R. 4173, § 210(n).

If the FDIC has not repaid its debt obligations to the Secretary within 60 months of issuance, the FDIC is then required to impose assessments on various creditors.[66] First, the FDIC will levy assessments on certain creditors involved in the covered financial company's liquidation. In particular, the FDIC will be able to clawback payments made in the liquidation to creditors that received more value (except for payments necessary to continue operations essential to implementation of the receivership or any bridge financial company[67]) for their claims than such creditors were entitled to receive "solely from the proceeds of the liquidation" of the covered financial company.[68]

As discussed in more detail below in the "Priority Scheme in Receivership" section, the Act lists three situations in which a creditor may receive more value than it is entitled to receive: (1) dissimilar treatment of similarly situated creditors; (2) the FDIC's determination that such payment was necessary to minimize losses to the FDIC from the liquidation of the covered financial company; or (3) dissimilar treatment of similarly situated creditors in the transfer of the covered financial company's assets or liabilities to a bridge financial company.[69] Assessments on creditors that received excess payments will be in the amount equal to the difference between the aggregate value the creditor received from the FDIC and the value the creditor was entitled to receive on such claim solely from the proceeds of the liquidation.[70]

If such assessments are insufficient to repay the debt obligations to the Secretary within 60 months of issuance, the FDIC is required to impose risk-based assessments on any bank holding company or financial company with total consolidated assets equal to or greater than $50 billion and any nonbank financial company supervised by the Board of Governors.[71] These assessments would be levied on a graduated basis, with larger companies paying a higher rate.[72] Thus, while certain financial companies may not otherwise be subject to the FDIC's enhanced supervision, they may be required to pay assessments for the liquidation of an unrelated covered financial company.[73]

POWERS OF THE FDIC AS RECEIVER

Upon the commencement of a liquidation pursuant to the Act, the FDIC would be authorized and empowered to do the following:

- Take over the assets and operate the covered financial company;
- Collect all obligations and money due to the covered financial company;
- Perform all functions of the covered financial company;
- Manage the assets and property of the covered financial company;
- Provide by contract for assistance in fulfilling any function, activity, action, or duty of the receiver;
- Organize a bridge financial company;
- Merge the covered financial company with another company;
- Provide for the exercise of any function by any member or stockholder, director or officer of the covered financial company; or
- Transfer any asset or liability of the covered financial company without any approval, assignment, or consent with respect to such transfer.[74]

In addition to the aforementioned powers, the Act requires the FDIC to remove members of the covered financial company's board of the directors that are deemed responsible for the company's "failed condition."[75]

The Act provides the FDIC with a significant amount of power and authority over the covered financial company.

66 The FDIC may, with the approval of the Secretary, extend the 60-month time period if an extension is necessary to avoid a serious adverse effect on the U.S. financial system. H.R. 4173, § 210(o)(1)(C).
67 In the Act, a bridge financial company means a new financial company organized by the FDIC for the purpose of resolving a covered financial company. H.R. 4173, § 201(a)(1)(3).
68 H.R. 4173, § 210(o).
69 *Id.*
70 *Id.*
71 H.R. 4173, § 210(o)(1)(D).
72 H.R. 4173, § 210(o)(2). In imposing these special assessments, the FDIC (in consultation with the Council) is required to create a "risk matrix" that takes into account, among other things, various economic and financial conditions generally affecting the financial companies, to permit assessments to be lower for financial companies that are facing "less favorable economic conditions." H.R. 4173, § 210(o)(4).
73 The FDIC will notify such financial company of the assessment being levied against it at the time of such assessment. H.R. 4173, § 210(o)(3).
74 H.R. 4173, § 210(a)(1)(B)-(G).
75 H.R. 4173, § 206(5).

Moreover, other than judicial review of antitrust claims pursuant to a merger and the allowance or disallowance of claims (discussed below), it appears that the Act largely provides that these powers of the FDIC would largely go unsupervised by a court.

For example, Chapter 7 of the Bankruptcy Code provides for the appointment of a trustee upon the commencement of the case. The trustee is the successor in interest to the rights, titles, assets, and affairs of the debtor and is authorized to wind down the debtor's business. The Bankruptcy Code, however, requires that actions outside the ordinary course of business—such as paying prepetition debts, selling significant assets, using cash collateral and obtaining credit—must be reviewed by the court and be open to challenge by parties in interest to determine whether such actions are in the best interest of the debtor's estate.

The Act provides that the FDIC in resolving the liquidation case must seek to maximize the value generated from the sale or disposition of assets and minimize the amount of loss.[76] There is, however, no independent entity overseeing the process to ensure that the FDIC is in fact acting to maximize value. Further, the Act does not provide any guidance as to how the FDIC should choose a buyer or whether the process will be competitive.

PRIORITY SCHEME IN RECEIVERSHIP

Similar to the Bankruptcy Code, the Act creates a priority structure for creditors in the following descending order:

76 H.R. 4173, § 210(a)(9)(E).

Rank	Category
1	Secured claims in so far as their collateral is sufficient to satisfy their claim.
2	Post-receivership financing incurred if receiver is unable to otherwise obtain credit.
3	Administrative expenses of the receiver.[77]
4	Any amounts owed to the U.S., unless the U.S. agrees or consents otherwise.
5	Wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual (other than senior executive and directors), but only to the extent of $11,725 for each individual earned not later than 180 days before the appointment of the FDIC as receiver.
6	Contributions to employee benefit plans, arising from services rendered not later than 180 days before the date of appointment of the FDIC as receiver, to the extent of the number of employees covered by each such plan, multiplied by $11,725 (as indexed for inflation, by regulation of the FDIC), less the aggregate amount paid to such employees under the priority category above, plus the aggregate amount paid by the receivership on behalf of such employees to any other employee benefit plan.
7	Any other general or senior liability of the covered financial company (which is not a liability described under the priorities listed below).
8	Any obligation subordinated to general creditors (which is not an obligation described under the priorities below).
9	Any wages, salaries, or commissions including vacation, severance, and sick leave pay earned, owed to senior executives and directors of the covered financial company.
10	Any obligation to shareholders, members, general partners, limited partners, or other persons with interests in the equity of the covered financial company arising as a result of their status as shareholders, members, general partners, limited partners, or other persons with interests in the equity of the covered financial company.

77 "Administrative expenses of the receiver" includes:

(a) The actual, necessary costs and expenses incurred by the receiver in preserving the assets of a covered financial company or liquidating or otherwise resolving the affairs of a covered financial company for which the FDIC has been appointed as receiver; and

(b) Any obligations that the receiver determines are necessary and appropriate to facilitate the smooth and orderly liquidation or other resolution of the covered financial company.

H.R. 4713, § 201(a)(1).

There are similarities between the Act's priority scheme and the Bankruptcy Code's priority scheme. Notably, both the Bankruptcy Code and the Act require secured claims and administrative expenses to be paid in full before unsecured claims are paid. In addition, both the Bankruptcy Code and the Act provide for the payment of certain employee, tax, and other employee-related claims before unsecured claims are paid. There are, however, significant differences that would have serious ramification for creditors.

One significant difference is that the Act requires that all obligations to the U.S. be paid in full before any other creditors are paid (other than secured creditors, post-receivership financing creditors and administrative creditors). While certain claims of the U.S. are given priority under the Bankruptcy Code, the debtor is not required to pay *all* obligations to the United States before unsecured creditors are paid.[78] Needless to say, the priority given to all of the U.S. claims would reduce the assets available to creditors that are not either secured or granted administrative priority.

Further, the Bankruptcy Code does not provide separate priority levels for employees based upon their level of seniority with the covered financial company. Pursuant to the priority scheme in the Act, the unpaid wages, vacation, and sick pay of senior executives and directors of the covered financial company are near the bottom of the priority scheme and, in many instances, those individuals likely would not receive any recovery on behalf of their wage claims. Moreover, the Act fails to offer any guidance regarding the employees that qualify as "senior executives," and this lack of clarity will cause unavoidable dispute and confusion throughout the liquidation claims process.

The Act generally protects security interests granted to secured creditors where the covered financial company holds the assets or property that is subject to such security interests. Similar to the Bankruptcy Code, the Act provides that the secured creditors are secured to the extent of the fair market value of their collateral.[79] The portion of any claim that exceeds the fair market value of such collateral would be treated as an unsecured claim.[80] The FDIC's liability for the unsecured portion of the claim would be limited to what such creditor would have been entitled to receive if the covered financial company had been liquidated under Chapter 7 of the Bankruptcy Code.[81] Thus, in this regard there is no difference between liquidation under the proposed regime and under Chapter 7 of the Bankruptcy Code. The legislation, however, does not provide any meaningful insight as to how the secured creditor's collateral should be valued, creating additional uncertainty among secured creditors.

Under the Act, the FDIC is given the ability to prime a secured creditor's collateral position with a lien that is senior or equal to the creditor's position in order to obtain credit for a bridge financial company organized by the FDIC. While the FDIC would be required to provide such secured creditor with adequate protection of the secured creditor's interest,[82] the legislation does not provide any guidance on what constitutes adequate protection of the secured creditor's interest and, perhaps more concerning, there is no independent arbiter to determine the sufficiency of the adequate protection provided. Under the Bankruptcy Code, there are several statutory parameters for determining adequate protection. With no similar parameters under the Act, the FDIC would have considerable latitude in determining the sufficiency of the adequate protection and the nature and extent of any claim for any diminution in the value of the secured party's collateral.

Under the Act, similarly situated creditors are treated in the same manner *unless* the FDIC determines that other treatment is necessary to:

- Maximize the value of the assets of the covered financial company;
- Initiate and continue operations essential to the implementation of the receivership or any bridge financial company;
- Maximize the present-value return from the sale or other disposition of the assets of the covered financial company; or
- Minimize the amount of any loss realized upon the sale or other disposition of the assets of the covered financial company.[83]

78 See 11 U.S.C. § 507 for the Bankruptcy Code's priority scheme.
79 See 11 U.S.C. § 506 for the Bankruptcy Code's determination of a creditor's secured status.
80 H.R. 4173, § 210(a)(3)(D); 11 U.S.C. § 506(a).
81 H.R. 4173, § 210(d).
82 H.R. 4173, § 210(h)(16).
83 H.R. 4173, § 210(b)(4).

Moreover, the Act allows any obligation that is "necessary and appropriate" for the smooth resolution of the covered financial company to qualify as an administrative expense, which is given the highest priority level among unsecured creditors.[84]

This section of the Act may cause considerable angst among the financial company's unsecured creditors. Under the protections of the Bankruptcy Code, in a Chapter 7 liquidation, creditors understand that, generally, they would not be treated differently from similarly situated creditors.[85] The Act, however, essentially gives the FDIC sole discretion to decide which creditors may be paid as administrative expense creditors and which creditors would be treated less favorably than other similarly situated creditors—all in order to achieve one of the above-listed goals. This provision gives the FDIC considerable leverage in dealing with unsecured creditors.

THE CLAIMS PROCESS

Under the Act, the FDIC is vested with the authority to allow or disallow all claims asserted against a covered financial company. Promptly after being appointed as receiver of a covered financial company, the FDIC must publish notice to the creditors to present their proofs of claims to the receiver by a specific date, which must be no less than 90 days after the date of publication of the notice.

After the FDIC publishes notice regarding the submission of claims, the burden throughout the claims process effectively shifts to the covered financial company's creditors.[86] After the creditors present their claims to the FDIC, with little initial judicial oversight, the FDIC would be required to make its determination on the claim within 180 days from the date such claim is presented. If the creditor is not satisfied with the FDIC's determination with respect to the claim, the creditor's only recourse is to file suit in the district or territorial court of the U.S. for the district where the covered financial company's principal place of business is located.[87] Thus, a creditor would be required to bear the burden and costs associated with presenting its claim to the FDIC and pursuing litigation should it not like the FDIC's determination regarding the claim.

AVOIDANCE OF FRAUDULENT TRANSFERS AND PREFERENTIAL TRANSFERS

Congress modeled the fraudulent transfer and preferential transfer sections of the Act largely on Sections 546, 547, and 548 of the Bankruptcy Code. Similar to the authority given to trustees in Chapter 7 cases to avoid fraudulent transfers under the Bankruptcy Code, under the Act the FDIC would have the authority and power to avoid a transfer made within two years before the commencement of the liquidation, of any interest in property, or obligation incurred by the covered financial company with actual fraudulent intent, or if:

- The covered financial company received less than a reasonably equivalent value in exchange for such obligation; and
- The transfer was made when the covered financial company was insolvent or became insolvent as a result of the transfer, would have resulted in an unreasonably small amount of capital remaining with the covered financial company, involved debts that would be beyond the covered financial company's ability to pay, or was made to or for the benefit of an insider.[88]

Similar to the rights afforded to a trustee under the Bankruptcy Code, the FDIC also would have the authority to avoid a transfer of an interest in property of the covered financial company that is a preferential transfer.[89] The Act's clawback period for preferential transfers is similar to that

84 H.R. 4173, § 201(a)(1).
85 *See* 11 U.S.C. § 726. There are, however, various exceptions to the generally understood rule in bankruptcy that creditors will not be treated differently from similarly situated creditors. For example, under the Bankruptcy Code, courts have allowed senior creditors to voluntarily cede a portion of their distribution to a junior creditor.
86 Within 60 days of the appointment of the FDIC as receiver, the FDIC also must file a report with the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives, containing among other things, a description of the assets and liabilities. H.R. 4173, § 203(c)(3).
87 H.R. 4173, § 210(a)(4).
88 H.R. 4173, § 210(a)(11).
89 H.R. 4173, § 210(a)(11). The Act defines a preferential transfer in a manner similar to the definition in Section 547(b) of the Bankruptcy Code. Specifically a transfer is a preference under the Act if it was made by the covered financial company while it was insolvent to or for the benefit of a creditor on account of an antecedent debt, and the transfer permitted the creditor to receive more than it would have received if the covered financial company had been liquidated under Chapter 7 of the Bankruptcy Code.

of the Bankruptcy Code—specifically applicable to transfers made within 90 days of the date on which the FDIC was appointed receiver or within one year of the appointment if the transfer was made to an insider.

Notably, the Act *does not* provide the FDIC with avoidance powers similar to those given to a trustee under Section 544 of the Bankruptcy Code, including the right to avoid transfers that could have been avoided by a "hypothetical creditor" under nonbankruptcy law. Also absent from the Act are the safe harbor defenses for fraudulent transfer or preference actions available to transferees and creditors under Section 546(e) of the Bankruptcy Code with respect to certain types of contracts, such as securities contracts, commodities contracts and forward contracts.

The Act, however, does incorporate by reference the defenses found in Sections 546(b), 546(c), 547(c), and 548(c) of the Bankruptcy Code. Transferees of a purported fraudulent or preferential transfer are able to rely upon certain limitations on avoidance powers found in Sections 546(b) and 546(c) of the Bankruptcy Code. These Bankruptcy Code sections make the FDIC's avoidance powers subject to certain perfected security interests and rights of reclamation of goods by a seller.[90] As a defense to a preferential transfer claim, the transferee may rely upon Section 547(c) of the Bankruptcy Code, which provides, among other things, that a trustee may not avoid transfers made for new value or in the ordinary course of business.[91] The transferee also may rely upon Section 548(c) of the Bankruptcy Code as a defense to an alleged fraudulent transfer. This section grants a good faith transferee a lien on the property transferred to the extent of value given.[92]

Under the Act, the FDIC also may avoid all transfers of property that are made after the FDIC is appointed receiver that are not otherwise authorized under the Act.[93] The Bankruptcy Code provides similar authority by allowing the trustee to avoid postpetition transfers that are not otherwise authorized under the Bankruptcy Code or approved by the Court prior to such transfer.[94]

90 11 U.S.C. § 546 (b) and (c).
91 11 U.S.C. § 547(c).
92 11 U.S.C. § 548(c).
93 H.R. 4173, § 210(a)(11)(C).
94 11 U.S.C. § 549.

SETOFF

Like the Bankruptcy Code, the Act generally preserves creditors' rights to setoff. The Act allows a creditor to offset a mutual debt owed by the creditor to the covered financial company that arose prior to the appointment of the FDIC as receiver if such setoff is enforceable under applicable noninsolvency law.[95] Setoff would not be enforceable, however, if: the creditor's claim is disallowed;[96] the claim was transferred to the creditor by another entity after the FDIC was appointed as receiver or after the 90-day period preceding the receivership;[97] or for the purpose of obtaining a right of setoff against the covered financial company, the creditor's debt was incurred after the 90-day period preceding the receivership.[98]

Unlike the Bankruptcy Code, however, the Act would allow the FDIC to destroy the mutuality of offsetting claims by transferring assets free and clear of setoff rights.[99] For example, if the FDIC transferred assets (*e.g.*, accounts receivable) of the covered financial company to another financial company, the creditor that otherwise had valid setoff rights would not be able to enforce its setoff rights against the transferee. Rather, upon such transfer, the creditor would be entitled to a claim against the covered financial company equal to the value of its setoff rights. Such claim would be junior in priority to secured claims, post-receivership financing claims, administrative expense claims, claims of the U.S., wage claims (other than claims of senior executives and directors), and employee benefit claims, but senior in priority to general unsecured claims, subordinated claims, certain wage-based claims by executives and directors, and equity interests.[100] Thus, if the FDIC transfers substantially all of the covered financial company's assets but is unable to preserve enough value to pay

95 H.R. 4173, § 210(a)(12).
96 H.R. 4173, § 210(a)(12)(A)(i).
97 H.R. 4173, § 210(a)(12)(A)(ii). If the setoff right is in connection with anything other than a QFC (as defined below) then the covered financial company must also have been insolvent during the 90-day period preceding the receivership. For purposes of setoff, the covered financial company is presumed to have been insolvent on and during the 90-day period preceding the receivership. H.R. 4173, § 210(a)(12)(D).
98 H.R. 4173, § 210(a)(12)(A)(iii).
99 H.R. 4173, § 210(a)(12)(F) ("[T]he[FDIC] . . . may sell or transfer any assets free and clear of the setoff rights of any party.").
100 H.R. 4173, § 210(a)(12)(F) ("[The setoff claimant] shall be entitled to a claim, subordinate to the claims payable under subparagraphs (A), (B), (C), and (D) of subsection (b)(1), but senior to all other unsecured liabilities defined in subsection (b)(1)(E), in an amount equal to the value of such setoff rights.").

all claims with senior priority, the creditor would likely receive nothing with respect to its setoff claim.

Unlike the Act, the Bankruptcy Code provides that a creditor with valid setoff rights has a secured claim to the extent of the amount subject to setoff and thus is entitled to all of the protections afforded secured creditors under the Bankruptcy Code.[101] Therefore, if the creditor's setoff right is cash in a bank account, for example, the Bankruptcy Code will prohibit the use or sale of such cash unless the creditor consents to the use or sale of the cash accounts[102] or unless adequate protection is provided to the creditor.[103] The Act does not provide creditors entitled to a right of setoff with similar protections.

CONTRACT PARTIES

The sections of the Act dealing with contractual relationships under the liquidation regime are modeled after Section 11 of the FDI Act, 12 U.S.C. § 1811.[104] For those entities that otherwise would be subject to the FDI Act, the provisions of the Act largely would not change the expectations of a nondebtor contract party. For those entities that otherwise would be subject to the Bankruptcy Code, the difference between the Bankruptcy Code and the Act are significant. This subsection discusses the impact the Act would have on nondebtor contract parties involved with Covered Financial Companies that, but for the new liquidation regime, would be subject to the Bankruptcy Code in a liquidation or reorganization.

First, under the Act, counterparties to a Qualified Financial Contract ("QFC")[105] would be stayed from exercising liquidation, termination, or netting rights until 5:00 p.m. EST on the business day following the date of the appointment of the receiver.[106] The purpose of the stay is to give the FDIC sufficient time to determine whether there is value in the covered financial company's QFCs and whether those QFCs should be sold or repudiated. This stay period deviates from the Bankruptcy Code, where counterparties to certain financial contracts may exercise immediately the right to terminate or accelerate the obligations, liquidate any collateral or setoff mutual debts as provided in the contract. The Act's stay period may impact parties that commonly effectuate netting rights immediately upon a bankruptcy filing.

Under the Act, the FDIC may disaffirm or repudiate any contract or lease: (i) where the covered financial company is a party; (ii) the performance of which the receiver, in its discretion, determines to be burdensome; and (iii) the disaffirmance or repudiation of which the receiver determines, in its discretion, would promote the orderly administration of the covered financial company's affairs.[107] The Bankruptcy Code allows a debtor to reject various contracts and unexpired leases that it deems burdensome.[108] The Bankruptcy Code requires, however, that such contracts be executory (*i.e.*, material performance remains for both parties under the contract). The Act does not limit the FDIC's repudiation authority to executory contracts. Under the Act, the FDIC would be able to repudiate a contract regardless of whether material performance remains for the parties under the contract.

Under the Act, damages for contract repudiation or disaffirmance are limited to "actual direct compensatory damages" (resulting in smaller damages claims than the damages assessed after the rejection of identical contracts pursuant to the Bankruptcy Code) determined as of the date of the appointment of the receiver.[109] No damages are allowed as to any punitive or exemplary damages; damages for lost profits or opportunity; or damages for pain and suffering. In the case of a repudiation or disaffirmance of a QFC, compensatory damages are deemed to include normal and reasonable costs of cover or other reasonable measures of damages utilized in the industry for such contract and

101 11 U.S.C. § 506(a).
102 11 U.S.C. § 363(a) and (c)(2).
103 11 U.S.C. § 363(e).
104 The FDI Act contains substantially similar provisions to the Act.
105 Under the Act, a QFC is defined as any "securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the FDIC determines by regulation, resolution, or order to be a qualified financial contract…." Generally, provisions in the Act relating to QFCs incorporate language similar to that used in the FDI Act and the Bankruptcy Code for similar agreements. H.R. 4173, § 210(c)(8)(D)(i); 11 U.S.C. §§ 555-556.
106 H.R. 4173, § 210(c)(10).

107 H.R. 4173, § 210(c)(1).
108 11 U.S.C. § 365.
109 If the FDIC repudiates a lease under which the covered financial company was a lessee, the FDIC will not be liable for any damages other than an amount equal to the contractual rent occurring before the later of (i) the notice of repudiation or (ii) the effective date of the repudiation. H.R. 4173, § 210(c)(4). Under the Bankruptcy Code, the damages are allowed up to a sum equal to the greater of one year's rent or 15 percent of the balance of the lease payments, up to an amount equal to three years' rent. 11 U.S.C. § 502(b)(6).

agreement claims.[110] This language mirrors the language under the FDI Act, and is a significant departure from the nature and extent of damages that would be permitted under the Bankruptcy Code in the event of a repudiation or disaffirmance of a QFC.[111] Such damages are determined as of the date of disaffirmance or repudiation of the QFC.[112]

Moreover, pursuant to the Act, the FDIC may enforce any contract, other than a director's or officer's liability insurance contract or a financial institution bond, entered into by the covered financial company notwithstanding provisions for termination, default, acceleration, or exercise of rights upon insolvency or the appointment of a receiver.[113]

The Bankruptcy Code allows debtors to assume various contracts that are deemed to be beneficial. Prior to assuming and assigning contracts, the debtor must provide adequate assurance of future performance.[114] Further, the Bankruptcy Code has provisions that provide, prior to assuming and assigning contracts, that the debtor must cure all contract defaults and compensate for damages.[115] The Act does not contain these protections for nondebtor contract parties.

Parties may be reluctant to enter into long-term contracts with a large financial company because of the parties' potential exposure in the event of such company's financial distress. Moreover, such nondebtor contract parties may seek to manage the risk by imposing stricter terms to their contractual relationships than they otherwise would impose if the uncertainty fostered by the Act's liquidation regime were not present.

