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Dodd Frank: One Year Later

Key Current Issues for Financial Institutions

One year after President Obama signed the Dodd-Frank Act, Congress, the Administration, financial institutions, their regulators and the American public are stepping back and asking where we stand today. Although global and domestic financial institutions and markets have largely stabilized, they remain under pressure from a variety of sources, including slow U.S. economic growth, a looming European debt crisis, potential economic challenges in Asia, and a relatively high degree of geo-political volatility. These and other considerations make it difficult to assess the true impact of the Dodd-Frank Act, which is widely viewed as the most significant U.S. financial services legislation in generations. Critics have suggested that the Act failed to accomplish its main goals—including solving "too big to fail" (a multi-faceted policy challenge). And whether the Act will effectively address the root causes of the financial crisis will remain an open question, at least as long as there is a lack of consensus regarding what those root causes were.

So, where do we stand on the first anniversary of the Dodd-Frank Act? We are at only the beginning of a multi-year regulatory implementation process, with the vast majority of regulatory standards yet to be implemented. Regulators are under pressure to write significant numbers of regulations that address complex issues and, in some cases must implement ambiguous statutory provisions. They face pressure from some on Capitol Hill to write the rules quickly but at the same time satisfy frequently conflicting views as to the legislative intent behind the laws they must implement—a daunting challenge. Regulators have begun to miss statutory deadlines and are likely to miss many more. Prospects for the enactment of a technical corrections bill, which was predicted with near certainty in the final days of the Dodd-Frank legislative process, remain dim.

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For many institutions, the persistent lack of certainty around potentially major regulatory requirements presents an independent challenge. Yet most institutions would rather see implementation of the Act take as long as necessary to avoid what virtually all observers recognize is a risk of potentially serious unintended consequences. In the meantime, financial institutions are actively planning their business and compliance strategies using their best judgments about future implementation of the Act. This is particularly difficult for internationally active financial institutions—whether based in the United States or abroad—which must address a range of cross-border issues that have emerged as a result of the Act, including potentially conflicting requirements in areas such as derivatives regulation, resolution planning, capital requirements and activities restrictions.

In short, as challenging as this first year has been, we stand at the beginning of a long road. In this memorandum, we review current issues facing financial institutions and their regulators, important new requirements that have been implemented thus far, and key areas to watch in the coming months.

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I. EXECUTIVE SUMMARY

In every subject area of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[1] (the "Act") that we covered in our Dodd-Frank memorandum last year, many key issues and new requirements remain open or unaddressed pending adoption of final implementing regulations. We have organized this first anniversary update largely around the same subject areas, with a few exceptions to reflect current areas of focus.

- **Systemic Risk and Financial Stability.** The new regulatory framework for overseeing systemic risk has begun to take shape, but many issues have yet to be resolved. The Financial Stability Oversight Council (the "Council") has proposed rules for the designation of nonbank financial companies as systemically important, subjecting them to enhanced supervision and regulation by the Board of Governors of the Federal Reserve System (the "Fed"), but it has not yet finalized the rules or exercised its authority to designate a nonbank financial company. The Council has, however, finalized rules for the designation of financial market utilities ("FMUs") as systemically important. Authority over thrifts and savings and loan holding companies ("SLHCs") has been transferred from the Office of Thrift Supervision (the "OTS") to the other Federal banking agencies, which are moving forward with rules and guidance to implement new capital requirements and other substantive regulations. At the same time, many of the most significant rulemakings have yet to be proposed, and financial institutions should expect major rulemakings in the coming months, including those implementing the Volcker Rule, strengthening capital requirements, establishing prudential standards for systemically important financial institutions ("SIFIs"), and placing new restrictions on transactions with affiliates.