110 The "costs of cover" for a commodities contract, for example, is the cost of purchasing contract rights to acquire the same commodity on the same date at the same price as provided for by the repudiated contract. *Employees' Retirement Sys. v. Resolution Trust Corp.*, 840 F. Supp. 972, 988 (S.D.N.Y. 1993). The concept of "cost of cover" also appears in Section 2-712 of the Uniform Commercial Code (the "UCC") as it relates to transactions in goods. Under the UCC, one of the buyer's remedies for breach of contract equals the difference between the cost of the replacement goods and the contract price—the cost of cover. U.C.C. § 2-712.
111 12 U.S.C. § 1821(e).
112 H.R. 4173, § 210(c)(3).
113 H.R. 4173, § 210(c)(13).
114 11 U.S.C. § 365(b).
115 11 U.S.C. § 365(b).

Inherently, this may have an adverse impact on large financial institutions that are struggling financially but are yet to be placed under the FDIC's control pursuant to the Act. Indeed, many contract parties may assume that the financial company is, eventually, going to be placed under the FDIC's control pursuant to the Act and, thus, attempt to seek adequate assurances—such as shorter payment terms or payment in advance—under various state law provisions prior to the commencement of the liquidation. This, in turn, may cause the financial institution to be placed under more severe financial stress which, ultimately, may lead to more strain on the economy at large.

The Bankruptcy Code requires that all unexpired leases and executory contracts be rejected or assumed by a certain date. The Act does not appear to contain a similar timing component, which would cause significant uncertainty through the liquidation process.

STUDIES AND REPORTS

The Act contemplates that the Administrative Office of the U.S. Courts (in one instance), the Comptroller General of the U.S., and the Board of Governors conduct certain studies and produce related reports for the purpose of evaluating the overall effectiveness of liquidating or reorganizing financial companies. The issues that are to be the focus of these studies and reports include:

- Ways to improve the efficiency and effectiveness of the Bankruptcy Court in liquidating or reorganizing financial companies;[116]
- Ways to increase international coordination relating to the liquidation of financial companies (including nonbank financial institutions) under the Bankruptcy Code;[117] and
- The similarities and differences in the treatment of secured creditors under this Act, the Bankruptcy Code, and FDI Act and how a reduction in secured creditors' claims (or a "haircut" as referenced in the Act) under these liquidation regimes could improve market discipline and protect taxpayers.[118]

116 H.R. 4173, § 202(e).
117 H.R. 4173, § 202(f); H.R. 4173, § 216.
118 H.R. 4173, § 215.

The requirement that that the Administrative Office of the U.S. Courts, the Comptroller General of the U.S., and the Board of Governors conduct these studies and produce these reports suggests that Congress is open to the idea of revising the current liquidation regimes, including the liquidation regimes authorized by the Act, the Bankruptcy Code, and FDI Act. Moreover, the very nature of these reports and studies indicate that Congress may be considering certain revisions that will provide for less-favorable treatment to secured creditors of financial companies. Indeed, Congress appears to have opened the possibility to an across-the-board cut to secured creditors' claims in the event a financial company liquidates under the Act, the Bankruptcy Code, or FDI Act. If Congress were to enact such amendments in the future, lending institutions may become even more wary extending credit under commercially viable terms to financial companies.

Moreover, because the FDIC is authorized to act with little judicial oversight over the exercise of its powers and functions and it is unclear in many instances under the Act whether a company would be subject to the proposed legislation, significant uncertainties will exist in dealing with the FDIC in the resolution and liquidation process and in dealing with financial companies that may, in the future, come under the control of the FDIC pursuant to the Act's liquidation regime. As a result, these uncertainties may adversely impact the desire of lending institutions to extend long-term credit to companies that may be subject to the legislation. Instead, such institutions will likely opt for short-term extensions of credit to minimize their exposure in the event that a company does in fact become subject to the liquidation regime. The provision of short-term lending, as opposed to long-term extensions of credit, may have the unintended consequence of destabilizing the economy, the opposite of the Act's intent.

CONCLUSION

As noted above, the Act would provide the FDIC with significant new power to liquidate and resolve Covered Financial Companies. It is quite clear that this new liquidation regime differs extensively from other statutory regimes, such as the Bankruptcy Code, and would significantly alter the rights and expectations of parties in interest. Many parties may see inherent risks associated with the FDIC's newfound power and may also view the procedures in the Act as near punitive to creditors. Indeed, there is no independent entity overseeing most of, or any real checks and balances to, the FDIC's actions to ensure that the FDIC is acting to maximize value.

HEDGE FUND, PRIVATE EQUITY, AND OTHER ADVISERS

Title IV of the Act is designated as the Private Fund Investment Advisers Registration Act of 2010 (the "Adviser Registration Act") and significantly expands the requirement for investment advisers to register pursuant to the Investment Advisers Act. The Adviser Registration Act will affect many investment advisers to hedge funds, private equity funds, and real estate funds, but will generally not apply to family offices, or investment advisers to venture capital funds and small business investment companies that meet SEC regulatory requirements. In effect, the Adviser Registration Act will, absent any of the specific exclusions or exceptions as discussed below, require any investment adviser of separately managed accounts with more than $100 million of assets under management, and any investment adviser solely to private funds (funds relying on the exemptions under Section 3(c)(1) or 3(c)(7) of the Investment Company Act) with more than $150 million of assets under management, to register with the SEC. An investment adviser falling below these thresholds (other than a non-U.S. investment adviser) will be generally required to register as such in the state where it maintains its principal place of business.

ELIMINATION OF THE PRIVATE ADVISER EXEMPTION

Until now, investment advisers to private funds have relied upon the exemption from SEC registration found in Section 203(b)(3) of the Investment Advisers Act (the "Private Adviser Exemption"). This generally exempted from registration any investment adviser that: did not hold itself out to the public as an investment adviser; had fewer than 15 clients during the preceding 12-month period; and was not an adviser to a registered investment company. A hedge fund or other private fund has traditionally been counted as a single client, even though a fund may have 15 or more investors. Under the Adviser Registration Act, the Private Adviser Exemption is simply eliminated for U.S.-based investment advisers. Absent any other specific exemption, U.S.-based investment advisers that are advisers exclusively to private funds will be required to register under the Investment Advisers Act if they have $150 million or more of assets under management. However, while investment advisers to private funds with less than $150 million of assets under management may avoid traditional Adviser Act registration, as discussed below, the SEC will, pursuant to the Adviser Registration Act, impose certain new recordkeeping and reporting requirements on those investment advisers.

OTHER EXCLUSIONS AND EXEMPTIONS

The Adviser Registration Act provides a limited number of exclusions and exemptions from SEC registration for certain investment advisers.

Venture Capital Funds. Investment advisers that advise solely one or more venture capital funds (as to be later defined by the SEC) will be exempt from registration, but the Adviser Registration Act provides that the SEC shall require those advisers to maintain records and file reports as the SEC determines appropriate.

Small Business Investment Companies. Investment advisers solely to one or more small business investment companies operating pursuant to the U.S. Small Business Investment Act of 1958 will be exempt from investment adviser registration requirements.

Family Offices. The Adviser Registration Act generally exempts family offices from the definition of investment adviser and thus any registration or reporting requirements under the Investment Advisers Act. The SEC is left with the task of defining "family office" based upon current exemptive orders and in consideration of the various organizational, management, and employment structures and arrangements used by different family offices.

Foreign Advisers. The Adviser Registration Act provides an exemption for non-U.S. investment advisers, but the exemption is very limited and would apply only if the non-U.S. investment adviser:

- Has no place of business in the U.S.;
- Has fewer than 15 clients and investors in the U.S. in private funds advised by investment adviser;
- Has aggregate assets under management attributable to U.S. clients and investors of less than $25 million (or such higher amount determined by the SEC);

- Does not hold itself out generally to the public in the U.S. as an investment adviser; and
- Is not an investment adviser to a registered investment company.

Given the very narrow band of non-U.S. investment advisers which might actually qualify for this exemption, the Adviser Registration Act significantly expands the extra-territorial reach of the Investment Advisers Act. The likely effect of these provisions will be that non-U.S. investment advisers will now have to register with the SEC if they access U.S. investors for their private funds.

NEW RECORDS AND REPORTS FOR PRIVATE FUNDS

The Adviser Registration Act gives the SEC broad authority to require any investment adviser registered under the Investment Advisers Act to maintain records of, and file with, the SEC reports regarding private funds. In addition to other recordkeeping requirements under the Investment Advisers Act, the Adviser Registration Act requires investment advisers of private funds to maintain for each fund a description of:

- The amount of assets under management;
- The use of leverage, including off-balance-sheet leverage;
- Counterparty credit risk exposure;
- Trading and investment positions;
- Valuation policies and practices;
- Types of assets held;
- Side arrangements or side letters;
- Trading practices; and
- Such other information as the SEC determines is in the public interest and for the protection of investors or for the assessment of systemic risk.

The SEC may vary the types of reports and records it requires based on the size or type of the fund being advised, may prescribe different time periods during which this information must be maintained and filed, and must share the information with the Council to the extent requested. The SEC is required to conduct periodic inspections of the records maintained by a registered investment adviser to a fund, and may conduct other reviews at any time, although there is no specific mandate as to the frequency of these reviews.

Private fund information provided to the SEC and the Council will be afforded certain limited confidentiality, but nevertheless may be disclosed to Congress, federal agencies, self-regulatory organizations, and/or in judicial proceedings brought by the SEC or the U.S. Government. Such other recipients will be bound by the same confidentiality limitations imposed upon the SEC and the Council, although all such parties will be exempt from the Freedom of Information Act with respect to such private fund information.

The Adviser Registration Act provides special confidentiality protection for "proprietary information of an investment adviser" with respect to research models and methodologies, trading strategies, trading data, computer hardware and software containing intellectual property, and any other information the SEC determines to be proprietary. While Section 210(c) of the Investment Advisers Act has traditionally prohibited the disclosure of client information other than in connection with an SEC enforcement action, the Adviser Registration Act now permits the disclosure of client information to the SEC and Council "for purposes of assessment of systematic risk."

CUSTODY OF CLIENT ASSETS

The Adviser Registration Act amends the Investment Advisers Act to authorize the SEC by regulation to require registered investment advisers with custody over client assets to engage an independent public accountant to verify such assets.

ADJUSTMENT OF INVESTOR STANDARDS

Under the Adviser Registration Act, the Accredited Investor net worth standard will be fixed for the next four years at $1 million for a natural person (either individually or jointly with spouse), but will now *exclude* the value of such person's primary residence. The new Accredited Investor threshold takes effect immediately, and may be modified by the SEC after the initial four-year period. Similarly, the Adviser Registration Act requires the SEC to adjust for inflation the net asset threshold for Qualified Clients permitted to pay performance based fees to registered investment advisers pursuant to Rule 205-3 of the Investment Advisers Act. While the current threshold remains in place for the moment, the SEC has one year to adjust the threshold, and then do so for inflation every five years thereafter.

TRANSITION

Except for the new Accredited Investor standard which, as noted above, takes effect immediately, the remainder of the Adviser Registration Act will take effect one year from the date of enactment. Accordingly, investment advisers subject to the new rules must be registered and/or meet the new recordkeeping and disclosure requirements by July 2011.

FEDERAL INSURANCE OFFICE

The insurance-related provisions of the Act are focused on studying the state regulation of insurance, not reforming it, and creating federal expertise in insurance where none currently exists. To that end, the legislation includes the Federal Insurance Office Act of 2010, which creates a FIO that has the ability to collect information and monitor developments in the state regulation of insurance but has no authority to regulate or supervise insurance companies.[119] Indeed, consistent with the McCarran-Ferguson Act, the Federal Insurance Office Act explicitly leaves regulation of insurance to the states, maintaining the existing system that allows each state to create its own capital and solvency requirements for insurers domiciled in the state.[120] As a practical matter, there are no changes in the way insurance company solvency is monitored, regulated, and enforced and this legislation will have virtually no impact on how insurers, insureds, and their counterparties conduct business vis à vis insurance.

The few provisions that do more than authorize the study of insurance are not likely to have a significant impact on the business of insurance.

First, the Act provides for preemption of any state insurance law that treats foreign (non-U.S.) insurers less favorably than domestic insurers in the limited circumstance in which a covered agreement is at issue, which is defined as an agreement between the U.S. and one or more foreign governments regarding prudential measures relating to insurance.[121] The Director of the Federal Insurance Office is exclusively authorized to make that determination in the first instance, which is subject to de novo judicial review.[122]

Second, the Act authorizes the FDIC to stand in the shoes of the state regulator and liquidate (but not rehabilitate) an insurance company, pursuant to state law, if the state regulator has not filed a judicial action to liquidate the company within 60 days of the Director of the Federal Insurance Office and the Board of Governors making a determination that the insurance company is "in default,"[123] defined as a situation in which the company has incurred or is likely to incur losses that will deplete substantially all of its capital, and there is no reasonable prospect for the company to avoid the depletion; the company's liabilities exceed its assets; or the company is unable to pay its obligations in the normal course of business.[124] This "backup authority" underestimates the ability and opportunity of state insurance regulators to identify and remedy an insurer's hazardous financial condition. Every state has adopted comprehensive legislation that sets standards for insurer solvency and procedures for routine monitoring. Moreover, every state provides its insurance regulator with an arsenal of tools that allow him or her to attempt to improve an insurance company's financial position without liquidating the company. Those alternatives are designed to protect policyholders and other interested parties and avoid liquidation, which is typically treated as a worst case scenario. It is difficult to conceive of a historic example where the backup authority delegated to the FDIC would have made a difference. More to the point, it is unlikely that a federal agency will be better suited to navigate the complex issues that frequently surround insurance company liquidations, through state law process. (Consider that the New York Insurance Department has an entire bureau dedicated to liquidating insurance companies, thereby condensing the necessary expertise in a separate division of the insurance department.) The backup authority provisions appear to be window-dressing at best and overreaching at worst. In either case, it is unlikely that they will impact the regulation of the business of insurance given that state regulators have been historically active in monitoring solvency and are more experienced at it.

Third, the Act resolves uncertainties about which state may regulate or charge fees or taxes with regard to certain insurance transactions that typically occur across several states, under provisions titled the Nonadmitted and Reinsurance Reform Act of 2010.[125]

119 Sec. 501 *et. seq.*
120 Sec. 502(j), (k).
121 Sec. 502(f).
122 Sec. 502(g).

123 Sec. 203(e)(3).
124 Sec. 203(c)(4).
125 Sec. 511 *et seq.*

THE DERIVATIVES LEGISLATION: IS THE WORLD NOW SAFER?

One section of the Act that has received a great deal of attention is Title VII, the section addressing swaps. Although swaps were not the root cause of the recent financial meltdown, as a newer financial product not widely understood outside of the financial marketplace, swaps have become a good target for those of various political stripes. These products have been touted as too "risky" (which has now become a bad word in Washington) and therefore evil or at least inappropriate for U.S. banks and many other financial institutions. Unfortunately, the political and populist anger over the financial crisis that has been directed at the derivatives area, together with an unwillingness to challenge the traditional roles of various government agencies, has resulted in sweeping, complicated new legislation affecting swaps that is itself a "risky scheme" (with apologies to Al Gore).

The enormity of the proposed changes, together with the excessive uncertainty resulting from the complexities and ambiguities found throughout the Act, as well as the regulatory structure it creates, could result in both short-term pain for users of swaps and participants in the derivatives markets generally and long-term unintended and undesirable changes in the marketplace. The word "reform" plays a prominent role in the title of the Act. "Reform" means to correct, rectify, or make better. Whether the Act actually accomplishes this remains to be seen.

THE BIG PICTURE

Abandoning the previous regulatory structure, which allowed "eligible contract participants" (a defined term designed to describe parties large enough to be financially sophisticated) to transact in swaps on a bilateral basis with little oversight or regulation, the new bifurcated jurisdictional framework submits virtually all swaps to regulation by either the SEC or the CFTC. The SEC regulates those transactions defined as "security-based swaps" and entities engaging in or related to such security-based swaps, and the CFTC regulates transactions defined as "swaps" and entities engaging in or related to such transactions. Both agencies share joint jurisdiction over "mixed swaps."[126] The Act requires mandatory clearing and trading on or through designated contract markets, national securities exchanges, or swap execution facilities for most swaps, with certain limited exemptions, and imposes significant new regulations and requirements on entities engaging in swap transactions.

- **"Re-regulation."** Most derivatives, including many that were deregulated by the Commodity Futures Modernization Act of 2000, will now be regulated by the CFTC or, in the case of security-based swaps, by the SEC. "Mixed swaps" will be jointly regulated by the CFTC and SEC.
- **Mandatory Clearing and Trading.** Mandatory clearing and trading on or through designated contract markets, national securities exchanges, or swap execution facilities is mandated for swaps designated for clearing by the SEC or CFTC, a group that is expected to include most swaps that are currently traded. A limited exception to clearing and trading requirements exists for swaps entered into by end-users hedging commercial risk, and an exception to trading requirements exists for swaps that are not accepted by any trading facility.
- **End-User Exemptions.** A commercial end-user exemption from mandatory clearing and trading exists. However, due to the lack of a corresponding exemption from margin requirements, the scope and effect of this exemption is unclear. Guidance through rulemaking or through future technical amendments to the Act will be required.
- **Swap Dealer and Major Swap Participant Regulation.** New requirements have been imposed on swap dealers as well as on a new category of non-dealer participants in derivatives markets—"major swap participants" ("MSPs"). In addition to mandatory clearing, these new requirements include yet-to-be determined position limits for certain trades, mandatory registration with either the CFTC or SEC (and sometimes both), real-time reporting of trades, enhanced recordkeeping requirements, and margin and capital requirements.
- **Capital and Margin Requirements.** Capital requirements apply to all trades executed by swap dealers and MSPs, and margin requirements apply to all uncleared trades

126 In this document, unless otherwise specified, both "security-based swaps" and "swaps" are generally referred to as "swaps," and other terminology from the legislation relating to swaps, such as "major swap participants" and "swap dealers," will, unless otherwise specified, include both the "swap" and "security-based swap" versions of such terms.

executed by these entities, potentially including preexisting trades and trades with end-users. However, the parameters for these new capital and margin requirements are left to various regulatory bodies that have been given discretion in the Act to determine appropriate capital and margin requirements. As discussed below, the extent to which existing trades will be exempt from the new margin and capital requirements remains a major point of contention.

- **Position Limits.** The CFTC and SEC are authorized to prescribe position limits in order to reduce the likelihood of market manipulation, fraud, or undue speculation, with the limits established by the CFTC potentially applied on a class-wide basis.
- **The "Push-Out" Requirements.** Spin-off requirements, albeit more narrowly implemented than originally contemplated, will require depository institutions that qualify as swap dealers to move all derivatives activities into separately capitalized affiliates other than specifically permitted swaps activities. This requirement is expected to be effective two years after the enactment of the Act, although insured depository institutions may be given an additional transition period of up to 24 months to conform to the new requirement.[127]
- **Insurance Override**. States will not be able to regulate swaps—particularly, credit default swaps—as insurance. However, to a certain extent, states may be able to continue to apply gaming and bucket shop laws to swaps.
- **Obligations to Certain Entities Engaged in Derivatives Activities.** Swap dealers and MSPs that act as swap counterparties to certain governmental entities, pensions, and endowments will have new responsibilities with respect to these entities, including verifying their status as eligible contract participants, making efforts to determine that such entities are receiving independent guidance from knowledgeable advisers, and providing significant disclosure. Additional responsibilities will also be imposed on swap dealers who act as advisers to these entities, including a requirement to act in the best interests of the entities.
- **Trade Reporting.** Real-time reporting of virtually all swap transactions will be required. This requirement could significantly change how a number of swaps are priced and could negatively affect liquidity for certain types of derivatives.
- **Global Reach.** While the overall extraterritorial effect of the Act's swap provisions may be somewhat limited as to activities outside of the U.S., the Act does not expressly exempt non-U.S. persons from the requirements applicable to swap dealers or MSPs. Ultimately, however, the Act's reach may depend on future decisions by various regulatory bodies.
- **Timing.** Few provisions of the Act are effective immediately, and the title containing the majority of the swap regulations is not generally effective until 360 days after its enactment. Many provisions will become effective in stages. Depending on the provision, the CFTC, SEC, and other U.S. financial regulators will be required to spend the next six to 18 months issuing the required implementing rules and regulations. During this time, market participants will be in the difficult position of having to make strategic decisions in an environment of continued regulatory uncertainty.
- **Implementation Process.** The regulatory implementation will be a dynamic process. Among other things, regulators will need to conform the required regulations to a follow-on technical bill that has been promised by Congressman Frank (D-MA) and Senator Dodd (D-CT). The regulatory process will also be affected by actions being taken in other countries—particularly the European Union—which will be implementing their own regulatory changes.

DO WE FINALLY HAVE CLARITY AS TO HOW SWAPS ARE DEFINED AND WHO IS RESPONSIBLE FOR REGULATING THEM?

The Act divides the world of derivatives into four categories: "swaps," "security-based swaps," "mixed swaps," and everything else. However, the historical complexity of determining into which "bucket" a particular derivative transaction falls,

127 We note that the transition period for a particular entity may be extended for an additional 12 months in some circumstances, and some uncertainty exists as to whether the transition period begins running at the enactment of the Act or at the effective date of the push-out provision. Additionally, some observers have suggested that Congress may have intended that the effective date of the push-out provision would be two years from the date the derivatives title is effective rather than two years from the date the Act is enacted (effectively creating a three-year period prior to effectiveness, as the derivatives title generally becomes effective 360 days after enactment). However, the current language of the provision looks to the date the Act is enacted rather than the date the derivatives title is effective.

and thus, who has regulatory authority over a given swap, remains as complicated as ever.

What is a Swap? A "swap" is defined very broadly. With certain exceptions, it includes virtually all over-the-counter ("OTC") derivatives transactions. Included are interest rate, currency, foreign exchange, credit, equity, commodity, weather, energy, metal, agricultural, and index swaps. Puts, calls, caps, floors, and collars are also generally included. Swaps are governed by the CFTC.

Given the broad the definition of "swap," it is perhaps easier to consider what is *not* a swap. The definition excludes "security-based swaps," exchange-traded futures, contracts for the sale of commodities for future delivery (or options thereon), physically settled forwards (and options thereon), and exchange-traded options on currencies and certain securities contracts.

What is a Security-Based Swap? A security-based swap is a "swap" (as defined above, disregarding the exclusion of security-based swaps from such definition) based on a narrow-based security index (including an interest therein or on the value thereof), a single security or loan (including an interest therein or on the value thereof), or certain events relating to a single issuer or narrow group of issuers. Options, forwards, and credit default swaps referencing corporate bonds and loans are included. Because security-based swaps are excluded from the definition of "swap," they are regulated by the SEC rather than the CFTC.

A swap that otherwise meets the definition of "security-based swap" will nevertheless be excluded if it references or is based on a government or other exempt security and is not a put, call, or other option. That is, swaps on government securities will be regulated by the CFTC and not the SEC.

Mixed Swaps. This third category includes derivative transactions that have characteristics of both swaps and security-based swaps. The Act grants the SEC and CFTC joint authority, in consultation with the Federal Reserve, over mixed swaps.

What is Excluded? Puts, calls, straddles, options, or privileges on securities that are subject to the Securities Act and the Securities Exchange Act of 1934 (the "Exchange Act"), exchange-traded options on currencies, securities futures products, and securities agreements are neither swaps nor security-based swaps. They nevertheless continue to fall within the definition of "security" under the Exchange Act. Contracts for the sale of commodities for future delivery (or options thereon) and forwards on nonfinancial commodities and securities that are intended to be physically settled (and options thereon) are also excluded. Agreements, contracts, or transactions with a Federal Reserve, the federal government, or a federal agency that is expressly backed by the full faith and credit of the U.S. are excluded as well.

Special Treatment for Foreign Exchange Swaps and Forwards. Foreign exchange swaps and forwards fall within the definition of "swaps" and are thus under the jurisdiction of the CFTC. However, the Act gives the Secretary the authority to exempt forward exchange swaps and forwards from regulation by the CFTC. To grant such an exemption, the Secretary will be required to determine that such transactions should not be regulated as swaps and that they were not structured in a manner designed to evade Title VII of the Act. In making such a determination, the Secretary will be required to consider whether the required trading and clearing of such swaps would create systemic risk, lower transparency, or threaten U.S. financial stability; to assess the extent to which such swaps are subject to adequate oversight by regulators; to consider whether adequate payment and settlement systems exist for such swaps; and to assess whether an exemption for foreign exchange swaps and forwards could be used to evade otherwise applicable regulatory requirements.

Much political debate surrounded foreign exchange swaps and forwards as the Act was being drafted, resulting in conflicting positions between the House and Senate. The final compromise was to keep these trades within the definition of a "swap" but to give the Secretary the power to exempt these trades from CFTC regulation. Nevertheless, even if the Secretary does indeed determine to exempt these trades from CFTC oversight, under the Act, parties that are swap dealers or MSPs entering into OTC foreign exchange swaps and forwards will be subject to certain business conduct standards. These swaps will also be subject to the Act's reporting requirements. Foreign exchange swaps and forwards that are cleared through a derivative clearing organization ("DCO") or traded on a designated contract market or through a swap execution facility would also remain subject to regulations prohibiting fraud and market manipulation.

What is Still Ambiguous? Elements of ambiguity and uncertainty remain in the various definitions. Not all swaps will fit easily into one category or another. For example, equity swaps and equity index swaps are defined as swaps, which gives the CFTC jurisdiction over these types of trades. However, as discussed above, a security-based swap, which is under the jurisdiction of the SEC, is defined as a swap based on, among other things, a single security or narrow-based index. Therefore, given that neither the Act, nor the Securities Act and Exchange Act, include separate definitions for "equity swaps" and "equity index swaps," a derivative transaction written on an equity could be characterized as an "equity swap" and thus a "swap" (regulated by the CFTC), as a "security-based swap" regulated by the SEC, or as both (with the CFTC and SEC each asserting jurisdiction). We will have to wait and see whether any clarity via rulemaking emerges.

Credit default swaps and total return swaps can be either security-based swaps or swaps depending on whether they reference a single security or narrow-based index, in the case of the former, or a broad-based index, in the case of the latter. Thus, whether the SEC or CFTC has jurisdiction over a particular credit default swap or total return swap will be dependent on whether it falls on the narrow-based or broad-based side of the divide. Further complicating matters, some types of these swaps, such as basket credit default swaps, could be considered either packages of individual swaps, which would suggest that such swaps should be governed by the SEC, or single swaps on a group of securities/issuers, which would suggest that such swaps should be governed by the CFTC.

Another example of ambiguity remaining in the definitions is the treatment of physically settled forward contracts on nonfinancial commodities. These contracts are excluded from the definition of "swap" as long as the parties to the swap "intend" for it to be physically settled. Absent clarity through the rulemaking process, there is presently no guidance as to how the intent to physically settle should be ascertained.

Revisions to Securities Laws. In 2000, the Commodities Futures Modernization Act severely limited the extent to which the SEC could regulate security-based swaps. Those limitations have now been repealed. Security-based swaps are now specifically included in the definition of "security" under both the Securities Act and the Exchange Act.[128]

Like securities, security-based swaps will now be subject to the Securities Act registration requirements, the antifraud provisions of the Securities Act and the Exchange Act, and, in the case of registered broker-dealers, the Exchange Act's requirements with respect to margin, capital, and books and records. As a result of these and other changes made by the Act, security-based swaps will no longer be able to be offered or sold to persons who are not "eligible contract participants" unless sold on a registered basis. Additionally, any security-based swap offered by or on behalf of the issuer of the security covered or referenced by the security-based swap will also be subject to registration. Going forward, this provision of the Act may subject many security-based swaps to SEC registration. To give effect to this requirement, the definitions of "purchase" and "sale" under the Securities Act have been amended to include the execution, termination prior to final maturity, assignment, exchange, or other similar transfer or conveyance of a security-based swap, or the extinguishing of rights or obligations thereunder.

Bringing security-based swaps within the definition of a security under the Securities Act and the Exchange Act still leaves open the extent to which security-based swaps will be regulated as securities for all purposes or only to the extent the statutes have been expressly made applicable pursuant to the Act. This remaining question may take on greater importance given the lack of clarity (as discussed elsewhere) as to whether certain derivative trades will be treated as swaps or as security-based swaps.

128 On the other hand, the Act provides that "security-based swap agreements" do not include "security-based swaps" for purposes of antifraud laws. Instead, the Act separately applies antifraud provisions to security-based swap agreements. Because the Gramm-Leach-Bliley Act, which was part of the Commodities Futures Modernization Act, carved out swaps from SEC oversight, a new definition of "security-based swap agreement" was then created in order to subject certain swaps to the antifraud, anti-manipulation, and insider trading prohibitions of the Securities Act and the Exchange Act. It appears that in retaining the separate definition of security-based swap agreements and separately applying the antifraud provisions to such agreements, Congress intended to ensure that swaps based on broad groups of securities or securities indices (which are not security-based swaps) are nevertheless subject to the antifraud provisions of the securities laws.

Revisions to Commodities Laws. As part of the overall regulatory restructuring, the Act now precludes any person, other than an eligible contract participant, from entering into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market. Further, the Act expands the CFTC's regulatory authority over swaps. In addition to the authority the CFTC historically has had with respect to cash market transactions and futures, the CFTC now has explicit antimarket manipulation oversight with respect to swaps, and the revised antimanipulation provisions include prohibitions on false reporting and the provision of false information. Further, the CFTC no longer has to prove "specific intent" to manipulate markets. It will now be sufficient to establish "reckless disregard."

Other changes to the commodities laws include the expansion of the definitions of "commodity trading adviser," "futures commission merchant," and "commodity pool operator" to include persons who provide advice or brokerage services with respect to, or that operate funds that trade in, swaps and certain other nonfutures products.

Changes to Disclosure Requirements. The Act provides that persons may be deemed to acquire beneficial ownership of equity securities for certain purposes by entering into security-based swaps as designated by future SEC rulemaking. If the SEC determines, in consultation with other regulators and the Secretary, that the purchase of certain security-based swaps gives the purchaser incidents of ownership comparable to direct ownership of the underlying security, and that to achieve the purposes of Section 13 of the Exchange Act the purchase of a security-based swap must be deemed to constitute the purchase of a beneficial ownership in the underlying security, the SEC will be entitled to require disclosure of such positions for purposes of Sections 13(d), 13(f), and 13(g). The Act adds a new subsection (o) to Section 13(d) to give effect to the foregoing. The SEC also has a similar option to apply the provisions of Section 16 of the Exchange Act to the acquisition of security-based swaps.

Trumping State Laws. The Act prohibits swaps and security-based swaps from being regulated as insurance contracts under state law. This provision of the Act puts a halt to the efforts of some state insurance regulators to regulate credit default swaps as insurance contracts under state law. The Act also prohibits states from applying state gaming and bucket shop laws to invalidate any security-based swap between eligible contract participants or any security-based swap effected on a national securities exchange. Interestingly, the Act contains no comparable provision with respect to swaps governed by the CFTC. This could raise questions as to the legality of some swaps under state laws whether or not entered into by eligible contract participants. State laws, other than state antifraud laws, governing the offer, sale, or distribution of securities that are security-based swaps or securities futures products are also preempted by the Act.

Practical Considerations. The split of regulatory authority between the SEC and CFTC contained in the Act creates an ongoing layer of uncertainty and complication for entities engaging in derivatives transactions. As discussed above, questions may arise regarding whether particular contracts are swaps or security-based swaps (or, perhaps, both or neither). The SEC and CFTC, notwithstanding the fact that the Act mandates that they coordinate their rulemaking, may well take opposing views regarding a particular swap, putting that swap in some degree of limbo until the regulatory disagreement is resolved. In addition, since many of the products to be regulated have similar features but will be regulated by two different agencies with historic differences of approach and opinion, it is possible that very similar types of products could be regulated differently based on the regulatory body having jurisdiction over the particular product.

MANDATORY CLEARING

A fundamental goal of the legislation is to push as many trades as possible into clearinghouses. The Act requires the clearing of all swaps that the CFTC or SEC determines should be cleared and that are accepted for clearing by a DCO for swaps or by a clearing agency for security-based swaps. The legislation provides for an ongoing review of swaps by the CFTC and security-based swaps by the SEC to determine which categories of swaps or security-based swaps are suitable for clearing. The SEC and CFTC must publish such determinations and provide for a subsequent comment period. Each DCO or clearing agency must submit to the SEC or CFTC, as applicable, (as well as to its own members) lists of swaps that the DCO or clearing agency intends to clear. The applicable regulatory body must review and publish such lists for a 30-day public comment period and must generally make a determination within 90 days of receipt of the submission (during which time the clearing requirement may be stayed).

In determining which swaps must be cleared, the CFTC and SEC are required to take into account, among other factors: notional exposures, trading liquidity, and adequate pricing data; the availability of rule framework, capacity, operational expertise and relevant infrastructure to clear the swap contract in accordance with its current terms and trading conventions; the effect on the mitigation of systemic risk and on competition; and the existence of reasonable legal certainty, in the event of the insolvency of the relevant clearinghouse or its clearing members, with regard to the treatment of customer and swap counterparty positions, funds, and property. Swaps outstanding prior to the effective date of the clearing requirement will not be required to be cleared. However, such swaps must comply with the reporting requirements that apply to uncleared swaps.

The Act does not force DCOs or clearing agencies to accept any swap for clearing, and a DCO/clearing agency can refuse to accept a swap for clearing if doing so would threaten its financial integrity. Early proposals with respect to clearing tended to identify which swaps would be required to be cleared based on whether the terms of the particular swap were sufficiently standardized to appropriately allow for clearing. As enacted, the Act does not expressly limit mandatory clearing to swaps with standardized terms. Therefore, whether a swap is ultimately mandated to be cleared and is, in fact, accepted for clearing by a DCO/clearing agency is likely to be based in significant part (at least initially) on whether the swap is clearable under existing clearing technology, whether sufficient valuation data exists, and whether sufficient liquidity exists for the particular category of swap.

Market participants are very likely to be members of multiple DCOs or clearing agencies. How netting and margin posting across clearing platforms are intended to work will have to be addressed in the rulemaking process. These issues may be particularly complex to the extent the DCOs or clearing agencies are located in multiple countries.

The Commercial End-User Exemption. Under the Act, there is an optional exemption from clearing available to any swap counterparty that:

- Is not a financial entity;
- Is using the swap to hedge or mitigate commercial risk; and
- Notifies the CFTC or SEC how it generally meets its financial obligations associated with entering into uncleared swaps.

For this provision, the term "financial entity" means a swap dealer, an MSP, a commodity pool, a private fund, an employee benefit plan, or a person predominantly engaged in the business of banking or in activities that are financial in nature. The definition of "financial entity" for purposes of a swap (but not a security-based swap) excludes certain captive finance companies, and the CFTC and SEC are authorized to exempt small banks and certain other entities from the definition of financial entity.

Any end-user choosing to take advantage of this clearing exemption must first obtain approval from an appropriate committee of its board of directors if it has outstanding securities registered under the Securities Act or is a reporting entity under the Exchange Act.

Grandfathering and Reporting Requirements for Uncleared Swaps. Swaps entered into before the date of enactment of the Act are exempt from the clearing requirement as long as they are reported to a swap data repository or to the applicable regulatory body within a specified time period. Unfortunately, this time period is slightly unclear—one provision of the Act states that preexisting swaps must be reported within 30 days of the issuance of the interim final rule relating to the reporting of preexisting swaps (which must be issued within 90 days of the enactment of the legislation), and another provision states that preexisting swaps must be reported within 180 days of the "effective date." For this purpose, "effective date" means 360 days after enactment of the legislation. A swap entered into on or after the effective date of the Act, but prior to any determination by the CFTC or SEC that such swap is subject to mandatory clearing, is exempt if it is reported within the later of 90 days of the effective date described above or such other time frame specified by the applicable regulatory body.

Mandatory Execution on Specified Platforms. The Act requires that all swaps subject to the clearing requirement be traded on a board of trade designated as a contract market or a securities exchange or through a swap execution facility, unless no such entity accepts the swap for trading. Trades may be executed other than on an exchange or through a swap execution facility if the clearing requirement does not apply. Therefore, trades that are not required to be cleared and trades with a nonfinancial entity that are exempt from clearing due to the commercial end-user exception are not subject to the mandatory execution requirement.

A swap execution facility is a new designation for a trading system or platform other than a designated contract market or national securities exchange pursuant to which multiple participants can execute or trade swaps by accepting bids and offers made by other participants. If this definition is interpreted to exclude electronic trade execution or voice brokerage facilities that facilitate the trading of swaps between two (rather than multiple) persons, it would significantly limit the platforms on which trades can be executed and could as a result potentially impair market liquidity.

ARE YOU COVERED BY THE ACT?

You are covered by the Act if you are a swap dealer or major swap participant. However, if you are a financial entity or end-user, the answer is more complicated. The Act divides the world of participants in the derivatives markets into newly designated categories, and the extent to which many of the new requirements of the Act apply will depend, in part, on the category into which a market participant falls.

What is a Swap Dealer? The Act defines "swap dealer" as any person that:

- Holds itself out as a dealer in swaps;
- Makes a market in swaps;
- Regularly enters into swaps with counterparties as an ordinary course of business for its own account; or
- Engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

A "security-based swap dealer" is similarly defined by substituting "security-based swap" in lieu of "swap." An entity may be designated as a swap dealer or security-based swap dealer in respect of a single type, class, or category of swap (or security-based swap). The definition excludes a person that enters into swaps for its own account, individually or in a fiduciary capacity, "but not as part of a regular business." The Act does not define what would be considered "part of a regular business." This is likely to be a fact-based analysis and, thus, it is unclear whether the CFTC or SEC will attempt to define the concept or otherwise provide guidance.

An insured depository institution will not be considered a "swap dealer" to the extent it offers to enter into a swap with a customer in connection with a loan being made to that customer. However, there is no comparable exception for depository institutions from the definition of "security-based swap dealer." Because, as noted above, swaps covering or referencing loans are treated under the Act as security-based swaps, a depository institution that enters into total return or credit default swaps on loans may need to register as a security-based swap dealer unless such swaps are deemed to have been entered into for hedging or mitigating risks directly related to the activities of the institution, and the institution is not otherwise holding itself out as a dealer in security-based swaps or making a market in such swaps. The Act does give regulators discretionary authority to allow depository institutions to enter into in a *de minimis* amount of swap and security-based swap transactions in connection with transactions with or on behalf of its customers without being treated as a swap dealer or security-based swap dealer, respectively. The parameters as to what will be considered *de minimis* will be determined through CFTC and SEC rulemaking.

Because the Act amends the definition of "dealer" under the Exchange Act, dealers in security-based swaps with eligible contract participants do not need to register as broker-dealers. Unfortunately, however, no similar exemption exists for persons acting as brokers of security-based swaps.

What is a Major Swap Participant? A "major swap participant" is defined under the Act as any non-swap dealer:

- That maintains a substantial position in swaps for any of certain major swap categories that are to be determined by the CFTC, excluding positions held for hedging or mitigating commercial risk and maintained by an employee benefit plan under ERISA for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

- Whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- That is a financial entity[129] that (i) maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC, (ii) is highly leveraged relative to the amount of capital it holds, and (iii) is not subject to capital requirements established by an appropriate U.S. banking regulatory body.

"Major security-based swap participant" is similarly defined by substituting "security-based swap" in lieu of "swap" and "SEC" in lieu of "CFTC." As is the case with swap dealers, designation as a major swap participant or major security-based swap participant can apply to a single type, class, or category of swap (or security-based swap).

Subject to criteria specified in the Act, captive finance companies that provide financing for products produced by an affiliate and that use derivatives to hedge commercial risk related to interest rate and currency exposures are exempt from the definition of MSP (but not from the definition of major security-based swap participant).

There are no particular jurisdictional limits in determining whether an entity is an MSP. A non-U.S. entity that engages in significant derivatives-trading activities within the U.S. or with U.S. persons could, in theory, be deemed to be an MSP and, accordingly, subject to these new requirements.

Questions Raised by MSP Definition. The definition of an MSP set forth above raises many as-yet-unanswered questions. It is left to the regulators to determine what constitutes a swap "held for hedging commercial risk"; what "substantial counterparty exposure" means; what factors are to be used to determine whether an exposure that "could have serious adverse effects" exists; and what "highly leveraged" means.

The regulators will also determine what constitutes a "substantial position," although in this case they at least have some guidance. The legislation requires the CFTC and SEC to each provide a definition of "substantial position" that is "prudent for the effective monitoring, management and oversight of entities that are systemically important or can significantly impact the financial system of the United States." Among factors to be considered (including any other criteria the CFTC and SEC wish to apply) are the value and quality of collateral held against counterparty exposure as well as the relative sizes of the entity's cleared and uncleared swap portfolios.

As a result of the many unanswered questions raised by the MSP definition and the generally broad nature of the drafting of this provision, many entities may not know if they must comply with the MSP requirements until the regulations are issued. Others may assume that they are not affected, only to find out later that the applicable regulator has taken a different view. Further, depending on how the regulations are written, it may be possible for an entity to float in and out of MSP status (for example, as a result of its level of swap holdings or leverage), with no clear guidance as to how this would be addressed and whether such an entity could deregister to escape the regulatory regime when it no longer qualifies.

The fact that a person could be designated as an MSP for one type, class, or category of swaps and not for another will likely be an additional complicating factor. Entities with large swap books may lack sufficient guidance as to which swaps are deemed to be swaps related to hedging commercial risks and which swaps fall into investment or speculative categories. Certainly, entities such as hedge funds that have large numbers of swap positions but little or no commercial risk (as likely to be defined by regulators) are likely to be deemed MSPs for at least some of their swap activity. Even large corporate or commercial entities risk being designated as MSPs for certain swap activities. In addition, note that as a result of the overly general language contained in the legislation, there may be no statutory basis for challenging a determination of MSP status by the CFTC or SEC.

Registration and Reporting. Swap dealers and MSPs will be required to be registered with the applicable regulator and will be subject to new regulatory requirements for recordkeeping, reporting, supervision, position limits, business

129 "Financial entity" is not specifically defined in connection with MSPs. However, elsewhere in the Act, a financial entity is defined to include hedge funds, commodity pools, certain employee benefit plans, and entities predominately engaged in activities that are in the business of banking or financial in nature, as defined in the BHCA.

conduct standards, disclosure (including conflicts of interest), capital and margin retention and posting, and examination provisions. The CFTC and SEC are required to issue rules for registration within one year of the Act's passage.

No Grandfathering. The Act does not, on its face, exempt persons who currently hold swaps from being treated as MSPs based on such preexisting holdings, whether or not they have any ongoing involvement in the swap markets. In addition, MSPs' preexisting swap holdings are not explicitly grandfathered by the Act and may be subject to minimum capitalization requirements and initial and variation margin requirements for outstanding uncleared swap positions as discussed below. Although the Act prohibits regulators from exempting MSPs from the registration and other requirements prescribed for MSPs, the regulators do have the power to further define what constitutes an MSP by regulation.

CAPITAL AND MARGIN REQUIREMENTS

Swap dealers and MSPs will be subject to capital requirements. Additionally, swap dealers and MSPs will be subject to initial and variation margin requirements on all uncleared swaps. The capital and uncleared swap margin requirements for banking entities that are swap dealers or MSPs will be determined by the applicable prudential regulator in consultation with the CFTC and SEC. For nonbank entities, the capital and uncleared swap margin requirements will be determined by the CFTC and the SEC. With respect to cleared swaps, the margin requirements will be those contained in the rules of the DCO or the clearing agency, as applicable.

What is the Level of Margin that Must be Provided? As noted, the amount of margin for uncleared swaps will be determined by the appropriate regulatory body. In making such determinations, the Act requires the margin requirements to (i) help ensure the safety and soundness of the swap dealer or MSP and (ii) be appropriate for the risk associated with the entity's uncleared swaps. Non-cash collateral will be permitted to meet margin requirements if it is determined that doing so will be consistent with preserving the financial integrity of the markets trading swaps and the stability of the U.S. financial system.

What is the Level of Capital that is Required? The appropriate regulatory body will determine the capital requirements for each entity, again focusing on ensuring the safety and soundness of the entity and making a determination appropriate for the risk associated with the entity's uncleared swaps. However, it is important to note that, in setting capital requirements for an entity, the regulatory bodies are required to consider the risks associated with all swap and other activities of the swap dealer or MSP, not just the risks related to those types, classes, or categories of swaps that caused such entity to qualify as a swap dealer or MSP in the first place.

No Express Grandfathering for Margin. The Act does not expressly provide for grandfathering with respect to capital or margin requirements for existing swaps. This has been a point of significant criticism and debate for a number of market participants. It is possible that the regulatory bodies, in carrying out their duties to establish the margin requirements, will have the ability to exempt certain existing trades from the new margin requirements. Although the Act prohibits exemptions from the requirements of the relevant sections of the legislation, it does not appear to preclude regulatory bodies from setting the margin and capital requirements lower for existing transactions or determining that the margin and capital requirements for existing trades remain the same as the requirements that were applicable to such trades prior to the enactment of the Act. If such adjustments are made, it is not clear whether these exemptions will be implemented on a broad or a case-by-case basis.

No Express Margin Exemption for End-Users. The Act does not expressly exempt from the margin requirements end-user swap counterparties that are otherwise exempt from the clearing requirements. However, a June 30, 2010 letter from Sen. Dodd (D-CT) and Sen. Lincoln (D-AR) to Rep. Frank (D-MA), and Rep. Peterson (D-MN) stated that it is not the intent that such nonfinancial swap counterparties be subject to the margin requirements. In discussing the Act's end-user clearing exemption, the Dodd-Lincoln letter states:

> The legislation does not authorize the regulators to impose margin on end-users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs of end-user transactions, they may create more risk. It is imperative that the

> regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end-users or impair economic growth.

While the letter is a helpful clarification as to the intent of the conferees, it is important to remember that it has no legally binding effect. In fact, when the Act was resubmitted to the Conference Committee in order to address the funding aspects of the Act, the Republican conferees attempted to add an amendment to the Act to clarify the margin requirements. This attempt was rebuffed by the Democrat conferees who stated that the clarification could subsequently be addressed by a technical amendment. The Republican conferees, in turn, expressed significant skepticism that any clarifications to the margin provisions would merely require a technical amendment as opposed to substantive changes to the Act. The Dodd-Lincoln letter was issued as a result of this heated debate.

Likelihood of Margin Exemptions or Reductions. As noted above, there is no explicit carve-out in the Act for existing swaps or end-user swaps from the margin requirements, and a separate provision of the Act appears to prohibit exemptions from the margin provisions contained in the legislation. On the other hand, there is also no provision in the Act that affirmatively directs regulators to retroactively apply new margin and capital requirements to existing swaps. The status of any exemptions or reductions in margin requirements for existing swaps or end-user swaps is therefore unclear.