- **The Volcker Rule.** The Volcker Rule[2] will prohibit banking entities from engaging in some types of proprietary trading and limit their ability to sponsor or invest in hedge funds or private equity funds. Rules to implement the Volcker Rule's substantive prohibitions have not been proposed, although a Council study and the Fed's final rules implementing the Volcker Rule transition period provide some clues on how it may be implemented. Despite the uncertainty, banks and other industry participants are actively engaged in structuring their activities and operations to comply with the Volcker Rule. Although the Act requires final rules to be promulgated by October 2011, proposed rules are not expected until August or September, suggesting that the agencies will likely miss the October deadline.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-230, 124 Stat. 1376 (2010).

[2] The Act, § 619.

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- **Orderly Liquidation Authority.** The Federal Deposit Insurance Corporation (the "FDIC") finalized rules implementing certain provisions of Orderly Liquidation Authority ("OLA") in July 2011. The final rules address the priority of unsecured claims, the administrative claims process, the treatment of secured creditors and the recoupment of executive compensation. They lack any provisions specifying how the "minimum recovery" requirement will be satisfied by the FDIC or clarifying the interplay between OLA and the Securities Investor Protection Act ("SIPA") in the resolution of a systemically significant broker-dealer. Future rulemakings are expected to address some of the issues missing from the final rules.

- **Resolution Plans ("Living Wills").** In April 2011, the FDIC and the Fed proposed rules implementing Section 165(d) of the Act, which requires certain systemically important financial companies to submit resolution plans describing their potential resolution under the Bankruptcy Code (the "Bankruptcy Code") in a manner that mitigates serious adverse effects to U.S. financial stability. Although the FDIC announced in a board meeting that it expects final rules (due in January 2012) to be issued by the end of August 2011, this seems likely to slip until later this year. The proposed rules describe which companies would be required to submit plans, the contents of the plans, the timing by which covered companies must submit plans and the consequences of filing a deficient plan.

- **Over-the-Counter Derivatives Regulation.** The rulemaking process for implementing Title VII of the Act has proved to be far more complex and time-consuming than Congress anticipated. Although the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC") have, taken together, published 73 proposed and interim final rules, only 6 final rules have been adopted. In several key areas—such as business conduct standards and margin requirements for swap and security-based swap dealers ("SDs") and major swap and security-based swap participants ("MSPs"), regulation of swap and security-based swap execution facilities ("SEFs") and real-time public reporting requirements—commenters have raised significant concerns with the proposed rules. Additionally, significant inconsistencies exist in the agencies' proposals, despite Congressional directions to the contrary. Moreover, neither regulator has provided extensive guidance on key matters of scope, such as the regulation of cross-border activity, the definition of U.S. person or treatment of inter-affiliate transactions, significantly complicating the efforts of many market professionals to structure their derivatives businesses in anticipation of the full implementation of Title VII.

- **Corporate Governance and Executive Compensation**. With respect to the new Federal regulation of incentive compensation paid by "covered financial institutions" that is mandated by the Act, proposed rules were published jointly by the Federal regulators in April 2011 and are expected to be finalized by the end of the year. Other than the new "Say on Pay," "Say When on Pay" and "Say on Golden Parachute" rules that went into effect this past proxy season for all publicly listed U.S. companies, the implementation of the Act's other corporate governance and executive compensation disclosure reforms is still pending the publication of proposed and/or final rules.

- **Securitization and Credit Rating Agency Reform**. The SEC and Federal banking agencies have proposed regulations implementing the risk retention rule and certain exemptions mandated by the Act. In addition, various Federal agencies have proposed or adopted different sets of rules and amendments to carry out the Act's mandates to remove references to credit ratings and to address concerns relating to the integrity and accuracy of ratings.

- **Investor Protection**.