The Dodd-Lincoln letter certainly suggests that the regulators did not intend to impose margin requirements on end-users, and one assumes that this intent applied to both existing and new end-user swaps. Further, the Dodd-Lincoln letter separately expresses a Congressional intent to avoid significant disruption to existing contracts, stating that "it is imperative that we provide certainty to ... existing contracts for the sake of our economy and financial system." This statement of Congressional intent relating to legal certainty for existing swaps could potentially be used to support a decision by regulators to minimize the imposition of margin on all preexisting swaps if the regulators interpret their rulemaking authority to allow a determination that small or no margin and capital requirements may be imposed in these instances. Additional statements in the Dodd-Lincoln letter could also be read to support such an interpretation:

> It is also imperative that regulators do not assume that all over-the-counter transactions share the same risk profile. While uncleared swaps should be looked at closely, regulators must carefully analyze the risk associated with cleared and uncleared swaps and apply that analysis when setting capital standards on Swap Dealers or Major Swap Participants. As regulators set capital and margin standards on Swap Dealers or Major Swap Participants, they must set the appropriate standards relative to the risks associated with trading. Regulators must carefully consider the potential burdens that Swap Dealers and Major Swap Participants may impose on end-user counterparties—especially if those requirements will discourage the use of swaps by end-users or harm economic growth. Regulators should seek to impose margins to the extent they are necessary to ensure the safety and soundness of the Swap Dealers and Major Swap Participants.

Further, in addition to these statements in the Dodd-Lincoln letter, Congressmen Peterson and Frank separately stated that they expected the level of margin required by regulators for swap dealers and MSPs to be minimal, in keeping with the greater capital that swap dealers and MSPs will be required to hold. These statements suggest that Congress intended to give regulators sufficient flexibility to assess appropriate margin levels based on assessments of relative risks associated with trading. On that basis, it may not be unreasonable to assume that the risk associated with preexisting swaps may not rise to the same level as future, ongoing swap activities and that the risk of discouraging the use of swaps by end-users by the imposition of large margins on such parties outweighs the potential benefits.

On the other hand, regulators could interpret their mandate to adopt rules requiring margin as allowing no exceptions to the margin provisions and little leeway in setting different margin requirements for preexisting or end-user swaps, given the separate provisions of the Act that indicate that the SEC and CFTC may not provide exemptions from the capital and margin requirements.

It is also possible (although perhaps unlikely) that Congress will adopt a technical amendment to address the margin requirements for end-user swaps and, potentially, all preexisting swaps.

Holding and Segregation of Collateral. A person holding margin for customers with respect to DCO-cleared swaps must register with the CFTC as a futures commission merchant. Persons holding margin for clearing agency-cleared security-based swaps for customers must register as brokers, dealers, or as security-based swap dealers with the SEC. The collateral held must be segregated, and the use of such collateral will be subject to rules to be issued by the CFTC or SEC, as applicable. These requirements do not apply to uncleared swaps. However, upon request by a counterparty on an uncleared swap, initial margin (but not variation margin) must be maintained in a segregated account with an independent third-party custodian. If a counterparty does not request collateral segregation, the collateral holder must provide quarterly certifications to the counterparty that the collateral is being held and maintained in accordance with the terms of the applicable contractual agreement with the counterparty.

POSITION LIMITS

Under the Act, the CFTC is empowered and directed to establish position limits on the aggregate number or amount of positions that can be held by any one person or group or class of persons in contracts based on the same underlying commodity. These aggregate limitations apply to each month across all (i) contracts traded on a designated contract market, (ii) contracts traded on a foreign board of trade that grants direct access to participants located in the U.S., and (iii) economically equivalent swaps that perform a significant price discovery function. In addition to such aggregate contract position limits, the CFTC is required by the Act to establish position limits on all physical commodity positions held by any person for any spot month, any other month, or any combination of all months (other than *bona fide* hedging positions). The stated goal of such physical commodity limits is to avoid market manipulation and excessive speculation and to ensure sufficient market liquidity and price discovery functions. In establishing such position limits, the CFTC must attempt to prevent such limits from causing price discovery in the applicable commodity from shifting to a foreign board of trade.

The potential to set position limits across groups or classes of persons granted to the CFTC is somewhat unusual. Regulatory action will be needed to determine how these powers will be used, as it is unclear how a group or class position limit would be established and enforced.

For security-based swaps, the Act requires that the SEC establish limits, including related hedge exemption provisions, on the size of positions in any security-based swap that may be held by any person. Such limits can be applied to any person on an aggregate basis; that is, a person would be forced to aggregate the security-based swap and any related instruments. Accordingly, such aggregate position limits may be established, regardless of the trading venue, on any security-based swap and any other instrument correlated with, or based on, the same security or loan or group or index of securities as such security-based swap.

The CFTC and SEC are authorized to exempt any person or class of persons or any swap or class of swaps from such position limits. Preexisting positions are exempt from any new position limits imposed by the CFTC; however, this exemption will cease to apply to any preexisting position increased after the effective date of the position limit.

VOLCKER RULE TRADING LIMITATIONS

The Volcker Rule could have severe effects on the scope of derivatives activities undertaken by banks for their own accounts. The rule generally prohibits "banking entities"[130] from engaging in proprietary trading, which includes using the trading account[131] of the banking entity to purchase or

130 "Banking entity" means any insured depository institution (as defined in Section 3 of the Federal Deposit Insurance Act), any company that controls an insured depository institution or that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.

131 "Trading account" means any account used for acquiring or taking positions in derivatives principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate federal banking agencies, the SEC, and the CFTC may determine. Because the definition addresses only "near-term" transactions and "short-term" price movements, these limitations leave open the door for banks to engage in other types of proprietary trading.

sell, or otherwise acquire or dispose of any derivative or an option on any derivative, among other prescribed investments.[132] The Act defines "proprietary trading" as engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Federal Reserve 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 agencies, the SEC, and CFTC may determine through rulemaking.

Permitted Activities. Some exemptions are carved out of the Volcker Rule prohibition including: (i) trading in federal, state, or local government instruments or instruments issued by Fannie Mae, Freddie Mac, or certain other government-sponsored entities; (ii) trading derivatives in connection with underwriting or market-making-related activities, not to exceed the expected near-term demands of clients or counterparties; (iii) risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts, or other holdings; (iv) trading of derivatives on behalf of customers; (v) proprietary trading by a foreign banking entity as long as the trading occurs solely outside of the U.S. and the banking entity is not directly or indirectly controlled by a banking entity organized in the U.S.; and (vi) such other activity as the regulators determine, by rule, would "promote and protect" the safety and soundness of the banking entity and U.S. financial stability.

Limitations of Permitted Activities. Even if an activity is a permitted activity, the Volcker Rule still prohibits such activity if it would (i) involve or result in a "material" conflict of interest (as defined by the SEC or CFTC) between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a "material" exposure to high-risk assets or high-risk trading strategies (as defined by the SEC or CFTC); (iii) pose a threat to the safety and soundness of such banking entity; or (iv) pose a threat to U.S. financial stability. Moreover, the appropriate federal banking agencies, the SEC, and the CFTC will adopt rules imposing additional capital requirements and quantitative limitations, including diversification requirements, regarding the permitted activities if such agencies determine that additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking entities engaged in such activities.

Implementation. None of the prohibitions, requirements, or limitations of the Volcker Rule will be effective until the earlier of (i) 12 months after the issuance of final rules implementing the rule; and (ii) two years after the date of enactment of the rule. After such effective date, there will be an initial two-year transition period during which banking entities must conform their activities and investments to be in compliance with the Volcker Rule. However, the Federal Reserve may grant up to three one-year extensions of the transition period, if "consistent with the purposes of this section" and "not detrimental to the public interest."

THE PUSH-OUT REQUIREMENT (THE "LINCOLN AMENDMENT")

A much-debated and much-reported provision of the Act prohibits "swap entities" from receiving "federal assistance."

What is the Push-Out Requirement? The swap push-out requirement provides that "Federal Assistance" may not be provided to any swap entity (other than insured depository institutions limiting their swap activities to certain permitted activities) and that taxpayer funding may not be used to prevent the receivership of any swap entity resulting from the swap activities of such entity if it is an FDIC-insured institution or has been otherwise designated as systemically important. If such an entity becomes insolvent or is put into receivership as a result of its swap activities, its swaps must be either terminated or transferred, and any funds incurred in the termination or transfer of such swaps must be recovered through the disposition of assets or through other financial assessments. No taxpayer funds can be used in the liquidation of any swap entity that is not FDIC insured or systemically important.

132 We note that the Volcker Rule also prohibits banking entities from acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring, any hedge fund or private equity fund; these prohibitions are not the subject of this White Paper.

The prohibition on federal assistance will go into effect two years following the enactment of the Act.[133] The insolvency/receivership rules appear to go into effect 360 days after the enactment of the Act.

What is a Swap Entity? "Swap entity" means any swap dealer or MSP, other than an MSP that is an insured depository institution. Insured depository institutions that are swap dealers are not excluded from the definition of "swap entity." Accordingly, an insured depository institution will be a swap entity only if it is a swap dealer. It should be noted that under the definition of "swap dealer," an insured depository institution is not considered to be a swap dealer to the extent it offers to, or otherwise enters into swaps with, a customer in connection with originating a loan with that customer. As a result, insured depository institutions whose swap activity is limited to providing such swaps would remain eligible for federal assistance without the need to push out such swap activities.

What is Federal Assistance? "Federal assistance" means any advance from any Federal Reserve credit facility or discount window other than in connection with programs having broad-based eligibility under Federal Reserve emergency lending powers, FDIC insurance, or guarantee, in each case, that is used for (i) making a loan to, or purchasing stock, an equity interest, or debt obligation of, a swap entity; (ii) purchasing the assets of a swap entity; (iii) guaranteeing any loan or debt issuance of a swap entity; or (iv) entering into any assistance arrangement, loss-sharing arrangement, or profit-sharing arrangement with a swap entity.

What is Required by the Push-Out Provisions? To avoid losing federal assistance, an FDIC-insured depository institution that is a swap dealer cannot enter into any swaps other than certain swaps permitted by the Act ("permitted swaps"), unless it spins out its swap dealer activities to a separately capitalized entity (which may be an affiliate controlled by the same bank holding company). The separate entity must be "ring-fenced" from the depository institution in accordance with the requirements of the Federal Reserve Act. Insured depository institutions that are subject to the push-out rule will have a transition period of up to 24 months following the date on which the federal assistance prohibition becomes effective (which may be extended by another 12 months) to divest or limit their swap activities to permitted swaps.[134] Any entity that chooses to remain a swap dealer but limit its activities to permitted swaps will do business subject to the Council's ability to terminate its federal assistance at any time if the council determines that other provisions of the Act are insufficient to mitigate systemic risks and protect taxpayers.

The CFTC, SEC, and Federal Reserve are required by the Act to issue rules governing the relationship between the insured institution and any affiliated swap entity. This rulemaking authority is quite broad. As a result, the nature of the ongoing relationship between insured depository institutions and their spun-off swap entities remains unclear. Also, it would appear that counterparties who have outstanding derivatives trades with depository institutions could be forced to have those derivatives trades assigned to such newly created swap entities or face having their trades terminated. It should also be noted that there does not appear to be any requirement that the newly created swap entity have the same credit ratings as its affiliated depository institution.

What are Permitted Swaps? Insured depository institutions will not be subject to the prohibition from receiving federal assistance if they limit their swap activities to the following types of swaps:

- Swaps entered into for hedging or mitigating risks directly related to the activities of the institution; or

133 Some observers have suggested that Congress may have intended that the effective date of the prohibition on federal assistance would be two years from the date the derivatives title is effective rather than two years from the date the Act is enacted (effectively creating a three-year period prior to effectiveness, as the derivatives title generally becomes effective 360 days after enactment). However, the current language of the provision looks to the date the Act is enacted rather than the date the derivatives title is effective.

134 We note again that some uncertainty exists as to whether the transition period begins running at the date of enactment of the Act or the effective date of the prohibition on federal assistance.

- Interest rate and currency swaps, certain precious metal swaps, and swaps on any other assets that are permissible investments for national banks,[135] including cleared credit default swaps on investment-grade securities.[136]

PRACTICAL IMPLICATIONS OF THE PUSH-OUT PROVISION AND THE VOLCKER RULE

As discussed, the push-out provisions will restrict the swap activity of insured depository institutions that do not spin off their swap business. However, this will not be the only restriction on swap activities by insured depository institutions and their affiliates. Any spun-off entity that is an affiliate of an insured depository institution, as well as any insured depository institution that retains a swap business but limits it activities to permitted swaps, will remain subject to the Volcker Rule, limiting the swap activities either type of entity may undertake. Further, any spun-off entity will have to independently satisfy the capitalization standards and other requirements set forth in the Act for a swap dealer, and it will have to be sufficiently capitalized to qualify as a participant in a clearing organization and to obtain a credit rating sufficient for counterparties to be willing to transact with the entity. The level of capitalization required to satisfy these requirements will be high; many insured depository institutions may not have the required funds or may determine that the establishment of an affiliated swap entity is not the best use of their funds. The combination of these factors may result in significantly fewer large swap counterparties willing and able to enter into swaps, potentially affecting the liquidity of the market for swaps.

135 National banks can invest in such assets as loans, notes and other extensions of credit, foreign currency, gold and other precious metals, U.S. government obligations, certain investment company shares, marketable investment-grade debt securities, and other similar obligations. National banks may not, however, deal in equity securities.

136 Some commentators have questioned whether U.S. branches of non-U.S. banks, given that they are noninsured banking institutions, will be able to continue engaging in these types of activities, since the Act now states that they are only permitted in the case of "insured depository institutions." However, unless such branches are somehow deemed to be receiving "federal assistance," these trading activities should continue to be permissible by non-U.S. banks and their U.S. branches.

NEW STANDARDS OF CONDUCT AND REAL-TIME REPORTING REQUIREMENTS

Under the Act, swap dealers and MSPs will be required to comply with new business conduct standards to be promulgated by the CFTC and SEC. Swap dealers and MSPs will be obligated to verify that their counterparties meet the eligibility standards for eligible contract participants and to disclose to counterparties other than swap dealers or MSPs (i) information about the material risks and characteristics of a proposed swap; (ii) material incentives and conflicts of interest the swap dealer or MSP may have in connection with a proposed swap; and (iii) receipt of the daily mark of the swap. Communications will be subject to a standard of fair dealing and good faith. Until the regulations have been promulgated, it is unclear how onerous some of these requirements will be, but certain requirements (especially disclosure requirements) could impose significant new obligations on swap dealers and MSPs that could cause these counterparties to be less willing to provide swaps to parties that are not swap dealers or MSPs, or to charge more for such swaps.

In addition to the business conduct standards, the Act requires reporting rules to be developed by the CFTC and SEC, including "real-time public reporting"[137] for swap transactions and, more importantly, pricing data. While the exact timing for reporting and the form the reporting will take is to be addressed through rulemaking, the real-time reporting mandate requires reporting of data relating to a swap as soon as is technologically practicable following execution. The extent to which detailed pricing data on a trade-by-trade basis must be disclosed remains to be seen. For uncleared swaps, the trade data reported must be made publicly available on a real-time basis but in a manner that does not disclose the details of the business transactions or market positions of any person. Trade reporting also cannot identify the counterparties. The timing for the issuance of reports for block trades may be delayed. The effects of these new requirements will not truly be known until the regulations have been developed, but real-time reporting of pricing for uncleared swaps could potentially collapse the

137 Although we believe real-time reporting is intended for all swaps, the provisions implementing this requirement contain what appear to be incorrect cross references, calling into question exactly which uncleared swaps will be subject to the real-time reporting provisions.

bid-ask spread on such swaps, causing dealers to be less willing to engage in such swaps**.**

Duties to Special Entities. Swap dealers and MSPs may be subject to additional standards of conduct based on the identity of their counterparties. Swap dealers and MSPs that advise "special entities" (which include municipalities, pension funds, retirement plans, and endowments) are prohibited from engaging in fraud, deception, or manipulation with respect to any transaction involving such special entity. Additionally, when advising special entities, swap dealers and MSPs have a duty to act in the "best interests" of the special entity and to undertake reasonable efforts to obtain information about the special entity as may be necessary to make a reasonable determination as to whether any proposed swap is in the best interests of the special entity given its financial position, tax status, and investment objectives.

When entering into a swap with a special entity, a swap dealer or MSP will be obligated to comply with CFTC and SEC rules that require the swap dealer or MSP to have a reasonable basis to believe that the special entity counterparty has a qualified independent representative that (i) has sufficient knowledge to evaluate the transaction and the risks; (ii) is not subject to statutory disqualification; (iii) is independent of the swap dealer or MSP; (iv) undertakes a duty to act in the best interests of the special entity counterparty; (v) makes appropriate disclosures; and (vi) will provide representations in writing to the special entity regarding the fair pricing and appropriateness of the swap. Before entering into a swap transaction with the special entity, the swap dealer or MSP must disclose in writing the capacity in which it is acting. These requirements do not apply to swaps initiated by a special entity on an exchange or swap execution facility or swaps in which the swap dealer or MSP does not know the identity of the special entity swap counterparty.

EXTRATERRITORIAL EFFECT

The Act's provisions on swaps do not generally apply to activities outside the U.S. However, the provisions relating to swaps regulated by the CFTC do apply to activities outside the U.S. that have a direct and significant connection with activities in, or effect on, commerce of the U.S. or contravene CFTC anti-evasion rules. The provisions related to security-based swaps apply to activities outside the U.S. only if such activities are conducted in contravention of the 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 U.S. commodities and securities laws.

It is very possible that the CFTC and SEC will interpret their respective jurisdictional reach sufficiently broadly so as to apply to non-U.S. persons transacting with U.S. market participants or executing or clearing swap transactions on or through a U.S. facility. Additionally, as noted in the discussion of MSPs, there are no explicit exemptions or exceptions from swap dealer and MSP registration and regulation with respect to non-U.S. financial institutions or other non-U.S. persons.

Additional restrictions on foreign entities are also possible under the Act. The Act provides that the CFTC or the SEC, in consultation with the Secretary, may prohibit an entity domiciled in a foreign country from participating in swap activities in the U.S. if the relevant agency determines that regulation of swaps in the foreign country undermines the stability of the U.S. financial system.

In addition, 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 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 and options on futures.

ADDITIONAL IMPACT ON EXISTING SWAPS

The Act contains an unusual provision that falls under the title of "Legal Certainty." The Act provides that, unless "specifically" reserved in applicable swap documentation, 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 provision directly affects the "illegality" termination event provision contained in standard International Swaps and Derivatives

Association ("ISDA") master agreements, as well as other potential additional termination event provisions that parties may have included in their swap agreements. Without this provision, standard swap documents could potentially be construed as allowing a party to terminate its affected swaps as a result of certain provisions of the Act. Whether this provision will operate to prevent swap 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.

Unfortunately, the Act provides no guidance on determining what types of early termination provisions have been effectively "nullified" by the Act. Absent clarification through the rulemaking process, one possible course of action would be for major market participants, with the assistance of ISDA, to formulate a voluntary protocol reflecting a market-based consensus on what is meant by "specifically reserved" in order to reduce the degree of economic uncertainty arising from these provisions in the Act.

This provision also seems to contradict other requirements of the Act. For example, it is hard to understand how to reconcile this provision, which could be construed as prohibiting termination resulting from a change in law or illegality, with newly required obligations to post margin not contemplated under the terms of any existing swap or the forced assignment of a swap from a depository institution to a newly created swap entity. There may very well be legal challenges as to the enforceability of this provision of the Act.

TIMING

Unless otherwise provided in the Act, its provisions will be effective 360 days after the date of enactment. This means that the CFTC and SEC must adopt rules imposing minimum capital and initial and variation margin requirements on all uncleared swaps for swap dealers and MSPs within 360 days of the Act's enactment. Generally, the clearing and exchange requirements will also not become effective until 360 days following enactment. Finally, swap dealers and MSPs will be required to register as such with the CFTC or SEC, as applicable, within one year of enactment.

It should be further noted that, to the extent any provision of the Act requires that rules first be written, such provision cannot be effective until at least 60 days after publication of the final implementing regulation. This is important given that most of the provisions of the Act are not self-actuating and require some action by the applicable regulatory agencies before they will become effective.

FINAL THOUGHTS: THE FUTURE IMPACT

Because of the transition periods embedded in the Act, the derivatives world will not change overnight. However, the certainty that many were hoping would come from passage of the Act has not materialized. The extent to which broad, overarching concepts must await the regulatory process to put the necessary "meat on the bones" is unprecedented. For at least the next year (and in some cases, much longer), until somewhat definitive regulatory guidance is provided, it will be difficult for many participants in the OTC derivatives markets to prepare in any significant respect for the new practices, operations, and business conduct requirements that are required by the Act. The uncertainty that will likely continue for at least the next year may create many unintended consequences, including driving derivatives activities to jurisdictions outside of the U.S.

Regulators are scrambling to hire additional personnel in order to tackle their massive rule-writing mandate. The period of time that has been given under the Act to the regulators to draft what are likely to be extremely complex rules is very aggressive in light of these complexities. Meeting the rulemaking deadlines imposed by the Act may require a number of preliminary or interim rules that will have to be polished, revised, and "finalized" over the next several years. The volume of comments alone that regulators are likely to receive following publication of proposed rules will no doubt be massive.

The extent to which the new clearing mandates will decrease systemic risks or simply give rise to new, presently unidentified problems is difficult to assess at this time. The increased potential efficiency and standardization resulting from the clearing process could reduce transaction costs, but such cost savings could be more than offset to the extent that the margin required by clearinghouses is greater than the margin levels participants have historically been required to provide for comparable trades. The additional price transparency arising through the new reporting obligations will undoubtedly reduce spreads. The cost of entering into "bespoke," uncleared swaps will rise due to, among other things, the increased capital and margin requirements that will likely apply to these trades. Although end-users should be able to continue to enter into bespoke, uncleared swaps, if these swaps become uneconomical, end-users may nevertheless be forced to substitute less costly cleared swaps for customized uncleared ones. The consequence may be greater mismatches in the future between the risks that end-users were hoping to hedge through OTC bespoke derivatives and the extent to which the substituted cleared swaps selected effectively hedge those risks. The end-user exemption may prove to be less helpful than many had hoped. Further, on a system-wide level, it is possible that the centralization of risk in clearinghouses could simply create new "too big to fail" entities that may require government assistance in the event of a future general market disruption.

We discussed above the other ambiguities surrounding the new end-user category of swap participants. Whether end-users will be required to post margin for outstanding uncleared derivatives positions awaits clarification. While the market has closely followed the debate regarding the extent to which the Act purports to retroactively apply its new margin requirements, we must remember that rulemaking guidance is also required for definitively determining which market participants will fall within the end-user "safe harbor" and which of their swaps will be considered swaps entered into for hedging commercial activities. Swap counterparties that are not end-users presently have even less clarity as to: (i) whether their preexisting uncleared swaps will retroactively become subject to new margin requirements; and (ii) the treatment of such preexisting swaps if these swaps do not contractually contemplate providing the margin or the counterparties under such swaps are not in a position to access the additional capital necessary to meet the new margin requirements.

As we also addressed above, significant uncertainty exists as to which derivatives players may become MSPs. The uncertainty is exacerbated by the fact that a market participant can be deemed to be an MSP for one type of derivative but not another. Market participants such as highly leveraged hedge funds that find themselves with an MSP designation may be dramatically affected by the simultaneous need to find additional capital and significantly increase their compliance and business operations. Other vehicles, such as special purpose structured vehicles, may find that they fall within the MSP web with no means to even raise the newly required capital.

The push-out rule, which will require U.S. banks that conduct certain derivatives activities to either spin off those activities or forego having access to certain federal assistance, raises many unanswered questions. The separately capitalized nonbank affiliates required in order to continue certain derivatives activities could be a significant capital drain to the parent banking organization, which would have the opposite effect from its intended purpose—strengthening the financial position of such banks. Presently left unanswered is the nature of the future relationships between such new affiliates and their sponsoring banks. Also unanswered is what happens to outstanding derivatives positions that would need to be transferred to the new affiliates. Finally, lawyers are likely to be the big winners because bank clients will require ongoing legal advice to navigate the nuances involved in determining which derivative transactions can remain at the bank and which ones must be conducted by the new nonbank affiliates, what types of derivative transactions continue to be permitted, and what types of derivative transactions are outright prohibited.

When regulatory reform was first proposed last year, many market participants hoped that the reform effort would give rise to an opportunity for streamlining the way the U.S. regulates its financial markets by merging together the CFTC and SEC. As the regulatory process moved forward, it became clear that the political will to tackle such an overhaul was lacking. As we have noted, the Act primarily divides the OTC derivatives world between swaps and security-based swaps and the responsibilities for regulating those derivatives between the CFTC and SEC, respectively. The line between the two types of transactions is quite fuzzy in many cases. Such ambiguity as to how certain derivatives are to be characterized and which body is responsible for their regulation will have significant consequences as market participants attempt to comply with the new statutory and regulatory framework. The extent to which the rulemaking process will provide the necessary clarity will depend in part on how well the CFTC and SEC are able to work together in areas of potentially overlapping jurisdiction.

It also cannot be forgotten that, in many circumstances, the SEC and CFTC share their new regulatory responsibilities with one or more federal banking regulatory agencies. While appropriate federal banking regulators have authority over derivatives-related capital, and margin requirements for banks and bank holding companies, the bank and nonbank regulators share authority in the case of affiliated swap dealers. The CFTC, SEC, and such banking regulators may all have a role with respect to the derivatives activities of those entities and their compliance with the push-out requirements and the Volcker Rule. The ambiguities as to “who is charged with doing what” among all of these regulatory agencies may bring the market years of turf battles, further complicating the burden of complying with the Act.

CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION

SAY-ON-PAY VOTES

The Act amends the Exchange Act to require periodic non-binding shareholder votes on compensation of executives of companies subject to the SEC's proxy solicitation rules. Section 951(a) of the Act provides that, not less frequently than once every three years, a company's proxy statement for a shareholder meeting that includes required executive compensation disclosure must also provide for a nonbinding shareholder vote on executive pay. Shareholders would be entitled to direct the frequency of these advisory votes, which could occur every one, two, or three years. The first say-on-pay votes, as well as the votes establishing the frequency of say-on-pay resolutions, would occur during the 2011 proxy season for most companies. The SEC has the authority to exempt small issuers from these requirements.

Excessive executive compensation remains a politically charged issue, and say-on-pay votes may have a meaningful impact on compensation practices in the U.S.—and, as a collateral consequence, on board elections. Still, say-on-pay votes have become customary and uneventful across Europe and in many other foreign markets. Pursuant to the Emergency Economic Stabilization Act of 2008, say-on-pay votes have been required in the U.S. for TARP recipients with little consequence.

Less than a handful of U.S. public companies soliciting shareholder approval of pay practices during the 2010 proxy season failed to receive the requisite vote. Given the anti-management focus on compensation and the provisions of the Act that prohibit broker discretionary voting on executive compensation matters, however, it is likely that more companies may fail to receive majority shareholder support of executive pay practices. At particular risk will be those companies that run afoul of the guidelines and recommendations of proxy advisory firms such as RiskMetrics Group and Glass Lewis & Co. The influence of those firms on changing corporate behavior, particularly when a shareholder vote is pending, has been unprecedented in the past few proxy seasons, and the Act's say-on-pay provisions could amplify their influence significantly. The influence of proxy advisory firms will likely be further enhanced as more and more institutional shareholders come to rely on the recommendations of these firms due to the institutional shareholder's inability to timely evaluate each of its portfolio company's compensation practices for purposes of the mandatory say-on-pay vote. Accordingly, companies should be mindful of these guidelines and the expected impact of negative recommendations in light of the increased influence that proxy advisory firms will have on voting outcomes in order to avoid an embarrassing "no confidence" shareholder vote on pay practices. Further, as a result of say-on-pay votes and the broker voting restrictions discussed below, companies may find that their compensation committee members are vulnerable to withhold-vote campaigns spearheaded by activist shareholders whose short-term interests may not align with the board's vision for encouraging management to provide long-term value to shareholders.

Companies will also need to carefully consider their recommendations to shareholders on the frequency of say-on-pay votes. Following the initial vote, companies will be required to allow shareholders to vote at least once every six years on say-on-pay frequency. Most U.S. companies that have voluntarily implemented say-on-pay have provided for annual votes, although a few, including Microsoft and Pfizer, have provided for less frequent reviews. Given that background, it is reasonable for shareholders to expect that companies implementing mandatory say-on-pay will recommend annual votes as well. A company considering recommending a less frequent vote should also weigh the consequences of appearing to call for less accountability of pay practices than is typical for its peer firms. Further, it is likely that the recommendations of proxy advisory firms will spur significant momentum toward an annual say-on-pay vote model.

SHAREHOLDER APPROVAL OF GOLDEN PARACHUTES

Section 951(b) of the Act also includes provisions requiring an advisory shareholder vote on so-called "golden parachutes." These provisions had appeared in the House of Representatives version of the Act, but were not included in the Senate version. These provisions apply to any proxy statement for a shareholder meeting at which shareholders are asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the company's assets. The provisions require disclosure regarding, and provide for a non-binding shareholder vote on (to the extent not previously approved under the mandated say-on-pay discussed above), any agreements or understandings with any named executive officer of the company (or the acquirer, if the company is not the acquiring entity) concerning any type of compensation that is based on or otherwise related to the transaction. As is the case with the periodic say-on-pay vote described above, the SEC has the authority to exempt small issuers from these requirements. The Act also provides that these rules are not intended to create or change existing fiduciary duties standards. Companies should continue to consider typical transaction-based compensation arrangements to the extent they are deemed by the board of directors to be necessary in connection with a corporate transaction.

BROKER VOTING

Like the recent changes to the rules of the New York Stock Exchange (the "NYSE"), Section 957 of the Act amends the Exchange Act to prohibit uninstructed broker voting in shareholder votes relating to the election of directors.[138] Section 957 reaches far beyond the NYSE rulemaking, however, as the provisions also prohibit uninstructed broker voting in *any* matters dealing with executive compensation, as well as "any other significant matter," as determined by SEC rulemaking.

These provisions may have a significant impact not only on elections of directors but also, as discussed above, on say-on-pay votes—presently, brokers may vote on management "say-on-pay" resolutions under the NYSE rules. The Act's prohibition on broker discretionary voting on executive compensation matters likely will significantly increase the influence of proxy advisory firms on voting behavior. Companies will need to closely monitor the evolving guidelines and recommendations of such firms when taking actions on executive compensation as well as other "significant" matters that might ultimately be submitted to a shareholder vote. Many companies, particularly those with a large retail shareholder base, likely will also face additional costs and efforts conducting "get out the vote" campaigns on matters previously considered to be routine.

PROXY ACCESS

Section 971 of the Act amends the Exchange Act to expressly authorize, but not require, the SEC to prescribe rules and regulations requiring proxy statements to include director nominees submitted by shareholders. The surprise amendment proposed by Senator Dodd during the conference committee negotiations, which included a two-year holding requirement and 5 percent ownership threshold for proxy access, failed to win the support of the House conferees. These provisions do not impose any specific rules or regulations with respect to proxy access; rather, it is intended simply to preclude a successful legal challenge to the SEC's authority to adopt proxy access rules based on lack of specific legislative authority.

In 2009, the SEC proposed rules that would expand the rights of shareholders to nominate and elect persons to serve on public company boards of directors. Under the proposed new Exchange Act Rule 14a-11, companies would be required, under certain circumstances,[139] to include shareholder nominees for director in proxy materials in connection with an annual meeting (or special meeting in lieu of an annual meeting). Shareholders also would have the ability to use the shareholder proposal procedure under Exchange Act Rule 14a-8 to modify the company's nomination procedures or disclosures regarding elections through a bylaw amendment, so long as such proposal does not otherwise conflict with state law or SEC rules. The proposed rules had been expected to be in place for the 2010 proxy season, and Chairman Shapiro indicated that she wanted to issue final rules early in 2010, a goal presumably delayed by this congressional action. The enactment of the Act likely will spur the SEC's efforts to put rules in place in time for the 2011 proxy season.

138 Section 957 exempts from this provision the uncontested election of a member of the board of directors of any investment company registered under the Investment Company Act of 1940.

139 The last version of the proxy access rules released by the SEC contained a sliding ownership threshold (1 to 5 percent based on the company's market capitalization) and a one-year holding period for a shareholder seeking to include its director nominee in the company's proxy statement.

The 2009 proposed rules marked the third time in the last several years that the SEC has dealt with direct access by shareholders to the proxy materials. The SEC received hundreds of comments to the proposed rules during the comment period, demonstrating the complexity of the issues and the magnitude of the effect that the proposed rules would have on the mechanics of board nominations and elections. For more information regarding the proposed proxy access rules, including a discussion of their expected impact on public companies, see the Jones Day Alert "SEC Proposes New Rules Facilitating Shareholder Nominations of Directors," June 2009, available at http://www.jonesday.com/sec__proposes__new__rules/.

HEDGING DISCLOSURE

Section 955 of the Act amends the Exchange Act to require the SEC to adopt rules requiring proxy statement disclosure regarding whether any employee or board member of the company, or their designees, is permitted to engage in hedging transactions in the company's equity securities.

The SEC rules currently require public companies to disclose their hedging policies. Item 402 of Regulation S-K requires companies to disclose, if material, any policies applicable to named executives regarding the hedging of the economic risk of ownership of company securities. It is currently unclear whether these provisions of the Act create an entirely new disclosure obligation or whether they will require the SEC to expand the scope of the current obligation in Item 402.

BOARD LEADERSHIP DISCLOSURE

Section 972 of the Act amends the Exchange Act to require the SEC to issue rules requiring all public companies to provide proxy statement disclosure regarding the rationale for why the company has chosen the same person, or different persons, to serve as chairperson of the board of directors and chief executive officer.

As with the newly mandated disclosure regarding a company's policy on hedging transactions, the SEC rules currently require board leadership disclosure similar to that mandated by the Act. Item 407(h) of Regulation S-K requires companies to provide proxy statement disclosure regarding the leadership structure of the board of directors and the rationale for the structure. It is unclear whether these provisions of the Act create an entirely new disclosure obligation or whether they will require the SEC to expand or modify the scope of the current obligation in Item 407(h).

CLAWBACK PROVISION

Section 954 of the Act amends the Exchange Act to require the SEC to direct national securities exchanges to require listed companies to develop, implement, and disclose clawback policies (with a three-year look-back period) for return of incentive-based executive compensation (including stock options) paid to any executive officer if the company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the federal securities laws.

Although the Act's clawback provisions are significantly less stringent than clawback provisions applicable to TARP recipients, the Act's clawback provisions are a substantial expansion of the clawback provisions of the Sarbanes-Oxley Act, not only because they are broader in scope, but also because they permit a private right of action to recover amounts paid. The Sarbanes-Oxley Act clawback provisions authorize the SEC to seek recoupment of certain compensation and equity-based awards granted to the chief executive officer and chief financial officer following an accounting restatement that results from misconduct.

The amount recoverable under the Act's clawback provisions is not the full amount of the compensation paid, but only the difference between that amount and what would have been paid on the basis of the corrected results. We believe that this provision was designed to operate solely for awards that were paid based on "threshold," "target," and "maximum" levels of achievement and not awards with fixed strike price (*e.g.*, stock options). Absent SEC guidance on how to calculate a share price and a restatement, it is unclear how these provisions will apply to equity-based awards with a fixed strike price (*e.g.*, stock options and stock appreciation rights).

COMPENSATION COMMITTEES

Section 952 of the Act amends the Exchange Act to require the SEC to direct national securities exchanges to require each member of a listed company's compensation committee to be independent. The independence criteria to be established by the exchanges must consider the source of compensation of board members, including any consulting, advisory, or other fees paid by the listed company to board members, and whether a board member is affiliated with the listed company. The Act also requires any compensation consultant, legal counsel, or other adviser retained by a compensation committee to be independent considering factors identified by the SEC. These factors must include:

- The provision of other services to the listed company by the employer of the adviser;
- The amount of fees received from the listed company by the employer of the adviser;
- The policies and procedures of the employer of the adviser that are designed to prevent conflicts of interests;
- Any business or personal relationship of the adviser with a member of the listed company's compensation committee; and
- Any stock of the listed company owned by the adviser.

The Act further provides that the compensation committee is directly responsible for the appointment, compensation, and oversight of any compensation consultant and the committee's legal and other advisers, and that each listed company must provide for funding of reasonable compensation of the committee's consultants and advisers. Finally, the Act requires disclosure of certain matters relating to the use of compensation consultants in the listed company's proxy statement.

While the NYSE rules currently require each company listed on the exchange to have a fully independent compensation committee, the NASDAQ Stock Market listing standards do not include a similar requirement. The Act does not appear to direct stock exchanges to require listed companies to have compensation committees but instead specifies that if a listed company has such a committee its members must be independent. The Act's provisions with respect to the ability to retain advisers and the obligations of listed companies to provide appropriate funding is not expected to significantly alter corporate behavior, as these concepts have become generally accepted elements of corporate governance.

EXEMPTION FROM SECTION 404(b) FOR CERTAIN SMALLER ISSUERS

Section 989G of the Act amends the Sarbanes-Oxley Act to exempt issuers that are neither "large accelerated filers" nor "accelerated filers" (as defined in Rule 12b-2 of the Exchange Act) from the internal control auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act. Section 989G also directs the SEC to conduct a study to determine how the SEC could reduce the burden of complying with Section 404(b) for companies with a market capitalization of between $75 million and $250 million while maintaining investor protections for those companies.

The exemption from Section 404(b) follows the adoption of numerous one-year extensions that delayed the implementation of Section 404(b) for non-accelerated filers until the fiscal years ending on or after June 15, 2010, and reflects Congress's view that the costs associated with attestation reports outweigh the benefits to investors in these companies.

DISCLOSURE OF RATIO OF CEO PAY TO MEDIAN TOTAL COMPENSATION

Section 953(b) of the Act directs the SEC to devise rules for proxy statement disclosure of the ratio of the median of the annual total compensation of all employees of the public company, excluding the CEO, to the CEO's total compensation for the year. These disclosures are evidently designed to promote greater "pay equity" by highlighting the contrasts between CEO pay and median employee compensation. The mechanics of making these calculations at large and diverse companies are likely to prove formidable since "compensation" is to be calculated in the same manner as disclosure in the proxy statement summary compensation table.

TABULAR DISCLOSURE OF PAY-FOR-PERFORMANCE

Pursuant to Section 953(a) of the Act, the SEC must promulgate rules requiring annual meeting proxy statements to include disclosure showing the relationship between executive pay and financial performance of the public company, including changes in stock price.

INVESTOR PROTECTION AND ENFORCEMENT PROVISIONS

SEC ENFORCEMENT

The Act contains a number of enforcement provisions aimed at improving securities laws and strengthening investor protections. These enforcement provisions, contained primarily within Title IX of the Act, include: adding new whistleblower protections and incentives; establishing aiding and abetting liability in SEC enforcement actions for those individuals who "recklessly" assist in securities violations; providing the SEC with authority to issue industry-wide collateral bars; disqualifying felons and other "bad actors" from Regulation D offerings; restricting or prohibiting mandatory predispute arbitration provisions; and establishing a 180-day deadline for the SEC to file an enforcement action after providing an individual with a Wells Notice. Senators Richard Shelby (R-AL), Robert Bennett (R-UT), Jim Bunning (R-KY), and David Vitter (R-LA) opined that Title IV is a "Christmas tree of amendments to the securities laws, many of which are not related to the recent crisis and will not help to prevent another crisis."[140] The following provides an assessment of the proposed legislation.

WHISTLEBLOWER INCENTIVES AND PROTECTIONS

The Act contains new protections and incentives for employees who "blow the whistle" on employers engaged in fraudulent or illegal activities. Specifically, the Act provides for increased monetary incentives for whistleblowers who provide information leading to a successful enforcement action by the SEC. Additionally, the Act creates a private right of action if an issuer retaliates against an employee who reports misconduct.

These new provisions recognize the importance of whistleblowers in uncovering fraud and illegality in public companies. In support of these provisions, Senator Robert Menendez (D- N.J.) noted that whistleblowers are the "first and most effective line of defense against corporate fraud and other misconduct."[141] Indeed, in 2008, whistleblower tips identified 54.1 percent of uncovered fraud schemes in public companies, compared to external auditors who detected only 4.1 percent of such schemes.[142]

Monetary Incentives. Section 922 provides a significant increase in the monetary awards allowed by the Exchange Act. Under the current Exchange Act, the SEC has authority to reward whistleblowers up to 10 percent of the penalties collected from the issuer but such compensation is restricted to the insider trading context.[143] Since the inception of this "bounty program" under the Exchange Act in 1989, the SEC has paid a total of $159,537.00 to five whistleblowers.[144]

Under the Act, however, the SEC may now award the whistleblower anywhere from 10 percent to 30 percent of the amount that is recouped.[145] The SEC has the discretion to award any amount within this range, considering factors such as: (i) the significance of the information provided by the whistleblower; (ii) the degree of assistance provided by the whistleblower; (iii) the programmatic interest of the SEC in deterring violations of the securities laws by making awards to whistleblowers; and (iv) other factors the SEC may establish by rule or regulation.[146]

Section 922 applies to any judicial or administrative action brought by the SEC that results in monetary sanctions exceeding $1 million.[147] In any such action, the SEC will be *required* to pay an award to a whistleblower who "voluntarily provided original information that led to the successful enforcement of the covered judicial or administrative action."[148] This provision provides a monetary incentive to "motivate those with inside knowledge to come forward and assist the government to identify and prosecute persons who have violated securities laws and recover money

140 *Restoring American Financial Stability Act*, S. Rep. No. 111-176 at 243 (2010).

141 156 Cong. Rec. S4076 (daily ed. May 5, 2010) (statement of Sen. Menendez).

142 2008 Report to the National Occupational Fraud and Abuse, Association of Certified Fraud Examiners, available at www.acfe.com/documents/2008-rttn.pdf.

143 15 U.S.C. § 78u-1(e).

144 SEC Office of the Inspector General, *Assessment of the SEC's Bounty Program* (Mar. 29, 2010), available at http://www.sec-oig.gov/Reports/AuditsInspections/2010/474.pdf.

145 H.R. 4173, 111th Cong. § 922(a) (2010).

146 *Id.*

147 *Id.*

148 *Id.*

for victims of financial fraud."[149] Whistleblowers may even be charged by the SEC for participating in the violations, as long as they are not criminally convicted.

Opponents of the legislation argue that this provision does not provide the SEC with the appropriate discretion.[150] Specifically, the SEC does not have the authority to pay whistleblowers less than 10 percent of the collected penalties, a marked departure from current law. Moreover, some argue that the anticipated increase in award claims will force the SEC to divert limited resources from investigating and prosecuting enforcement actions to administrating award claims by whistleblowers. Under the legislation, dissatisfied whistleblowers may directly appeal the SEC's monetary award to the appropriate federal court of appeals.[151]

These enhanced incentives may increase the volume of whistleblower claimants. Senator Shelby noted that "the guaranteed massive minimum payouts and limited SEC flexibility ensures that a line of claimants will form at the SEC's door, hoping for some of the hundreds of millions in the whistleblower pot."[152]

It is also unclear whether the new provisions will improve corporate compliance. These new monetary rewards provide employees with an incentive to report violations externally, rather than taking proactive measures internally to stop such violations. Moreover, a monetary incentive provides SEC witnesses a financial stake in SEC enforcement actions, which may undermine the SEC's credibility in prosecuting those cases.

Retaliation Protection. Section 922 further amends the Exchange Act by creating a private right of action for employees who have suffered retaliation because of any act done by the whistleblower in: (i) "providing information to the [SEC] in accordance with this section"; (ii) "initiating, testifying, or assisting in any investigation or judicial or administrative action of the [SEC] based upon or related to such information"; or (iii) "in making disclosures that are required or protected" under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), the Exchange Act, or any other law, rule, or regulation, subject to the jurisdiction of the SEC.[153] An employee may bring such an action in the appropriate federal district court.[154]

These new protections against retaliation contain several important changes to the current whistleblower provisions contained within Sarbanes-Oxley. First, Section 922 allows the employee to proceed directly to federal court.[155] Under the current provisions of Sarbanes-Oxley, an employee must first file a complaint with the Department of Labor through the Occupational Safety and Health Administration ("OSHA").[156] OSHA, however, has not demonstrated an ability to handle its current volume of complaints. In January 2009, the Government Accountability Office ("GAO") criticized OSHA's whistleblower program, noting that OSHA lacked the ability to address the volume of claims.[157] The Act provides employees who have allegedly suffered retaliation with an avenue to bypass the OSHA bottleneck and proceed directly to federal court.

Section 922 also increases the time frame for employees to assert whistleblower claims. An employee may file a civil claim within three years after the date the material facts become known or six years after the date the retaliation occurred, whichever is less.[158] Currently, Sarbanes-Oxley imposes a 90-day window from the date the violation occurs for a whistleblower claim to be filed.[159]

Finally, Section 929A clarifies that the whistleblower protection of Sarbanes-Oxley applies to employees of any subsidiaries of publicly-traded companies "whose financial information is included in the consolidated financial statements of a traded company."[160] This amendment is particularly important because a number of nonpublicly traded subsidiaries have escaped liability under Sarbanes-Oxley because it is the *parent* company that files reports with the SEC. Often, the parent company has few direct employees. Instead, subsidiaries frequently employ a high percentage

149 S. Rep. No. 11-176 at 110.
150 S. Rep. 111-107 at 244.
151 H.R. 1473, 922(a).
152 156 Cong. Rec. S4076 (daily ed. May 20, 2010) (statement of Sen. Shelby).
153 H.R. 4173, 111th Cong., 922(a).
154 *Id.*
155 *Id.*
156 18 U.S.C. § 1514A(b).
157 United States Government Accountability Office, Whistleblower Protection Program, (January 2009) available at http://www.gao.gov/new.items/d09106.pdf.
158 H.R. 4173, 111th Cong. § 922(a).
159 18 U.S.C. § 1514A(b)(2)(d).
160 H.R. 4173, 111th Cong. § 929A.

of the workforce of the consolidated entity. The Act confirms that these nonpublic subsidiaries are subject to the requirements of Sarbanes-Oxley.

These revised retaliation provisions will present new challenges for public company employers. Direct access to federal court will most likely increase the volume and expense of retaliation litigation. Additionally, the extended statute of limitations raises new administrative problems if an employer does not keep employment, payroll, or similar records for six years. Employers may thus find themselves faced with a retaliation claim without the necessary records needed to defend the suit.

AIDING AND ABETTING AUTHORITY

The Act also includes several provisions which expand the SEC's enforcement powers in the context of aiding and abetting liability under the federal securities laws.[161] First, Section 929O adds authorization for the SEC to bring aiding and abetting charges against persons who "recklessly" provide substantial assistance to a primary violator of the Exchange Act. This provision substantially expands liability beyond those who "knowingly" assist primary Exchange Act violators. Second, Sections 929M and 929N authorize the SEC, for the first time, to bring aiding and abetting charges for reckless or knowing substantial assistance to primary violators of the Securities Act, the Investment Advisers Act, and the Investment Company Act. In the last several years, the Enforcement Division's track record in successfully litigating aiding and abetting cases under the Exchange Act has been spotty at best, and this multi-pronged expansion will substantially increase the prospect of liability for secondary actors in enforcement actions.