  - **Morrison v. National Australia Bank**. The Supreme Court's landmark 2010 decision in Morrison v. National Australia Bank set forth a "transactional" test that greatly constricted the extraterritorial reach of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"). Within a month of that decision, however, the Act restored the power of the SEC and the Department of Justice (the "DOJ") under Section 10(b) to the broader, "conduct-effects" test that prevailed before Morrison. While leaving the transactional test in place for private rights for the time being, Dodd Frank requires the SEC to conduct a study (due January 2012) on whether Congress should partially or wholly restore the conduct-effects test for private rights of action as well. In the meantime, the transactional test has resulted in the dismissal of many private Section 10(b) actions by lower courts, often involving foreign issuers, that would have survived under the conduct-effects test.

  - **Fiduciary Standard for Brokers, Dealers and Investment Advisers**. The SEC released its study and recommendations on applying the standard of conduct required of investment advisers to brokers and dealers providing personalized investment advice and recommendations to retail customers about securities, as mandated by the Act.

  - **Whistleblower Bounty Program.** As required by the Act, the SEC has created a program (effective August 12, 2011) to provide rewards or "bounties" to certain whistleblowers. Qualifying whistleblowers who volunteer original information to the SEC about a violation of the U.S. securities laws that leads to a successful enforcement action and monetary recovery by the SEC of over $1,000,000 can receive from 10% to 30% of the monetary recovery. The final rules are controversial because they do not require whistleblowers to first report suspected violations internally before contacting the SEC.

  - **Disqualification of "Bad Actors".** The SEC has proposed amendments to Rule 506 of Securities Act of 1933 (the "Securities Act") Regulation D that would prohibit certain felons and other "bad actors" from participating in offerings that are exempt from registration under that rule.

  - **Municipal Securities Rulemaking Board.** The Act subjects municipal advisers to SEC registration requirements and the regulatory jurisdiction of the Municipal Securities Rulemaking Board (the "MSRB"). The SEC has promulgated a temporary rule requiring the registration of municipal adviser firms, and the MSRB has extended its fair dealing rule—and proposed a number of other rules that would apply—to such firms and persons associated with them.

- **Private Fund Reforms**. The Act repealed the "15-client exemption", but the SEC's final rules and rule amendments under the Investment Advisers Act of 1940 (the "Advisers Act") to implement provisions of Title IV of the Act establish new exemptions from registration. This will ultimately result in the registration of many hedge fund and private equity fund advisers, as well as non-U.S. advisers with limited activities involving U.S. clients or management of funds with U.S. investors, unless they can rely on one of the new narrow exemptions. The final rules extend until March 30, 2012, the July 21, 2011 deadline previously set by the Act for registration of advisers that are no longer exempt under the Advisers Act as a result of the repeal of the "15-client exemption."

- **Tax Issues**. Although the Act contains only one provision amending the Internal Revenue Code, the sweeping changes to the structure of the financial markets and the conduct of business by financial institutions required by the Act have numerous tax implications. Among the most significant issues of these are: (1) the tax consequences for financial institutions and their customers of the centralization of customer business in particular types of financial institutions (e.g., nonbanks) or in "home country" financial institutions, as a result of swap dealer registration rules, the swaps push-out rule and possibly "living will" requirements; (2) novel tax issues raised by the clearing of swaps through centralized swap clearinghouses; (3) the tax consequences of restructurings required by the Volcker Rule's restrictions on proprietary trading and on hedge fund and private equity fund investments; and (4) new rules governing the amount and types of capital that financial institutions must raise, in particular the still-emerging paradigm for hybrid capital instruments.

- **Specialized Disclosure Provisions.** Title XV of the Act includes three provisions that establish disclosure requirements for companies engaged in specified types of business. The provisions relate to use of "conflict minerals," mining safety, and payments to governments by reporting companies engaged in resource extraction. The provision on mine safety took effect immediately. The SEC proposed rules in December 2010 under all three provisions, but none of these rules have become final, and the current expectation is for final rules by year-end 2011.

- **Consumer Protection.** Over the past year, the Consumer Financial Protection Bureau (the "Consumer Bureau") has focused on establishing the agency ahead of July 21, 2011, the date when the Consumer Bureau was vested with the authority to enforce the existing Federal consumer protection laws transferred to it to under the Act. Certain powers that can be exercised over entities not covered by existing consumer protection laws may not be exercised until the Consumer Bureau's director is confirmed. As a result, the Consumer Bureau has not issued new rules or announced programs and will not do so until a director is confirmed. On July 18, 2011, President Obama nominated former Ohio Attorney General Richard Cordray as director but the timing of a vote on his confirmation, as well as the outcome, is uncertain. A related issue is the degree to which state consumer financial laws are preempted. On July 20, 2011, the Office of the Comptroller of the Currency (the "OCC") issued a final rule on preemption. The U.S. Department of the Treasury (the "Treasury") and state attorneys general had criticized the OCC's proposed rule, arguing that it would not implement what they characterize as the much higher threshold for preemption of state

consumer financial laws as provided for in the Act. The OCC addressed some of these concerns in its final rule.

- **Insurance.** The Federal Office of Insurance (the "FIO") has been established within the Treasury, as required by the Act. The Treasury also announced the creation of a Federal Advisory Committee on Insurance, comprising members of state and tribal insurance regulators and industry experts, to advise and present recommendations to the FIO.

II. SYSTEMIC RISK AND FINANCIAL STABILITY

Restructuring Federal Banking Supervision: Systemic Risk and Beyond

- The Act created a new framework for overseeing systemic risk, placing key responsibility for systemic risk supervision and regulation in the hands of the Fed and the FDIC, and giving the Council a largely advisory, coordinating and persuasive role. One year after enactment, the Act's framework for managing systemic risk continues to take shape. Three key issues have emerged in the last 12 months:
  - the processes and criteria for identifying nonbank financial institutions as SIFIs, particularly with respect to the Council's designation of nonbank financial institutions;
  - the methods for overseeing and measuring the risks SIFIs pose to the financial system, through stress testing, capital plans and so-called "living wills" requirements; and
  - the tools for regulating the activities of certain entities, notably through heightened capital requirements and the activity restrictions of the Volcker Rule.
- **Financial Stability Oversight Council.** Significant questions surround the future role of the Council, particularly with respect to how the Council will perform its duty to designate nonbank SIFIs and FMUs for heightened supervision.
  - For many financial institutions, the Council's most significant authority is its mandate to designate nonbank financial companies as systemically important; however, a year after enactment, final rules have not been released, and uncertainty remains as to how and when the Council will make these designations. The Council's proposed rules on the designation process and criteria it will apply will allow it to retain significant discretion when evaluating potentially significant nonbank financial institutions. In doing so, the proposal provides little guidance as to which companies might be so designated.
  - The Council is also responsible for designating FMUs and specific payment, clearing or settlement activities conducted by financial institutions as systemically important. A final rule describing a two-part designation process for FMUs was approved on July 18, 2011. As with the Council's proposal for designating nonbank financial companies as SIFIs, the rule grants broad discretion to the Council in making designations. The Council has not yet proposed rules on the evaluation criteria for other payment, clearing or settlement activities by financial institutions.
  - The Council has also been active in its advisory capacity. On January 18, 2011, the Council released its study on the Volcker Rule's prohibitions on proprietary trading and investing in, and sponsoring of, private equity and hedge funds by banking entities (the "Volcker Rule Study"), which is expected to play a significant role in the pending rulemaking to implement the Volcker Rule.
- **Federal Reserve Board.** Although the Fed's future supervisory role was in question at times during the legislative process leading up to the Act, the Fed emerged from the

legislative process with a clear statutory mandate as the primary supervisor and regulator of SIFIs, including nonbank financial companies and FMUs designated as such by the Council. Although the Act expanded the Fed's supervisory powers, it limited the Fed's discretion in other areas and subjected it to additional oversight and disclosure requirements.