While unquestionably enhancing the SEC's authority to remedy violations of federal securities laws by secondary actors, the Act does not create a private right of action for aiding and abetting violations, despite the efforts of two high-profile House and Senate Democrats. Indeed, Senator Arlen Specter (D-PA) and Representative Maxine Waters (D-CA) introduced virtually identical amendments to provide for a private right of action for aiding and abetting liability under the federal securities laws, which—if adopted—would have served to legislatively overturn the Supreme Court's recent decision in *Stoneridge*.[162] That decision declined to recognize such a cause of action under the law, as currently written. Neither amendment, however, emerged out of committee, and despite House conferees' efforts, Senate conferees would not agree to its inclusion in the final version of the Act. But the issue is not entirely closed. Section 929Z directs the GAO to study whether private plaintiffs should be allowed to sue aiders and abettors.

161 H.R. 4173, 111th Cong. §§ 929M-929O.

THE SEC'S EXPANDED AUTHORITY FOR COLLATERAL BARS

Section 925 provides the SEC with expanded authority to impose collateral bars against individuals who violate federal securities laws. This section amends Sections 15(b)(6)(A), 15B(c)(4), and 17A(c)(4)(C) of the Exchange Act and Section 203(f) of the Investment Advisers Act.[163] Under the old provisions, the SEC had authority to bar a regulated person who violates the securities laws from the industry in which the individual participated. The regulated industries include brokers, dealers, investment advisers, municipal securities dealers, municipal advisers, transfer agents, and nationally recognized statistical rating organizations. Under the Act, the SEC may now bar a regulated person who violates the securities laws not only in the specific industry in which the violation occurred, but from all of the other industries mentioned above.[164] For example, the SEC could bar a broker who misappropriates a customer's funds from participating in the financial services industry as an investment adviser. The SEC maintains discretion to suspend such an individual for 12 months or to issue a permanent bar.[165]

The legislation reverses current legal precedent. In *Teicher v. SEC,* the D.C. Circuit interpreted the current provisions contained within the Investment Advisers Act and the Exchange Act, and determined that the SEC was only permitted to bar a securities violator from participation in the particular industry in which he committed the violation,

162 *See Stoneridge Investment Partners, LLC v. Scientific Atlanta*, 552 U.S. 148 (2008) (declining to recognize a private right of action for aiding and abetting under the federal securities laws).
163 H.R. 4173, 111th Cong. §925.
164 *Id.*
165 *Id.*

not to bar him from any industry regulated by the SEC.[166] Justifying its decision, the court explained that the "logic of the statutory structure convinced [it] that Congress withheld that power."[167] The Act removes any doubt about legislative intent; Congress clearly intends for the SEC to wield the power to issue industry-wide collateral bars.

The expansion of collateral bars was part of the Obama Administration's 2009 legislative proposal, the Investor Protection Act.[168] Proponents argue that this expansion of authority is justified by the interrelationship among the securities activities under the SEC's jurisdiction, the similar grounds for exclusion from each, and the SEC's overarching responsibility to regulate the industry. Moreover, they contend that the current law does not adequately police recidivist securities violators. Indeed, "individuals could be barred from one registered entity for violations, such as fraud, but then work in another industry where they could prey upon other investors."[169]

The policy behind this expanded power was summarized by SEC Commissioner Luis Aguilar, who noted that "when a broker or an investment adviser defrauds investors, the best way to protect future investors is to make sure that the individual no longer has the opportunity to engage in the securities business."[170] Arguing for this increased authority, Commissioner Aguilar observed that given "someone who steals investor money as a broker-dealer is a similar risk to steal money if they become an investment adviser, we need the authority to bar a bad actor from the entire securities industry, not just the particular job in which she or he committed fraud."[171]

DISQUALIFYING FELONS AND OTHER BAD ACTORS FROM REGULATION D OFFERINGS

The Act requires the SEC, within one year of the legislation's enactment, to issue rules that disqualify felons and other "bad actors" from offerings and sales of securities under Section 506 of Regulation D.[172] Section 506 provides exemptions from the registration requirements of the Securities Act, and is the favored exemption of start-up companies and venture capitalists. Offerings made under Regulation D are private placement offerings, meaning that companies issuing them cannot use general solicitation or advertising to market them. Because they are not publicly advertised, companies using this exemption are not required to register their securities or file periodic reports with the SEC. (Rule 503 requires filing of Summary Form D).

Because Regulation D offerings are exempt from registration under federal securities law, however, there is virtually no regulatory scrutiny, "even where the promoters or broker-dealers have a criminal or disciplinary history."[173] Given this relaxed scrutiny, Regulation D offerings present opportunity for fraud.[174] Section 926 is intended to protect investors who "fall victim to sellers who repeatedly engage in securities fraud." [175] Senator Chris Dodd (D-CT) believes these provisions will "protect investors from those unscrupulous persons while encouraging capital formation."[176]

Section 926 would disqualify any offering or sale of securities by a person that: has been convicted of a felony or misdemeanor in connection with the purchase or sale of any security or involving the making of a false filing with the SEC; or is subject to final punitive orders by certain regulatory agencies, including the SEC.[177] The disqualification applies to issuers that are, or have directors, officers, general partners, or 10 percent beneficial owners that are subject to these final orders.

Section 926 replaces prior language of the proposed Senate bill that would have required the SEC to undertake a 120-day review period of all securities offerings made under Section 506 of Regulation D. Under the earlier language, if the SEC did not act within the prescribed 120-day period, the securities offerings would have been subject to individual state securities regulations. Opponents of this provision protested that if the SEC did not review a company's Form D filing

166 177 F.3d 1016 (D.C. Cir. 1999).
167 *Id.* at 1017.
168 U.S. Department of the Treasury, Investor's Protection Act (2009), available at http://www.treas.gov/press/releases/docs/tg205071009.pdf.
169 S. Rep. No. 111-176 at 12.
170 Commissioner Luis A. Aguilar, SEC Commissioner, Compliance Week 2010, Washington, D.C.: *Market Upheaval and Investor Harm Should Not be the New Normal* (May 24, 2010).
171 *Id.*

172 H.R. 4713, 111th Cong. § 926.
173 156th Cong. Rec. S3813 (daily ed. May 17, 2010) (statement of North American Securities Administrators Association).
174 *Id.*
175 *Id.* (statement of Sen. Dodd).
176 *Id.*
177 H.R. 4713, 111th Cong. § 926.

within the 120-day period, the company would have been forced to register their securities or otherwise comply with individual state regulations, and thus lead to a significant disruption to the "well-established federal framework that governs private securities offerings."[178] Amidst concerns that such provisions would inhibit the growth of small businesses and start-up companies, the 120-day review period was replaced with the bad actor disqualification provision.

Section 926 does not change the substantive requirements for offerings made pursuant to Section 506 of Regulation D. Indeed, Section 926 "ensures uniform regulation of these private offerings across the United States" and maintains the status quo of the current reporting requirements for entrepreneurs.[179] Moreover, by presenting new regulatory hurdles to felons and other bad actors, it clears the path for legitimate venture capitalists who do not seek to engage in fraud.

RESTRICTING MANDATORY PRE-DISPUTE ARBITRATION PROVISIONS

A mandatory predispute arbitration clause waives the investor's right to go to court, instead requiring binding arbitration, usually before the Financial Industry Regulatory Authority ("FINRA"), a securities industry controlled forum.[180] Disputes between broker-dealers and their customers are routinely arbitrated. This practice is a direct consequence of the Supreme Court's decision in *Rodriguez v. Shearson/American Express, Inc*., where the Court ruled that a predispute agreement to arbitrate an investor's securities claims against a brokerage firm was enforceable given the strong federal policy favoring arbitration.[181] Ever since this decision, predispute mandatory arbitration has been common throughout the industry.

178 Letter from The Financial Services Roundtable, Investment Program Association, National Association of Real Estate Investment Trusts, Private Equity Council, Real Estate Investment Securities Association, The Real Estate Roundtable, Securities Industries and Financial Markets Association, and the U.S. Chamber of Commerce to Harry Reid, Majority Leader of the United States Senate, and Mitch McConnell, Minority Leader of the United States Senate (Apr. 8, 2010).

179 156th Cong. Rec. S3813 (daily ed. May 17, 2010) (statement of Angel Capital Association, Apr. 21, 2010).

180 FINRA is the largest independent regulator for all securities firms doing business in the United States, overseeing nearly 4,700 brokerage firms, about 167,000 branch offices, and approximately 635,000 registered securities representatives. *About the Financial Industry Regulatory Authority*, http://www.finra.org/AboutFINRA.

181 490 U.S. 477 (1989).

Sections 921 and 1028 of the Act authorize the SEC and the newly-created Consumer Financial Protection Bureau ("CFPB") to regulate mandatory predispute arbitration agreements in the securities and consumer financial products industries. In the securities context, the relevant part of Section 921 provides that "the [SEC], by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."[182] This provides the SEC discretion to restrict or even prohibit the use of mandatory arbitration clauses in customer contracts with broker-dealers and investment advisers.

In the non-securities context, Section 1028 authorizes the CFPB to conduct a study on the issue and submit a report to Congress before the agency may limit the use of mandatory predispute arbitration clauses.[183] If the Bureau finds that "a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers," the CFPB is authorized to limit or ban mandatory predispute arbitration clauses in consumer financial contracts. [184]

Interest groups such as the North American Securities Administrators Association ("NASAA"), Consumer Federation of America, and AARP have asserted that mandatory predispute arbitration is unfair to investors.[185] Indeed, there are "high up-front costs; limited access to documents and other key information; limited knowledge upon which to base the choice of arbitrator; an absence of a requirement that arbitrators follow the law; and extremely limited grounds for appeal."[186] Indeed, some reform advocates have argued that arbitrators may be biased in favor of brokerage firms, given the potential to receive future work from those entities. NASAA noted that "the mandatory

182 H.R. 4173, 111th Cong. § 921(a).

183 *Id.* § 1028(a).

184 *Id.* § 1028(b).

185 S. Rep. 11-176 at 110; *see also* Letter from Americans for Financial Reform, *et al*, to Barney Frank, Chairman, House Financial Services Committee and Spencer Bachus, Ranking Member, House Financial Services Committee (Nov. 3, 2009).

186 S. Rep. 11-176 at 110 (citing Letter from AARP to Senators Chris Dodd and Richard Shelby, November 19, 2009).

industry arbitrator, with their industry ties, automatically puts the investor at an unfair advantage."[187]

Supporters of the Act have suggested that mandatory predispute arbitration harms the public because it impedes the development of federal securities laws and impedes public disclosure of important information.[188] Unlike an order issued by a court, an arbitrator's ruling is not publicly available. Moreover, there is no public record maintained of arbitration outcomes. Without public accountability, supporters argue that mandatory arbitration clauses eliminate any incentive for arbitrators to treat consumers fairly. Making arbitration optional would temper this perceived structural bias.

Despite the many concerns about mandatory predispute arbitration clauses, the Act does not eliminate mandatory predispute arbitration. At its core, it compels nothing; it merely *authorizes* the SEC to draft rules restricting the mandatory arbitration practice.[189] Moreover, the Act does not prohibit a customer from entering into a voluntary arbitration agreements after a dispute has arisen.[190]

THE NEW SEC ENFORCEMENT DEADLINE

The Act establishes a new 180-day deadline for the SEC to bring an enforcement action once it has issued a Wells Notice against an individual.[191] Section 929U is an amendment to the Exchange Act, the current provisions of which contain no such time constraints.[192] Section 929U provides that the SEC, within 180 days of sending a Wells Notice, must either: file an enforcement action or provide notice to the Director of the Division of Enforcement at the SEC (the "Director") of its intent to *not* file an action.[193] The SEC, however, may seek an additional 180-day extension of this deadline in instances where the Director: determines that the investigation is sufficiently complex that the filing of the action cannot be completed within the 180-day deadline; and provides notice to the Chairman of the SEC ("the Chairman") of its determination.[194] Subject to the Chairman's approval, the Director may extend this deadline for additional, successive 180-day periods.[195]

Section 929U establishes the same deadline for examinations conducted by the Office of Compliance Inspections and Examinations ("OCIE"). OCIE conducts examinations of the nation's registered entities, including broker-dealers, transfer agents, investment advisers, investment companies, the national securities exchanges, clearing agencies, and the nationally recognized statistical rating organizations. Under the Act, OCIE must conclude such examination within 180 days of the later of: the last day of its on-site examination, or the date on which it receives the last records it has requested.[196] At the end of this 180-day period, OCIE must conclude its examination by requesting corrective action or reporting that it has no findings. This deadline can similarly be extended for a complex examination, but only for a *single* 180-day period.[197]

Section 929U appears to be a compromise provision: an earlier version of the Wall Street Reform and Consumer Protection Act of 2009 contained the more dramatic provision that the SEC "shall complete any examination, investigations, or *enforcement action* initiated by the [SEC] not later than 180 days after the date on which such examination, inspection, or *enforcement action*, is commenced."[198] Further, the earlier version of the Act permitted only one additional deadline extension of 180 days.[199] Thus, a 180-day (or 360-day) deadline for the SEC to complete the entirety of an enforcement action case from start to finish would have been a revolutionary change from the current process, where cases commonly take years to complete.[200]

187 *Id*. (citing *Enhancing Investor Protection and the Regulation of Securities Markets- Part II: Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs,* 111th Cong, 1st Session, p. 18 (2009) (Testimony of Mr. Fred Joseph)).
188 Letter from Americans for Financial Reform, Consumer Federation of America, *et al* to Barney Frank, Chairman, House Financial Services Committee and Spencer Bachus, Ranking Member, House Financial Services Committee (Nov. 3, 2009).
189 The CFPB, on the other hand, is permitted merely to conduct a study on mandatory predispute arbitration and submit a report to Congress before it may limit the use of such clauses.
190 H.R. 4173, 111th Cong. § 1028(c).
191 A Wells Notice is a writing notifying an individual that the SEC staff intends to recommend that the SEC file an enforcement action against that individual.
192 H.R. 4173, 111th Cong. § 929U.
193 *Id.*
194 *Id.*
195 *Id.*
196 *Id.*
197 *Id.*
198 Investor Protection Act of 2009, H.R. 3817 111th Cong. § 208 (2009) (emphases added).
199 *Id.*
200 Bruce Carton, *Dissecting the Investor Protection Act*, Compliance Week (Jan. 12, 2010), http://www.complianceweek.com/article/5744/dissecting-the-investor-protection-act.

The existence of this section may indicate congressional irritation with SEC enforcement actions and examinations that extend endlessly without conclusion. While the earlier draft of Section 929U would have resulted in a drastically reduced time frame for SEC enforcement actions, this amended version will likely have a limited effect. In fact, critics argue that the SEC could successfully evade the §929U deadline by requesting successive 180-day extensions in enforcement cases.[201] Moreover, even if the SEC instigates an enforcement action within 180 days from the date it issues the Wells notice, there are no time limits for the *completion* of the enforcement action. Thus, Section 929U will have little effect in bringing enforcement actions to earlier resolution.

OTHER KEY ENFORCEMENT PROVISIONS

While certainly not meant to be exhaustive, this section provides a brief summary of some of the remaining significant enforcement provisions contained within the Act.

- **Standard of Care for Broker-Dealers, § 913.** The Act requires the SEC to conduct a study on the effectiveness of the current standards of care for broker-dealers, investment advisers, and associated persons who provide personalized investment advice to retail customers. The SEC must submit a report to the Senate Banking and House Financial Services Committees, containing its findings and recommendations within six months of the Act's enactment. Upon the conclusion of this study, Section 913 gives the SEC the discretion to establish a uniform fiduciary duty for those individuals who provide personalized investment advice to retail clients or other customers.
- **Enhanced Scrutiny of Investment Advisers, § 914.** Under the Act, the SEC is required to conduct a study analyzing the "need for enhanced examination and enforcement resources for investment advisers." This study must consider: the number of investment adviser examinations conducted by the SEC in the past five years; whether a self-regulatory organization for advisers would improve the frequency of such examinations; and the current and potential approaches for examining investment adviser activities. The SEC must submit a report to the Senate Banking and House Financial Services Committees within six months of the Act's passage, making recommendations on appropriate legislation. The SEC is further obligated to use its findings to revise its own rules, if necessary.
- **Fair Fund Amendments, § 929B.** The Act gives the SEC authority to add civil penalty payments to a fund to be distributed to victims of securities law violations. Previously, the SEC was only permitted to contribute to such a fund if it had obtained disgorgement against the violator.
- **Nationwide Service of Subpoenas, § 929E.** The Act allows for the nationwide service of subpoenas in civil SEC actions filed in federal court.
- **Enforcement Actions Against Wrongdoers Who Have Left the Industry, § 929F.** The Act provides that the SEC may bring enforcement actions against wrongdoers who were formerly associated with certain regulated or supervised entities, even if those persons are no longer employed in the industry.
- **Securities Investor Protection Corporation ("SIPC") Reforms, § 929H.** The Act increases the customer cash amount protected under the Securities Investor Protection Act from $100,000.00 to $250,000.00, and prohibits a member of SIPC with customer accounts from entering into an insolvency, receivership, or bankruptcy proceeding without the SIPC's consent.
- **Protecting Confidentiality of Materials Submitted to the SEC, § 929I.** Under the new provisions of the Act, the SEC may not be compelled to disclose information obtained from registered persons pursuant to the Investment Advisers Act unless done in an effort to comply with: a request from Congress or other federal agency; or an order of a U.S. court in an action brought by the United States or the SEC.
- **Maintaining Privileges for Information provided to the SEC, § 929K.** Information submitted to the SEC, which is subject to claims of government law enforcement and deliberative privileges, the attorney-client privilege, the work product doctrine protection, and other privileges, will remain subject to any of these privileges if shared by the SEC with other governmental agencies, self-regulatory organizations, the Public Company Accounting Oversight Board, or any state or foreign regulator. This provision is designed to enhance cooperation and coordination among regulators.

201 W. Hardy Callcott, *The Role of the SEC Under the House of Representatives Financial Services Reform Bill*, Bingham McCutchen LLP (Dec. 18, 2009), available at http://www.bingham.com/Media.aspx?MediaID=10062.

- **Increased Authority to Impose Monetary Penalties, § 929P(a).** The Act provides the SEC with new authority to impose monetary penalties in administrative cease-and-desist proceedings against "*any person*" for violations of securities laws. Previously, this penalty was available only against *registered persons*. Moreover, under the old provisions, the SEC was only able to obtain civil monetary penalties in enforcement actions filed in federal court. The Act now permits the SEC to seek monetary penalties in both administrative proceedings and civil enforcement actions.
- **Revisions to the Record Keeping Rule, § 929Q.** Under this section, the records of a person having custody or use of securities, deposits, or credits of a client that relate to such custody or use, are subject to "reasonable, periodic, special, or other examinations and other information and document requests by representatives of the SEC as the SEC deems necessary or appropriate to the public interest or for the protection of investors."
- **Proposed Study on Private Claims against Secondary Actors, § 929Z.** The Act requires the GAO to conduct a study on the "impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws." The GAO must consider the role of secondary actors in companies' issuance of securities, judicial decisions related to secondary liability under the securities laws, and the types of lawsuits decided under the Private Securities Litigation Reform Act. The GAO must make a report to Congress within one year of the passage of the Act.

CREDIT RATING AGENCIES

In addressing aspects of the recent financial crisis related to a perceived over-reliance on flawed credit ratings, the Act continues the process, already begun by the SEC, of intensifying the regulation of credit rating agencies. In particular, Congress concluded that inaccurate ratings of structured financial products contributed significantly to the adverse economic impacts caused by the mismanagement of risks by financial institutions and investors and determined that credit rating agencies' role as critical financial "gatekeepers" should subject them to the same standards of liability and oversight applicable to other participants in securities offerings, such as auditors and securities analysts. Although clearly targeting the ratings actions on structured finance securities, many of the Act's provisions will apply generally to the ratings process, including for issuers of unsecured debt securities.

The Act focuses principally on those credit rating agencies that qualify as nationally recognized statistical rating organizations ("NRSROs").[202] NRSROs play a key role in many federal and state statutes and regulations that tie regulatory requirements to credit ratings issued by NRSROs. Prior to adoption of the Act, the SEC exercised regulatory authority over NRSROs principally through the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act"), which, among other things, provides the process by which credit rating agencies apply to the SEC for registration as an NRSRO. The Rating Agency Act, which is largely codified in Section 15E of the Exchange Act, provides the SEC with rulemaking authority over NRSROs. The SEC has adopted and amended rules implementing the Rating Agency Act with the stated goal of fostering accountability, transparency, and competition in the credit rating industry.

The Act builds on this existing base of regulation by enhancing the SEC's power to oversee and regulate NRSROs; requiring NRSROs to adopt specified internal controls; expanding the scope of regulations intended to address conflicts of interest that may affect credit ratings issued by NRSROs; expanding the disclosure obligations of NRSROs to increase competition in the credit rating industry and add transparency to the ratings process; and (v) exposing credit rating agencies to greater potential liability to SEC enforcement actions, as well as private actions under the securities laws.

202 Ten credit rating agencies are currently registered as NRSROs, but Moody's Investors Service and Standard & Poor's dominate the industry.

INCREASED SEC REGULATION OF NRSROs

Section 932 of the Act directs the SEC to establish an Office of Credit Ratings (the "OCR") to administer the SEC's rules regarding NRSROs, to promote accuracy in credit ratings issued by NRSROs, and to ensure that conflicts of interest do not unduly influence credit ratings. The OCR will conduct, and make public the essential findings of, annual examinations of each NRSRO to review specified aspects of the NRSRO's business activities, including internal supervisory controls and management of conflicts of interest. By deeming an NRSRO's registration materials as "filed" with (rather than "furnished" to) the SEC, the Act subjects an NRSRO to many of the anti-fraud provisions of the securities laws, including Section 18 of the Exchange Act. The SEC is also given an expanded ability to establish penalties for, including a newly added ability to fine, NRSROs that violate the requirements and rules under Section 15E of the Exchange Act. Section 932 broadly empowers the SEC to suspend or permanently revoke the registration of an NRSRO with respect to a particular class or subclass of securities if the SEC finds that the NRSRO lacks adequate financial and managerial resources to consistently produce credit ratings with integrity. In making these determinations, the SEC must consider, along with such other factors as the SEC may determine, whether the NRSRO has failed to produce over a sustained period of time, as determined by the SEC, accurate ratings with respect to such securities.

ENHANCED INTERNAL CONTROLS AND CONFLICTS OF INTEREST

The Act requires each NRSRO to establish, maintain, enforce, and document, and submit to the SEC annual reports assessing the effectiveness of, an internal control structure governing the implementation of and adherence to policies, procedures and methodologies for determining credit ratings. Because this internal control structure expressly must consider such factors as the SEC may prescribe by rule, the full scope of the internal control structure is subject to continued rulemaking by the SEC.

Section 932 attempts to address the perceived conflicts of interest in the current "issuer-pays" model of the credit rating industry by directing the SEC to adopt rules preventing sales and marketing considerations from influencing the production of ratings. If an NRSRO violates these rules, and the SEC finds such violation to have affected a rating, the rules will provide for suspension or revocation of NRSRO status. As is the case with many aspects of the Act, the scope and details of the nexus between sales and marketing considerations and their potential affects on ratings is to be determined.

To address employee-based, "revolving door" conflicts of interest, Section 932 includes disclosure and review procedures relating to conflicts of interest that may arise when an employee of an NRSRO leaves to take a position with a person subject to, or a person related to a security subject to, a credit rating issued by the NRSRO. Specifically, Section 932 requires NRSROs to adopt and enforce policies and procedures reasonably designed to ensure that the NRSRO will review whether any conflicts of interest influenced a rating. They are also required to take appropriate action to revise a rating (in accordance with rules to be prescribed by the SEC) whenever a current employee of a person subject to a credit rating of the NRSRO or the issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating of the NRSRO was formerly employed by the NRSRO and participated in any capacity in determining credit ratings for such person or such security or money market instrument during the one-year period preceding the date an action was taken with respect to the credit rating. Furthermore, NRSROs must report to the SEC any instance in which the NRSRO knows or can reasonably be expected to know that any person formerly employed by the NRSRO within the past five years obtains employment with any obligor, issuer, underwriter, or sponsor of a security or money market instrument for which such NRSRO issued a credit rating in the past 12 months, if the former employee was a senior officer of the NRSRO or participated in, or supervised an employee that participated in, determining credit ratings for the such obligor, issuer, underwriter, or sponsor.