- The Fed has seen its emergency lending authority curtailed by the Act, most notably by the Act's limiting it to programs with broad-based eligibility and by prohibiting lending to insolvent borrowers.
- The Fed also faces new reporting and disclosure requirements on the use of its lending authority.
  - In December 2010, pursuant to the Act, the Fed made public its data on the Primary Dealer Credit Facility program and other emergency lending facilities.
  - In March 2011, the Fed released over 25,000 documents on discount window advances between August 2007 and March 2010 pursuant to a court order issued in response to Freedom of Information Act ("FOIA") requests from several organizations.
- In many areas, the Act grants other Federal regulators concurrent or back-up authority with the Fed.

- **Federal Deposit Insurance Corporation.** The FDIC also gained additional regulatory authority as a result of the Act.
  - The FDIC has been leading the development, in coordination with the Fed, of rules to implement the Act's requirements that SIFIs prepare resolution plans, or living wills. The Fed and the FDIC jointly issued a proposed rule on April 22, 2011, with a final rule expected later this year.
  - The FDIC has also been actively developing its rule to implement OLA, and released its final rule on July 6, 2011. As part of OLA, the Act granted the FDIC new examination and backup enforcement authority over SIFIs.
  - Furthermore, the FDIC gained the authority to require reports from insured depository institutions ("IDIs") without the agreement of their primary regulator and (along with the OCC) new backup examination and enforcement authority over the nonbank affiliates of banks, which previously were subject only to Fed examination.

- **Thrifts.** On July 21, 2011, the OTS's supervisory and rulemaking authority over thrifts and SLHCs was divided and transferred to the other Federal banking agencies. Federal thrifts are now regulated by the OCC, SLHCs are now regulated by the Fed, and state thrifts are now regulated by the FDIC.
  - The Act expressly preserved most of the existing laws and regulations (and OTS interpretations) governing thrifts and SLHCs. A key issue to watch is how the

framework evolves in the hands of the newly responsible agencies, as the Fed, OCC and FDIC integrate thrifts and SLHCs into their existing supervisory programs. For example, the Fed has signaled its intention to revise the supervisory and regulatory standards for SLHCs to align them more closely with the standards that apply to bank holding companies ("BHCs").

Heightened Prudential Standards for Systemically Important Financial Institutions

- **Systemically Important Financial Institutions.** All BHCs with total consolidated assets of at least $50 billion and nonbank financial companies designated by the Council as systemically important will be subject to heightened prudential standards promulgated and administered by the Fed.

  - The Fed is expected to release a proposed rule to implement these heightened prudential standards in the near future. One open question is how the Fed will apply these standards to foreign banking organizations with small U.S. footprints, but more than $50 billion in total assets worldwide. Although pending proposals suggest that the Fed might apply these rules based on a global asset test, this would require heightened supervision and regulation (even if calibrated) of dozens of foreign banks that have relatively small U.S. operations.

- **Systemically Important Financial Market Utilities.** Title VIII of the Act authorizes the Council to identify and designate FMUs that it determines are, or are likely to become, systemically important. Designated FMUs will be regulated by the Fed and subject to heightened prudential requirements.

  - The Council has approved a final rule on the designation process that provides for broad discretion in making such designations.

  - Separately, in April 2011, the Fed proposed risk-management standards for designated FMUs based on international standards developed by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions.

- **SIFI Surcharge.** SIFIs are expected to be subject to additional capital requirements (the "SIFI Surcharge").

  - The Fed is expected to issue a proposed rule on the SIFI Surcharge this summer; most observers expect that the Fed's SIFI Surcharge will range between 1% and 3%.

  - In June 2011, the Basel Committee announced that global systemically important banks will be subject to a capital surcharge between 1% and 2.5%, depending on the bank's systemic importance, with an additional 1% surcharge applied in certain circumstances. A definitive list of G-SIBs was not included in the Basel Committee's proposal, which predicted that approximately 28 banks will be designated as G-SIBs.

  - The Basel Committee rejected the use of contingent capital to satisfy the surcharge, which must be met with common equity. However, the Basel Committee continues to review contingent capital instruments.

  - **Stress Tests.** In June 2011, the Fed, the FDIC and the OCC jointly proposed supervisory guidance regarding stress-testing practices at banking organizations with more than $10 billion in consolidated assets.

  - The guidance specifies that an effective stress-testing framework would need to be forward-looking and flexible. Stress-testing, which was developed for the largest U.S. banks during the financial crisis, marks a significant departure from pre-crisis supervisory approaches, which focused to a much greater degree on a bank's capital levels and controls at a "moment in time."

  - The proposed guidance describes several processes that large banks should consider using, such as scenario analysis, sensitivity analysis, enterprise-wide testing and reverse stress testing.

  - The proposed guidance does not address the stress-testing requirements of Section 165(i) of the Act, which requires the Fed to conduct annual stress tests on SIFIs, all SIFIs to conduct semiannual stress tests and all BHCs with over $10 billion in assets to conduct annual stress tests. Reports of internal stress tests must be reported to the Fed and the institution's primary Federal regulator. The Federal banking agencies have indicated that rules implementing Section 165(i) would be consistent with the principles discussed in the proposed guidance.

- **Capital Plans for Large BHCs.** In June, the Fed proposed a rule that would require U.S. BHCs with at least $50 billion in total consolidated assets to submit annual capital plans to the Fed for review. This would cover nearly twice as many BHCs as those that submitted capital plans under the Supervisory Capital Assessment Program and the Comprehensive Capital Analysis and Review.

  - Capital plans would need to describe, among other things, how the BHC will continue operations and maintain capital during periods of economic and financial stress.

  - The capital plan proposal is noteworthy in several respects, including the formality of the procedures required for the submission and evaluation of capital plans and regulatory action on the plans, and the strictness of the proposed legal requirements that would attach to the plans, including new restrictions on payment of dividends, stock repurchases and other capital distributions.

  - The proposal would cover U.S.-domiciled BHC subsidiaries of foreign banking organizations ("FBOs") that meet the asset threshold. In addition, the Fed expects to extend the capital plan requirements to large SLHCs and nonbank financial companies supervised by the Fed.

New Capital Rules and Activity Restrictions

- **New Minimum Capital Requirements (the "Collins Amendment")**. Under the Collins Amendment, all U.S. depository institutions, depository institution BHCs and nonbank SIFIs will be subject to a capital floor for their leverage, Tier 1 and total risk-based capital ratios based on the generally applicable capital adequacy guidelines (Basel I). The Collins Amendment also calls for a phase-out of certain capital components from Tier 1 capital calculations, most significantly, trust preferred securities.
    - The Federal banking agencies adopted a final rule implementing the capital floor provision of the Collins Amendment, representing the first finalization of a capital regulation required by the Act.
        - The final rule will have the greatest impact on the largest U.S. banking organizations known as "core banks"—those with $250 billion or more in total assets that are required to use Basel II's Advanced Approaches. The final rule effectively transforms Basel II into a one-way ratchet that will lead to higher capital requirements for core banks. To comply with the final rule, core banks will be required to calculate their capital requirements under both Basel I and Basel II indefinitely, and must satisfy the higher of the two capital requirements. Accordingly, the final rule effectively removes any incentive for banking organizations that were contemplating opting into Basel II and forces core banks to incur the significant costs associated with building Basel II-compliant systems, without realizing any benefits from more tailored capital requirements.
        - The final rule was silent as to how the Federal banking agencies will conduct capital equivalency and comparability determinations that are required when FBOs seek to establish new branches or agencies in the United States, make bank acquisitions, or elect to become financial holding companies. However, in the preamble to the final rule, the Federal banking agencies indicated that they "will continue to evaluate equivalency issues on a case-by-case basis."
            - The Federal banking agencies may take a similar approach to the determination of comparability and equivalency in this context as they have in the past with respect to the leverage ratio, which was unique to U.S. (and Canadian) banking organizations prior to Basel III's proposed leverage ratio. While an FBO's leverage ratio is considered as part of the equivalency or comparability determination, a leverage ratio that did not satisfy U.S. guidelines did not independently lead to a determination that the equivalency or comparability standard was not met.
    - Intermediate U.S. BHCs of foreign banks that relied on the Fed's Supervision and Regulation Letter SR 01-1 for exemption from the U.S. capital requirements will be subject to a 5-year phase-in period to comply with the Collins Amendment.