Section 939H of the Act further addresses conflicts of interest by expressing Congress's intent that the SEC exercise its rulemaking authority to prevent improper conflicts of interest arising from employees of NRSROs providing consulting, advisory, or other services unrelated to the issuance of credit ratings to the issuers of securities.

INCREASED TRANSPARENCY OF RATING METHODOLOGY

One goal of the new legislation is the creation of a more competitive ratings market by increasing the transparency of the ratings process and forcing NRSROs to compete on the basis of the accuracy of their ratings. This goal has been recognized by the SEC for some time, and the SEC has previously adopted rules to cause NRSROs to disclose information on ratings histories and to make information underlying initial ratings on structured finance securities available to other NRSROs wishing to provide unsolicited ratings on such securities.[203] Section 932 of the Act builds on the SEC's existing regulations by directing the SEC to issue rules requiring NRSROs to publicly disclose information on the initial credit rating determined for each type of obligor, security, and money market instrument and any subsequent changes to such credit ratings. At a minimum, these disclosures must be comparable among NRSROs so that users of credit ratings can compare them across the industry, be clear and informative for investors having a wide range of sophistication, include performance information over a range of years and a variety of types of credit ratings (including withdrawn ratings), be made easily available on each NRSRO's web site and in writing if requested, and be appropriate to the business model of an NRSRO. The disclosures must also include an attestation from the NRSRO affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and that such rating was an independent evaluation of the risks and merits of such instruments.

The Act addresses criticisms of NRSROs' inconsistent and delayed application of changes to rating methodologies by further requiring the SEC to issue rules requiring each NRSRO to (i) ensure that credit ratings are determined

203 17 C.F.R. § 240.17g-5 (2010).

using procedures and methodologies, including qualitative and quantitative data and models, that are approved by its board of directors and in accordance with its policies and procedures for developing and modifying credit rating procedures and methodologies; (ii) ensure that, when material changes to credit rating procedures and methodologies are made, the changes are applied consistently and within a reasonable time to then-current ratings (in the case of changes to surveillance procedures and methodologies) and the reason for the changes is disclosed; and (iii) notify users of credit ratings what version of a procedure or methodology was used for a particular credit rating, whether a material change has been made (including the likelihood that this change will affect current ratings), and when a significant error in a procedure or methodology is identified that may require credit rating actions.

The SEC is further directed to increase the transparency of rating methodologies and underlying information by requiring NRSROs to develop a form to accompany the publication of each credit rating that discloses information about assumptions underlying rating procedures and methodologies, the data relied upon to determine the rating, if applicable, how and with what frequency servicer or remittance reports were used to conduct surveillance of the rating, and any other information that can be used by users of credit ratings to better understand ratings in each class of rated securities. Qualitatively, the form must include: (1) the credit rating produced; (2) the main assumptions and principles used in the rating process; (3) the potential limitations of the credit rating, and the types of risks excluded from the credit rating that the NRSRO does not comment on, including liquidity, market, and other risks; (4) information on the uncertainty of the credit rating, including information on the reliability, accuracy, and quality of the data relied on in determining the credit rating and a statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited; (5) whether and to what extent third-party due diligence services have been used, a description of the information that such third party reviewed in conducting any such due diligence services, and a description of the findings or conclusions of such third party; (6) a description of the data about any obligor, issuer, security, or money market instrument that were relied upon for the purpose of determining the credit rating; (7) a statement containing an overall assessment of the quality of information available and considered in producing a rating for an obligor, security, or money market instrument, in relation to the quality of information available to the NRSRO in rating similar issuances; (8) information relating to conflicts of interest of the NRSRO; and (9) other information required by the SEC. Quantitatively, the form must include an explanation or measure of the potential volatility of the credit rating; information on the content of the rating, including the historical performance of the rating and the expected probability of default and the expected loss in the event of default; information on the sensitivity of the rating to assumptions made by the NRSRO (including five assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on a rating if the assumptions were proven false or inaccurate, and an analysis, using specific examples, of how each of those five assumptions affects a rating); and other information required by the SEC.

It is unclear from the Act whether the publication by an NRSRO of required general information about ratings and changes thereto, as well as individual ratings and the accompanying disclosure form, would involve the filing of such information with the SEC or be deemed part of the disclosure materials upon which investors may rely.

Finally, when asset-backed securities are being evaluated by an NRSRO, additional transparency is required under Section 932 with respect to due diligence investigations underlying credit ratings. Congress was clearly influenced by testimony directed to the perceived inadequacy of due diligence, particularly with respect to residential mortgage-backed securities subject to unreliable credit ratings, and concluded that the issuer or underwriter of any asset-backed security must make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter. Specifically, if an NRSRO, an issuer or an underwriter employs a third-party due diligence service provider in connection with a rating of an asset-backed security, that provider must provide the NRSRO with written certifications to ensure that the provider has conducted a thorough review of data, documentation, and other relevant information necessary for the NRSRO to provide an accurate rating. The SEC is directed to issue rules requiring each NRSRO to disclose such certification in a manner that allows the public to determine the adequacy and level of such due diligence services. The responsibility of the NRSRO, issuer, or underwriter for the accuracy and sufficiency of such certifications is unclear.

EXPANDED LIABILITY AND STATE OF MIND REQUIREMENTS IN PRIVATE ACTIONS

Section 933 extends the anti-fraud enforcement and penalty provisions of the entire Exchange Act to all credit rating agencies (not just NRSROs), whereas the present-day Exchange Act expressly excludes any private right of action against credit rating agencies. Specifically, these enforcement and penalty provisions apply to an undefined category of "statements made by a credit rating agency." The SEC may clarify what these "statements" entail in subsequent rulemaking, but for now it appears that credit rating agencies will be subject to the same Exchange Act liabilities that already apply to public accounting firms and securities analysts. Credit rating agencies will therefore be subject to, among other things, liability for misleading statements under Section 18 of the Exchange Act and class actions and private securities fraud actions under Section 21D of the Exchange Act. The Act further clarifies that statements by credit rating agencies will not be deemed forward-looking statements for purposes of the safe-harbor for forward-looking statements under Section 21E of the Exchange Act.

In conjunction with extending Exchange Act anti-fraud liability to credit rating agencies, Section 933 also modifies the "state of mind" requirements for plaintiffs to survive the pleadings stage of litigation against credit rating agencies. Under Section 933, plaintiffs need only plead with particularity facts giving rise to a strong inference that the credit rating agency "knowingly or recklessly failed . . . to 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 to obtain reasonable verification of such factual elements." The reasonable verification (which may be based on a sampling technique that does not amount to an audit) must come from other sources the credit rating agency considered to be competent and that were independent of the issuer and underwriter.

By not requiring plaintiffs to plead that a credit rating agency knowingly or recklessly engaged in a deceptive misrepresentation or omission in its statements, the new rule has the practical effect of allowing many more plaintiffs to survive a motion to dismiss. Once the complaint has survived a motion to dismiss, the discovery process begins, and the credit rating agency may be required to produce nonprivileged (but confidential) documents of a third party (such as an issuer or underwriter). The majority report of the Senate Committee on Banking, Housing and Urban Affairs states that, although the modified state of mind provision makes it easier for a plaintiff to pass the motion to dismiss stage of litigation, the modification does not change the fact-finder's standard for determining whether the basic elements of a fraud claim have been met. Another practical implication of the new state of mind standard will be the need to produce evidence of a "reasonable investigation or verification" of the factual elements relied upon in rating securities. Such evidence will likely become the target *du jour* of discovery requests because the evidence will help plaintiffs identify other potentially liable parties. Likewise, it will not be surprising to see an increase in cross-claims or claims for indemnification whereby credit rating agencies seek to recover costs and losses from third-party issuers, underwriters, and service providers who developed the factual statements relied upon in rating securities.

Accordingly, legal and compliance departments of credit rating agencies should coordinate with employees working on the front lines of rating securities to ensure proper documentation and retention of relevant evidence. Third parties should likewise coordinate with their employees because plaintiffs may bypass the credit rating agency altogether by issuing a non-party subpoena. In any event, confidentiality agreements usually obligate credit rating agencies and third parties to notify each other upon receipt of a request for documents, which preserves the parties' right to object prior to production of documents.

Finally, as foreshadowed by the SEC's 2009 Concept Release on Possible Rescission of Rule 436(g) under the Securities Act, Section 939G of the Act eliminates Rule 436(g) under the Securities Act, so that NRSROs are no longer exempt from possible "expert status" under Section 11 of the Securities Act. Subject to a "due diligence" defense, Section 11 imposes almost strict liability for experts who make material misstatements, or omit to state material facts, in portions of public registration statements attributable to them. As a practical matter, this change will require issuers to obtain an NRSRO's consent to include rating information in registration statements, although it remains unclear to what extent NRSROs will consent to being deemed "experts" for purposes of the Securities Act. Indeed, immediately following passage of the Act, NRSROs indicated they were unwilling to consent to the inclusion of rating information in registration statements relating to issuances of certain asset-backed securities as required by Regulation AB. To facilitate the issuance of these securities, the SEC issued a no-action letter on July 22, 2010 to permit the omission of this rating information for a period of six months.

REQUIREMENTS FOR NRSROs TO CONSIDER THIRD-PARTY INFORMATION AND TO REFER TIPS TO AUTHORITIES

Section 934 adds a mandatory whistleblowing provision requiring NRSROs to refer to the appropriate law enforcement or regulatory authority any information the NRSRO receives and finds credible suggesting that an issuer of securities rated by such NRSRO has committed or is committing a violation of law. NRSROs are not required to verify any such information, and the Act does not require the information to be provided in any tangible form. Presumably, NRSROs will be inclined to err on the side of disclosure if they receive marginally credible information of this nature. Section 935 requires NRSROs to consider information about an issuer that the NRSRO has or receives from a source (other than the issuer or underwriter) that the NRSRO finds credible and potentially significant to a rating decision. This provision does not require NRSROs to seek out such information, but it suggests that NRSROs will consider more closely press reports and information regarding issuers sent to the NRSRO from third parties.

UNIVERSAL RATING SYMBOLS

Congress reacted to arguments (for example, by state treasurers) that NRSROs apply stricter standards when rating municipal debt relative to corporate debt, thereby making it more difficult for a municipal debt instrument to receive the same rating as a corporate bond or asset-backed security. To address these potential discrepancies, Section 938 requires NRSROs to clearly define symbols used to denote credit ratings and apply such symbols consistently for all securities they rate. The Act permits NRSROs to use distinct credit rating symbols for different types of securities, thereby creating the potential for a proliferation of symbols specific to types of rated securities.

REMOVAL OF STATUTORY REFERENCES TO CREDIT RATINGS

Section 939 continues the process, also already begun by the SEC, of removing specific references to credit ratings by NRSROs from federal statutes and regulations (including the Federal Deposit Insurance Act, the Investment Company Act, and the Exchange Act) and replacing these references with generic references to creditworthiness, such as "meets standards of creditworthiness as established by the [relevant federal regulator]." Although Section 939 itself replaces specific references to NRSRO credit ratings only in certain specified statutes, each federal agency is directed to review all their regulations that require an assessment of creditworthiness of securities or money market instruments and replace references to or requirements for credit ratings with such standards of creditworthiness as the agency deems appropriate. In making such determinations, the agencies must seek to establish, to the extent feasible, uniform standards of creditworthiness, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of creditworthiness. These reviews and modifications must be completed within one year of passage of the Act. Given the extensive use of references to NRSRO credit ratings in critical federal statutes and regulations, significantly modified standards for assessing the creditworthiness of securities for regulatory purposes may have a material impact in a number of industries and financial markets.

ELIMINATION AND EXEMPTION FROM FAIR DISCLOSURE RULE

Regulation FD provides that when an issuer discloses material nonpublic information to certain individuals or entities—generally, securities market professionals, such as broker-dealers and investment advisers, or holders of the issuer's securities who may trade on the basis of the information—the issuer must make public disclosure of that information. Currently, disclosures made to credit rating agencies for the purpose of developing a credit rating are expressly exempt from Regulation FD. However, within 90 days of passage of the Act, the SEC is directed to remove this exemption. It is unclear whether a rating agency could avail itself of the exemption from the regulation for any person "who expressly agrees to maintain the disclosed information in confidence."[204] Accordingly, issuers will need to analyze disclosures of nonpublic information to rating agencies to determine if public disclosure is required under Regulation FD, and credit rating agencies may practically need to agree to maintain the confidentiality of such information to qualify for an exemption for disclosure under Regulation FD.

FUTURE STUDIES

Within one year of passage of the Act, the SEC is directed to report on their study of the feasibility and desirability of (i) standardizing credit rating terminology for all credit rating agencies; (ii) standardizing market stress conditions for evaluating ratings; (iii) requiring quantitative correspondence between ratings and ranges of default probabilities and loss expectations under standardized conditions of economic stress; and (iv) standardizing ratings terminology across asset classes. Within three years of passage of the Act, the SEC must report the results of its study of the independence of credit rating agencies and how independence affects credit ratings. To encourage NRSROs to provide more accurate ratings in light of the perceived conflicts of interest in the "issuer-pay" model of compensation, the Comptroller General will study alternative means of compensation for NRSROs. The Comptroller General will also study the feasibility and merits of creating a professional organization for rating analysts.

CONFLICTS OF INTEREST AND INITIAL CREDIT RATING ASSIGNMENTS FOR STRUCTURED FINANCE PRODUCTS

To address perceived conflicts of interest inherent in the current ratings process between NRSROs and issuers of structured finance products, Section 939F directs the SEC to study (i) the credit rating process for structured finance products and conflicts of interest associated with the current issuer-pay and subscriber-pay models; (ii) the feasibility of having a third-party assign NRSROs to rate specific structured finance products; (iii) the range of metrics that could be used to determine the accuracy of credit ratings; and (iv) alternative means for compensating NRSROs that would create incentives for accuracy. The SEC is to report its findings and recommendations within 24 months of passage of the Act. Once the SEC has submitted its report on this study, the SEC is directed to create rules that would establish a system for assigning NRSROs to determine the initial credit ratings of structured finance products in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the NRSRO that will issue and monitor the initial credit rating of the product. Section 939F directs the SEC to consider the so-called "Franken amendment" to the original Senate bill and to implement the system described in the amendment unless the SEC determines that an alternative system would better serve the public interest and the protection of investors. Whatever system emerges from the SEC's study of this issue, the resulting rules may introduce substantial changes to the existing process for obtaining ratings of structured finance products.

TIMING OF REGULATIONS

Unless explicitly stated otherwise, the SEC has one year after passage of the Act to issue any regulations relating to credit rating agencies.

204 Rule 100(b)(2)(ii)

ASSET-BACKED SECURITIES

The Act provides a number of material changes for the structured finance market. The credit risk retention requirement is arguably the most significant aspect of the legislation applicable to securitization. This requirement obligates originators/securitizers to retain credit exposure to their securitized assets in order to incentivize improved underwriting quality. Risk retention is not new; the topic has been under discussion almost since the financial crisis began. Other provisions of the Act applicable to securitizations focus primarily on increased disclosure and reporting requirements and reforming the rating agency process for structured finance investments. Under the Act, many of the details of the new regulatory scheme have been left for the regulators to flesh out in the near future.

The Office of the Comptroller of the Currency, the FDIC, the SEC, and the Federal Reserve will jointly prescribe regulations that require originators/securitizers of asset-backed securities to maintain a minimum of 5 percent of the credit risk of the underlying assets supporting the issuance of asset-backed securities. However, the regulators have the ability to impose lower credit risk retention requirements for certain assets and asset classes and allocate the requirement to retain credit risk between a securitizer and an originator in circumstances where a securitizer purchases assets from an originator. RMBS backed by certain high-quality underwritten mortgages will be exempt from the risk retention requirements. Certain qualifying CMBS products may also get relief from the risk retention rules. Hedging or otherwise transferring the retained credit risk through derivatives, insurance, or any other means is strictly prohibited.

For purposes of the credit risk retention requirement, the term "asset-backed securities" is broadly defined and includes "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on the cash flow from the asset." The definition goes further to specifically include CMOs, CBOs, CDOs, and CDOs of CDOs. We agree with the majority of commentators who believe CLOs are captured under the definition of "asset-backed securities" and will be subject to the risk retention requirement. There is a movement spearheaded by the Loan Syndications and Trading Association to exempt certain CLO products from some of the new regulations, including the credit risk retention rule. It will be interesting to see the final details of the new rules and which industries and lobbying groups were most successful in influencing the regulators.

Some critics of the new regulation have expressed concern that the requirement for 5 percent "skin in the game" will not be enough to promote the improvement of underwriting standards. Notably absent from the legislation is a detailed description of the type and form of the credit risk required to be held (*e.g.*, an equity position, a 5 percent vertical slice of all tranches of an issuer's capital structure, etc.). In the past, many originators/securitizers retained significant credit risk in the form of residual interests and junior tranches of securities. The ownership of these positions did not appear to result in improved underwriting quality of the related underlying assets.

There is a need to coordinate accounting standards with the new regulations. Strict interpretation of Financial Accounting Standards 166 and 167 makes it more difficult for securitization transactions, especially where the originator retains credit risk, to meet the conditions necessary for both a sale of assets for accounting purposes and the deconsolidation of the special purpose issuer, which is necessary for the seller to move the assets off balance sheet. These new accounting standards use "control" tests for the determination as to whether an originator of financial assets has surrendered control in connection with the sale of the asset and in connection with the activities of the special purpose issuer, as well as an analysis of the originator's obligation to absorb significant losses or right to significant benefits from the securitization. Credit risk retained pursuant to the new regulations may constitute a "controlling financial interest" for purposes of the new accounting rules and dissuade securitizers from structuring new deals if off balance sheet treatment is an important goal. This would be a disastrous outcome for the securitization market, especially if the banking regulators apply different capital and legal isolation standards to transactions based upon the accounting treatment. The Act directs regulators to examine and report on the combined impact of the credit risk retention requirement and Financial Accounting Standards 166 and 167 on the availability of credit, prior to any rulemaking.

Rating agencies will be required to disclose the representations, warranties, and enforcement mechanisms available to investors in rated securitized transactions and the aspects of the transactions that differ from other similar asset-backed transactions. This additional disclosure is intended to aid investors in their analysis of asset-backed securities. Some critics have argued that the Act does not go far enough and should have moved the industry closer to using standardized representations and warranties for asset classes. However, the market has seen how the adoption of standardization, such as recent proposals by the American Securitization Forum, can adversely affect the marketability of legacy or bespoke transactions.

The Act obligates securitizers to disclose fulfilled and unfulfilled repurchase requests across all of their transactions. As discussed below, it is difficult to criticize any of the new laws that promote heightened transparency. However, the mechanisms available for investors to force repurchases have been ineffective. Recent history has revealed that enforcement of repurchase claims is a difficult, costly, time-consuming process that often results in litigation and little recovery for the investors.

Important improvements in disclosure regarding a transaction's underlying assets are set forth in the new legislation. Standardization of data available to investors, including new requirements for individual asset-level data, is intended to aid investors when comparing securitization products. Sponsors of securitizations will also have to provide additional information on the brokers/originators, compensation for such parties, and the nature and amount of credit risk retained by the originator/securitizer. Increased disclosure is a positive step for the securitization market, boosting investor confidence and allowing investors to independently analyze and value the assets backing a securitization product. Nonetheless, there is the risk that the increased expense and effort will negatively affect the economic efficiency of structured finance transactions.

PREEMPTION

The scope of federal preemption of state consumer law under the National Bank Act ("NBA")[205] has been a major battleground in the legislative process—and promises to continue to be a battleground in the regulatory and litigation arenas long after financial regulatory reform is enacted into law. Since 1996, regulations of the OTS have declared that the federal regulatory scheme "occupies the entire field of lending regulation for federal savings associations," preempting state law.[206] In 2004, the Office of the Comptroller of the Currency ("OCC") adopted regulations finding that state laws that "obstruct, impair or condition a national bank's ability to fully exercise its Federally authorized" powers are preempted.[207] The OCC's regulations list whole categories of state laws directed at core banking activities of deposit-taking, non-real estate lending, and real estate lending that are, accordingly, preempted.

Supported by consumer advocates and state regulators, the Obama administration proposed strictly limiting federal preemption of state consumer financial regulation, arguing that state regulation would have curbed "predatory" consumer lending that contributed to the credit crisis. This was resisted not just by the banking industry but also by the OCC (under the continuing leadership of Bush appointee John Dugan), which argued that uniform national consumer laws are needed to enable nationally chartered financial institutions to offer consumer products on an interstate basis. The Act that has emerged throws the issue back to the regulators and the courts, but with new standards and procedural requirements designed to make the kind of sweeping, principled preemption advanced by the federal regulators more difficult to adopt and sustain.

205 12 U.S.C. § 21 *et. seq.*, and the Home Owners' Loan Act ("HOLA"), 12 U.S.C. § 1461 *et. seq.*
206 12 C.F.R. 560.2.
207 12 CFR 7.4009.

CONFLICT PREEMPTION REQUIRED

The Act provides that state consumer financial laws are preempted only if "in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in *Barnett Bank v. Nelson*,[208] the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers."[209] This standard makes clear that preemption must be based on a "conflict" theory rather than "occupation of the field." But it is less clear whether this standard will be construed, as state law proponents hope, to limit the scope of conflict preemption.

In *Barnett*, the Supreme Court found that a state law forbidding a bank's sale of insurance through a subsidiary was preempted by a federal statute intended to permit such activity, because the state law "stand[s] as an obstacle to the accomplishment" of one of the federal statute's purposes.[210] The Court explained that the history of national bank law litigation "is one of interpreting grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily preempting contrary state law."[211] Accordingly, the Court found that, in the absence of express language indicating that a federally granted power is subject to a local condition, "no such condition applies."[212] The Court noted that the case law takes the view that states may regulate banks only where "doing so does not prevent or significantly interfere with the national bank's exercise of its powers."[213]

The Act codifies this "prevents or significantly interferes with" *dicta*, while indicating that it is to be read in its *Barnett* context. As noted by the Supreme Court, this unanimous decision applied "ordinary preemption principles;"[214]consistent with

208 517 U.S. 25 (1996), § 1044(a).
209 The Act also provides for preemption where the state law would have a discriminatory effect on a national bank or federal savings bank, respectively, in comparison with the effect of the law on a bank chartered by that state; and the state law was preempted by a different federal law.
210 *Barnett Bank*, 517 U.S. at 31.
211 *Id.* at 32.
212 *Id.* at 34.
213 *Id.*
214 *Id.* at 28.

the multiple linguistic formulations of the conflict preemption standard that have been suggested by the case law.[215] The OCC, in fact, relied on *Barnett*'s conflict analysis, rather than field preemption, in adopting its preemption regulations.[216]

In support of its conflict preemption standard, the Act adds a "rule of construction" for both the NBA and HOLA stating that each "does not occupy the field in any area of State law."[217] The Act also contains an additional "rule of construction," which provides that its consumer protection title may not be construed as preempting state law obligations "except to the extent that any such provision of law is inconsistent with the provisions of this title, and then only to the extent of the inconsistency."[218] It further provides that state law is "not inconsistent with the provisions" of this title if the "protection" "that it affords to consumers is greater than the protection under this title."[219]

The interplay of all of these provisions will undoubtedly be the subject of future litigation. Proponents of state regulation will contend that Congress has indicated through these provisions an intent to subject the business of banking to state-imposed regulation that is more protective than federal rules. However, neither the *Barnett* standard nor these rules of construction would necessarily preclude adoption of broad preemption regulations, which bar enforcement of more consumer-friendly state law, on grounds that state regulation would significantly interfere with the powers of national banks to conduct the business of banking.