- By year-end, the Fed is expected to issue a proposed rulemaking addressing the provision of the Collins Amendment that requires the phase-out of trust preferred securities from Tier 1 capital.

- **Affiliate Transaction Rules.** Effective July 21, 2012, the Act will broaden the restrictions on affiliate transactions in Section 23A of the Federal Reserve Act in several important respects:

  - The term "affiliate" will be expanded to include any investment fund that is advised by a bank or an affiliate of the bank (including hedge funds, private equity funds and offshore funds).

  - The definition of "covered transactions" will be expanded to include derivative transactions and the borrowing or lending of securities to the extent that the transaction causes a bank to have credit exposure to an affiliate, and the acceptance of debt obligations of an affiliate as collateral for a loan or extension of credit to a third party. Reverse repurchase transactions will be treated as extensions of credit rather than asset purchases and thereby become subject to collateral requirements.

  - In addition, the Act will impose ongoing collateral maintenance requirements and eliminate special treatment for financial subsidiaries, which will no longer be exempt from Section 23A's 10% quantitative limits.

  - The Fed is authorized to issue regulations or interpretations defining the term "credit exposure" and is expressly permitted to take into account netting arrangements in measuring the total exposure of a bank to its affiliates. The Act also provides the FDIC an effective veto over Section 23A exemptions granted by the Fed (or, in the case of Federal thrifts, the Fed and the OCC).

- The Act makes similar amendments to the laws regulating loans to insiders and loans to one borrower, effective July 21, 2012, by expanding the definition of "extension of credit" to include credit exposures arising from derivative transactions, repurchase and reverse repurchase transactions, and securities lending and borrowing transactions.

III. THE VOLCKER RULE

One of the more controversial provisions of the Act, the Volcker Rule, will prohibit banking entities from engaging in some types of proprietary trading and will impose limits on sponsoring or investing in hedge funds or private equity funds. Rules to implement the substantive provisions of the Volcker Rule have not yet been proposed. Nevertheless, banks and other industry participants are actively engaged in structuring their activities and operations to comply with the rule in anticipation of its July 2012 effective date and July 2014 conformance date.

- The "banking entities" covered by the rule include all IDIs, their BHCs, FBOs with U.S. banking operations and their affiliates and subsidiaries (each, a "Banking Entity"). Nonbank SIFIs may face additional capital and quantitative limits on such activities.

- The Volcker Rule contains important exceptions to its limitations on proprietary trading and sponsoring and investing in private equity and hedge funds, permitting, for example, underwriting and market-making related activities, risk-mitigating hedging, trades on behalf of customers, and sponsoring and investing in funds as part of traditional asset management activities, subject to certain constraints. It also provides exceptions for the non-U.S. trading and fund activities of FBOs. The scope of these various exceptions and authorities will be critical to determining the final impact of the Volcker Rule.

- In January 2011, the Council released the Volker Rule Study, which made several significant recommendations regarding the implementation of the Rule.

  - The primary focus of the Volcker Rule Study was on distinguishing proprietary trading from permitted trading activities (e.g., market-making, underwriting, hedging, trades on behalf of customers) and preventing the concealment of proprietary trading.

    - It indicated strong support for permitted activities, such as market-making and hedging, suggesting that implementing regulations may provide broad empowerments for banking entities to continue to engage in these activities.