CASE-BY-CASE REQUIREMENT

A requirement that preemption regulations or orders must be made by the Comptroller on a "case-by-case basis" could prove a greater obstacle to broad regulatory preemption than the *Barnett* conflict standard. The Act defines "case-by-case basis" as "a determination made by the Comptroller concerning the impact of a particular State consumer financial law on any national bank that is subject to that law or the law of any other state with substantively equivalent terms."[220] This language may be construed to mean that the OCC must make preemption findings concerning "the impact of a particular State consumer finance law" on national banks, but may also adopt a general rule concerning other state laws "with substantively equivalent terms."[221] An additional provision, however, suggests that a determination to preempt similar state laws may require case-by-case consideration of each state law with the help of the Bureau of Consumer Financial Protection (the "Bureau"):

> (B) CONSULTATION. When making a determination on a case-by-case basis that a State consumer financial law of another State has substantively equivalent terms as one that the Comptroller is preempting, the Comptroller shall first consult with the Bureau of Consumer Financial Protection and shall take the views of the Bureau into account when making the determination.[222]

Opponents of federal preemption can be expected to argue that the case-by-case requirement means that the OCC must make a determination addressed to each state law it intends to preempt, or at least must describe with particularity which laws are "substantively equivalent."

Uncertainty regarding the scope of preemption is likely to be exacerbated by the differences between the Comptroller and the Bureau, which the Comptroller is obliged to consult (but not follow). Under the previously discussed "rule of construction," the Bureau will presumably be constrained to find that its regulations do not preempt state consumer rules

215 *Id.* at 28. *Barnett* recounted well-established preemption principles drawn from Supreme Court precedents:

> Sometimes courts, when facing the pre-emption question, find language in the federal statute that reveals an explicit congressional intent to pre-empt state law. *E.g., Jones v. Rath Packing Co.,* 430 U.S. 519, 525, 530-531 (1977). More often, explicit pre-emption language does not appear, or does not directly answer the question. In that event, courts must consider whether the federal statute's "structure and purpose," or nonspecific statutory language, nonetheless reveal a clear, but implicit, pre-emptive intent. *Id.*, at 525; *Fidelity Fed. Sav. & Loan Assn. v. De la Cuesta*, 458 U.S. 141, 152-153 (1982). A federal statute, for example, may create a scheme of federal regulation "so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it." *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947). Alternatively, federal law may be in "irreconcilable conflict" with state law. *Rice v. Norman Williams Co.*, 458 U.S. 654, 659 (1982). Compliance with both statutes, for example, may be a "physical impossibility," *Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142-143 (1963)*; or, the state law may "stan[d] as an obstance to the accomplishment and execution of the full purposes and objectives of Congress." *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

517 U.S. at 31.

216 69 Fed. Reg. 1904, 1910 (Jan. 13, 2004)

217 § 1041(a)(1).

218 § 1041(a)(1).

219 § 1041(a)(2).

220 § 1044(a).

221 *Id.*

222 *Id.*

that provide "greater protection" than the federal rules. But even where the Bureau found that a "more protective" state law was not preempted by its regulation, the Comptroller could determine that the same state rule is preempted by the Bureau's federal standard, on grounds that multiple state requirements would interfere with the powers of national banks to provide interstate banking services.

JUDICIAL REVIEW

The meaning of the *Barnett* standard and whether the Comptroller has complied with the "case-by-case" requirement will, of course, be determined by the courts on judicial review. The Act provides a special directive for judicial review of a preemption decision by the Comptroller, stating that the court "shall assess the validity of such determinations, depending upon the thoroughness evident in the consideration of the agency, the validity of the reasoning of the agency, the consistency with other valid determinations made by the agency, and other factors which the court finds persuasive and relevant to its decision." These are factors that would, of course, ordinarily be considered by a reviewing court. The provision may, however, be used by litigants to argue for more searching judicial scrutiny of OCC preemption decisions: courts may require more to show such "thoroughness" than is ordinarily required by the arbitrary and capricious standard.

JUDICIAL ENFORCEMENT OF PREEMPTING REGULATIONS

The Act also contains a provision addressing the use of a preemptive regulation as a defense to a state law enforcement proceeding. It provides that no regulation or order of the Comptroller can be interpreted or applied to preempt a provision of state consumer law "unless substantial evidence, made on the record of the proceeding, supports the specific finding regarding the preemption of such provision in accordance with the legal standard of" *Barnett*.[223] This requirement of a "specific finding" of preemption supported by "substantial evidence" is unlikely to make any practical difference in cases in which a preemption regulation clearly addressed to the state law exists. In other contexts it might, however, be used to argue that defendants must produce "substantial evidence" of interference with their ability to exercise bank powers to support preemption.

223 § 1044(a).

WATTERS OVERTURNED; *CUOMO* CODIFIED

The Act provides that subsidiaries of federal financial institutions that are not themselves federally chartered are fully subject to state law, thus overturning the Supreme Court's decision in *Watters v. Wachovia Bank*.[224] It further provides that federal visitorial powers should not be construed to prevent states from bringing enforcement actions against a national bank "[I]n accordance with the decision of the Supreme Court of the United States in *Cuomo v. Clearing House Assn., L.L.C.*, ___ U.S. ___, 129 S. Ct. 2710 (2009)."[225]

STATE ENFORCEMENT AUTHORITY

The Act gives states an unusual role in enforcing the federal standards.[226] The Act empowers state attorneys general and regulators to enforce the federal consumer law enacted by the Act against state-chartered institutions. The Act also empowers a state attorney general to bring a civil action in a federal or state court to enforce regulations issued by the Bureau against a national bank or federal savings association.[227] The Act does not however, include the authorization that was part of the original House bill to sue as *parens patriae*, which could have enabled state authorities to sue for damages incurred by their citizens. However, before ini-

224 550 U.S. 1 (2007); § 1044(a).
225 § 1047.
226 The bill also gives states the power to compel the Bureau to initiate a rulemaking where "a majority of the States has enacted a resolution in support of the establishment or modification of a consumer protection regulation by the Bureau." § 1041(c).
227 § 1042(a)(2).

tiating any action in court or other administrative regulatory proceeding, the state attorney general is required to provide a copy of his complaint to the Bureau, which is authorized to intervene in the action as a party and remove the case to federal court.[228]

CONCLUSION

The Act requires the Comptroller to conduct a review of each preemption determination through public notice and comment within five years after the determination is made and make a determination whether to continue or rescind the determination. This will, presumably, compel the Comptroller to subject his 2004 regulations (and the 1996 regulation of the OTS) to this administrative review process soon after these provisions become effective (which is at the “transfer date” that will occur from six to 12 months after the statute is enacted).

It is not clear whether or the degree to which the OCC will seek to maintain an effective regime of federal preemption. John Dugan’s five-year term as Comptroller expired on August 4, 2010. Preemption of state law will be among the first and most important problems facing his successor.

The absence of clear preemption rules would, of course, significantly complicate efforts of financial institutions to offer consumer products and services on a uniform, national basis, and could subject nationally chartered institutions to an array of state law enforcement and damage actions. The new law will not necessarily prevent the new Comptroller from creating an effective regime of federal preemption. But it will require him or her to make less general, more specific “case-by-case” determinations of the state laws that are preempted. The more limited, specific preemption regulations that the Act seeks to require will likely create large areas of uncertainty that will only be resolved through litigation.

228 § 1042(b)(2)(A).

CONSUMER PROTECTION

This section covers Title X and Title XIV of the Act. Title X, otherwise known as the Consumer Financial Protection Act of 2010, establishes the Bureau of Consumer Financial Protection (the "Bureau") within the Federal Reserve System, charged with regulating "the offering and provision of consumer financial products or services under the Federal consumer protection laws." Title XIV, the Mortgage Reform and Anti-Predatory Lending Act, reforms consumer mortgage practices by amending the Truth in Lending Act ("TILA") to provide accountability for such practices and to set minimum standards for consumer mortgage loans.

Both Title X and Title XIV are designed to establish federal consumer financial laws with the goal of ensuring fair, transparent, and competitive markets for consumer financial products and mortgage lending activities. In addition to amending existing laws applicable to specific types of consumer financial products and lending practices, the Act imposes new disclosure requirements and fiduciary duties on those who sell consumer financial products or provide residential mortgage loans, in an effort to provide consumers with maximum information about the products or services they are purchasing. As with other parts of the Act, the creation of bureaucratic entities, the delays in regulatory rulemaking, the imposition of fiduciary duties, and the expansion of civil liability, taken together, will likely increase costs and uncertainty for lenders and borrowers, having the unintended consequence of decreasing opportunities for consumers to borrow in the short term.

TITLE X: THE CONSUMER FINANCIAL PROTECTION BUREAU

Structure of the Bureau. While the Federal Reserve officially houses the Bureau, the director of the Bureau (the "Director") will be appointed by the President, subject to Senate confirmation, to five-year terms. In addition, the Act includes provisions meant to preserve the autonomy of the Bureau despite being a part of the Federal Reserve System.

- The Federal Reserve may delegate the authority to the Bureau to examine persons subject to the Federal Reserve's jurisdiction for compliance with consumer financial protection laws. But the Federal Reserve may not interfere or intervene in any matters pending before the Bureau, including with regard to examination and enforcement, unless specifically allowed by law.
- The Federal Reserve has no authority to appoint or remove employees of the Bureau and may not consolidate the functions of the Bureau with any functions of the Federal Reserve.
- Any rule or order issued by the Bureau will not be subject to review by the Federal Reserve.
- The Director may periodically designate a percentage of the Federal Reserve System's earnings for transfer to the Bureau, subject to statutory maximums.

Bureau Functions and Authority. The consumer financial protection functions of the Federal Reserve, OCC, OTS, FDIC, NCUA, HUD, and FTC are effectively transferred to and consolidated in the Bureau, subject to the back-up enforcement authority of those institutions. The Act enumerates six primary functions of the Bureau:

- Conducting financial education programs;
- Collecting, investigating, and responding to consumer complaints;
- Collecting and publishing information about the market for consumer financial products and identifying consumer risks;
- Supervising persons that offer consumer financial products and services;
- Undertaking enforcement actions to address violations of federal consumer financial law; and
- Issuing rules, orders, and guidance to implement federal consumer financial law.

The Bureau possesses almost exclusive rulemaking authority, subject to some shared authority with the FTC, to implement consumer financial protection laws. But this authority is checked by a requirement that it consult with the Federal Reserve, OCC, and FDIC and publish any objections logged by those agencies. Bureau-proposed rules are also subject to a public comment phase and the ability of the Council to set aside any rule adopted by the Bureau that puts the safety and soundness of the banking system or the stability of the financial system at risk.

The Act also imbues the Bureau with the exclusive responsibility to supervise, including requiring reports from and conducting examinations of many nonbank institutions that provide consumers with financial products or services, including mortgage loan originators, brokers and servicers, and mortgage loan modification and foreclosure relief service providers. In addition, the Bureau will supervise any "larger participant" (as defined by rule adopted post-enactment) in the consumer financial products and services markets. This supervisory authority may extend to nonbank subsidiaries of traditional insured banks and entities that provide services to supervised institutions.

The Bureau's primary authority to supervise and enforce applies only to institutions with total assets of more than $10 billion, which does not include most institutions. Smaller institutions remain under the supervisory and rulemaking authority of their prudential regulators, and the Bureau may request reports and conduct examinations only on a "sampling basis." Several exemptions also exist for retailers extending credit to customers for the purchase of nonfinancial goods or services; certain business types such as real estate brokerages and persons regulated by a state security commission, among others; and activities related to the writing of insurance or reinsurance.

Preemption Provisions of Subtitle D. Federal consumer protection regulations enacted to implement Title X preempt state consumer financial protection laws to the extent that they conflict with such federal regulation. Where state law does not directly conflict with or provide for less consumer protection than federal law, state law remains intact. State laws enacting stricter standards for consumer protection than federal law provides are not in conflict with federal law under the Act. In addition, the application of a state consumer financial protection law to a national bank or federal thrift is only preempted if:

- Application of the state law would have a discriminatory effect in favor of state-chartered institutions;
- The state law conflicts with the preemption standard in *Barnett Bank v. Nelson* (a stringent standard preempting only those state laws that prevent or significantly interfere with the operation of a national bank's powers), as determined by the OCC or a state court; or
- The state law is preempted by another federal law.

These preemption protections do not apply to nonbank subsidiaries and affiliates of national banks and federal thrifts, however. Nonbank subsidiaries and affiliates are subject to state law to the same extent as it would apply to any other nonbank entity.

State attorneys are also given the power to enforce the Act or the Bureau's regulations in state and federal court, and state regulators maintain enforcement power over state-chartered institutions with regard to the Bureau's regulations. State attorneys may not, however, institute "class action-like lawsuits" against national banks and federal thrifts. The enforcement power of state attorneys is also subject to review and potential intervention by the Bureau.

TITLE XIV: THE MORTGAGE REFORM AND ANTI-PREDATORY LENDING ACT[229]

Fiduciary Standards for Residential Mortgage Loan Origination.[230] The Act amends TILA (by designating the second section of Section 129 as 129A and adding a new Section 129B) in order to prescribe fiduciary standards for originators of residential mortgages, to ensure that consumers are offered such loans on terms that "reasonably reflect their ability to repay."[231] Prior to making a residential mortgage loan, creditors must make a "reasonable and good faith determination based on verified and documented information" that the consumer has a reasonable ability to repay the loan, all applicable taxes, insurance, assessments, and other mortgage loans, if applicable.

To make such determinations, a creditor must consider the consumer's credit history, current income, expected income, current obligations, debt-to-income ratio, employment status, and the consumer's financial resources, other than the

229 One provision in the Act not covered in detail in this section is the creation of an Office of Housing Counseling within HUD, which will be responsible for implementing certain procedures, providing consumer counseling and distributing informational materials to consumers. H.R. 4173, § 1442. Also not discussed in detail are certain mortgage servicing requirements that, *inter alia*, require mortgage lenders to establish escrow or impound accounts for the payment of taxes, hazard insurance, and other applicable insurance and periodic payments. H.R. 4173, § 1461.

230 The fiduciary standards outlined in this subsection do not apply to reverse mortgage or temporary bridge loans with a terms of 12 months or less, including any loan to purchase a new dwelling when the consumer plans to sell a different dwelling within 12 months. H.R. 4173, § 1411.

231 H.R. 4173, § 1402; H.R. 4173, § 1411.

consumer's equity in the property that secures the mortgage.[232] For standard loans, a creditor must determine the ability of the consumer to repay using a payment schedule that fully amortizes the loan over the term of the loan. Nonstandard loans require different methods—variable loans that defer repayment of principal or interest require a creditor to use a fully amortizing repayment schedule, whereas for an interest-only loan, a creditor must use the payment amount required to amortize the loan by its final maturity.[233]

The Act establishes a presumption that a creditor satisfies the requirements ensuring a consumer's ability to repay if the loan is a "qualified mortgage."[234]

The Act also establishes a duty of care that requires mortgage originators[235] to be qualified and, when required, registered and licensed in accordance with applicable state and federal law.[236]

232 Creditors must assess the consumer's ability to repay using a fully amortizing payment schedule. Creditors must verify the consumer's income by reviewing the consumer's IRS Form W-2, tax returns, payroll receipts, bank records, or other third-party documents. H.R. 4173, § 1411.

233 H.R. 4173, § 1411.

234 A "qualified mortgage" is any residential mortgage loan with the following characteristics: (a) the regular payments do not (i) result in an increase of the principal balance or (ii) allow the consumer to defer repayment of the principal; (b) the terms do not result in a balloon payment (*i.e.*, a scheduled payment that is more than twice as large as the average of earlier scheduled payments); (c) the income and financial resources relied upon are verified and documented; (d) the underwriting (for a fixed rate loan) is based on a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments; (e) the underwriting (for an adjustable rate loan) is based on the maximum rate permitted under the loan during the first five years, and a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments; (f) complies with any guidelines or regulations established by the Federal Reserve relating to ratios of total monthly debt to monthly income, or alternative measures of ability to pay regular expenses after payment of total monthly debt; (g) the total points and fees payable in connection with the loan do not exceed 3 percent of the total mortgage amount; (i) the term does not exceed 30 years; and (j) for a reverse mortgage, meets all the standards for a qualified mortgage, as set by the Federal Reserve. H.R. 4173, § 1412.

235 "Mortgage originator" is defined as "any person who, for direct or indirect compensation or gain ... (i) takes a residential loan application; (ii) assists a consumer in obtaining or applying to obtain a residential mortgage loan; or (iii) offers or negotiates terms of a residential mortgage loan." The definition also includes "anyone who represents to the public ... that such person can provide any of the activities described [above]." The definition specifically excludes persons "who perform purely administrative or clerical tasks on behalf of a person" described above, "an employee of a retailer of manufactured homes... who does not advise a consumer on loan terms," persons that only perform real estate brokerage activities, and mortgage servicers. H.R. 4173, § 1401.

236 The Federal Reserve will prescribe regulations to require depository institutions to establish procedures to ensure and monitor compliance of the institutions, their subsidiaries, and employees. H.R. 4173, § 1402.

Prohibition of Steering Incentives. Mortgage originators are prohibited from receiving compensation that varies based on the terms of the loan, other than the principal amount, a practice known as "steering incentives."[237] In general, a mortgage originator may not receive an origination fee or any other charge (except *bona fide* third-party charges) from someone other than the consumer, unless the mortgage originator does not receive any compensation from the consumer and the consumer does not make an upfront payment.

The Federal Reserve is authorized to prohibit mortgage originators from steering consumers to residential mortgage loans where the consumer lacks a reasonable ability to repay or that have predatory characteristics or effects (such as equity stripping, excessive fees, or abusive terms). The Federal Reserve must also prohibit mortgage originators from steering consumers away from qualified mortgages to unqualified mortgages; conducting abusive or unfair lending practices that promote disparities among consumers of equal creditworthiness but of different race, gender, age, or ethnicity; and mischaracterizing a consumer's credit history or the appraisal value of a property.[238]

Additional Standards and Requirements. A residential mortgage that is not a qualified mortgage may not contain terms requiring a consumer to pay a prepayment penalty.[239] For the purposes of this subsection, "qualified mortgage" does not include a residential mortgage that has an adjustable rate or has an annual percentage rate that exceeds the average prime offer rate by specified percentage points according to comparable circumstances.

A qualified mortgage may not require a consumer to pay a prepayment penalty that exceeds 3 percent of the outstanding loan balance during the first year; 2 percent of the outstanding loan balance during the second year; or 1 percent of the outstanding loan balance after the third year. After the end of the three-year period beginning on the date the loan is consummated, no prepayment penalty may be imposed on a qualified mortgage. Additionally, a creditor may not

237 H.R. 4173, § 1403.

238 H.R. 4173, § 1403. The maximum liability of a mortgage originator for failing to comply with this section will not exceed the greater of actual damages or three times the total amount of direct or indirect compensation or gain accruing to the mortgage originator in connection with the mortgage involved in the violation, plus the cost to the consumer, including reasonable attorneys' fees. H.R. 4173, § 1404.

239 H.R. 4173, § 1414.

offer a consumer a residential mortgage that has a prepayment penalty without offering the consumer a residential mortgage that does not have a prepayment penalty as a term of the loan.

No creditor may finance any life, disability, unemployment, property, accident, loss-of-income, or health insurance, or any payments for debt cancellation or suspension agreement or contract, in connection with any residential mortgage or extension of credit secured by the principal dwelling of the consumer.[240] Insurance premiums or debt cancellation or suspension fees calculated and paid in full on a monthly basis will not be considered as financed by the creditor for purposes of this subsection. Also, this subsection does not apply to credit unemployment insurance under certain enumerated circumstances.

The Act also exempts a creditor or assignee from liability to an obligor under this section if the obligor or co-obligor have been convicted of obtaining the residential mortgage loan by actual fraud.[241]

High-Cost Mortgages. The Act further amends TILA by setting standards for points and fees related to high-cost mortgages,[242] open-end consumer credit plans, and *bona fide* discount points and prepayment penalties.

For example, the Act prohibits high-cost mortgages from containing balloon payments, *i.e.*, a scheduled payment that is more than twice as large as the average of earlier scheduled payments.[243] In addition, a creditor must not recommend default on an existing loan in connection with the closing of a high-cost mortgage that refinances all or any portion of such existing loan or debt.[244] Creditors are also prohibited from imposing late payment fees on a high-cost mortgage that is in excess of 4 percent of the payment past due, unless the loan documents specifically authorize the charge, or more than once with respect to a single late payment. Lastly, a high-cost mortgage may not contain a provision permitting the creditor to accelerate the indebtedness, except when repayment of the loan is accelerated by a default in payment, due to a due-on-sale provision or pursuant to a material violation of the loan unrelated to payment.[245]

There is a safe harbor provision for creditors who fail to comply with these provisions. Such safe harbor occurs if, within 30 days of the loan closing or 60 days of discovery, the creditors make the necessary adjustments to the loan so as to either satisfy the requirements of this section or change the terms so that the loan will no longer qualify as a high-cost mortgage.[246]

Appraisal Activities. A creditor may not extend a higher-risk mortgage[247] without first obtaining a written appraisal of the property to be mortgaged.[248] An appraisal of the property must be performed by a certified and licensed appraiser who conducts a physical property visit of the interior of the mortgaged property. If the purpose of the higher-risk mortgage is to finance the purchase of the property within 180 days of the purchase of such property at a price that is lower than the current sale price, the creditor must obtain a second appraisal from a different certified or licensed appraiser. The second appraisal must include an analysis of the difference in sale prices, changes in market conditions, and any improvements made to the property between the previous sale and the current sale.[249]

240 H.R. 4173, § 1414.
241 H.R. 4173, § 1417.
242 A "high-cost mortgage" means a consumer credit transaction (other than reverse mortgages) that is secured by the consumer's principal dwelling, where (a) the total points and fees payable (other than *bona fide* third-party charges not retained by the mortgage originator) exceed 5 percent of the total transaction amount for transactions of more than $20,000 or the lesser of 8 percent or $1,000 for transactions below $20,000, or (b) the credit transaction documents permit the creditor to charge prepayment fees or penalties more than 36 months after the transaction closing or such fees or penalties exceed more than 2 percent of the amount prepaid. H.R. 4173, § 1431.
243 H.R. 4173, § 1432.
244 H.R. 4173, § 1433.
245 H.R. 4173, § 1433.
246 H.R. 4173, § 1433.
247 A "higher-risk mortgage" means a residential mortgage loan (other than a reverse mortgage loan that is a qualified mortgage) that is secured by a principal dwelling, is not a qualified mortgage, and has an APR that exceeds the average offer rate for a comparable transaction by either 1.5 percent or 2.5 percent or more in the case of first lien mortgage loans (the latter applies when the mortgage's principal exceeds the amount of the maximum limitation on the original principal obligation of a mortgage of a comparable residence), or 3.5 percent or more for a subordinate lien mortgage loan. H.R. 4173, § 1471.
248 H.R. 4173, § 1471.
249 H.R. 4173, § 1471.

In addition, when extending credit secured by the principal dwelling of the consumer, the Act makes it unlawful to engage in any act or practice that violates appraisal independence. An appraiser conducting an appraisal may not have any interest in the property, whether direct or indirect, financial or otherwise. If, at or before consummation, a creditor knows of a violation of the appraisal independence standards, the creditor may not extend credit based on such appraisal unless the creditor documents that the creditor has acted with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of such dwelling.[250]

250 H.R. 4173, § 1472.