    - The Volker Rule Study also emphasized the need for quantitative analysis in defining impermissible proprietary trading, and called for relatively extensive supervisory review of activities, as well as horizontal reviews across institutions. Implementing the necessary compliance systems may present significant challenges.

  - The Volker Rule Study also discussed some issues related to the Volcker Rule's restrictions on investing in or sponsoring private funds:

    - The Volker Rule Study helpfully acknowledges the over-breadth of the definition of private equity fund and hedge fund, which is based on the registration exemptions contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "'40 Act"), providing some hope that implementing rules may narrow and clarify its scope. However, the Volcker Rule Study also suggests that

certain funds (such as commodity pools) that do not rely on Section 3(c)(1) or 3(c)(7) could be covered by the Volcker Rule as "similar funds."

  - The Volker Rule Study raises other important questions, such as how to define and measure ownership interests in a fund.

- The Fed's final transition rules for compliance with the Volcker Rule became effective in April 2011. Although the Volcker Rule will become effective on July 21, 2012, Banking Entities will have a two-year conformance period to bring their activities and investments into compliance. There is the potential for up to three one-year extensions (and an additional extension for up to five years is possible for investments in certain "illiquid funds").
  - The preamble to the final rule confirms that the conformance period will apply to "any activities, investments and relationships" that will later be prohibited or restricted by the Volcker Rule, clarifying that it should apply to the full range of Volcker Rule prohibitions. However, it suggests that the conformance period applies only to "activities commenced prior to the Volcker Rule's effective date," leaving open some interpretive questions regarding what activities will be permitted during the conformance period—e.g., will existing proprietary trading operations be permitted to take new positions after the Volcker Rule's effective date, so long as they are closed out before the end of the conformance period.
  - The deadline for requesting an extension of the conformance period will be 180 days before the expiration of the applicable time period. Each one-year extension will be granted separately, and banks seeking multiple extensions would need to reapply, which could present significant logistical issues for the Fed and applicant institutions.
    - The final rule and preamble suggest that the Fed is likely to take a conservative approach to granting extensions.
  - Beyond the three one-year extensions, the Fed is authorized to grant an additional extension of up to five years for investments in certain "illiquid funds" where a Banking Entity had a "contractual obligation" to invest or retain its investment as of May 1, 2010.
    - Under the final rule, a Banking Entity has a "contractual obligation" to invest or retain an investment only if it (1) is contractually prohibited from redeeming, selling or otherwise transferring its investment, (2) lacks the authority to unilaterally terminate the contractual obligation and (3) uses its reasonable best efforts to obtain the consent of other persons if their consent is required to terminate the contractual obligation.
    - This approach to the "contractual obligation" requirement may require Banking Entities to sell fund interests at significant discounts. Industry comment letters criticized this approach as inconsistent with the spirit of the illiquid funds exemption, but the Fed declined to make any significant modifications in the final rule.

- ○ The Fed indicated that it expects to revisit the final conformance rule after the substantive regulations implementing the Volcker Rule are completed later this year, suggesting that further modifications or adjustments could be made to the final conformance period rule at that time.

IV. ORDERLY LIQUIDATION AUTHORITY

Generally

- Over the past year, the FDIC has engaged in a series of rule proposals, resulting in final rules implementing certain provisions of the OLA regime under the Act. The FDIC has also helpfully continued a dialogue with market participants on how best to create an effective and credible means for addressing the failure of a systemically important financial company in a way that both mitigates moral hazard and protects financial markets.

- As part of this dialogue, the FDIC published a white paper on how it would have addressed the failure of Lehman Brothers had the provisions of OLA been available, providing insight into the FDIC's thinking on possible resolution techniques.[3]

- While much progress has been made in clarifying the operation of OLA domestically, cross-border issues continue to remain largely unaddressed and present perhaps the most substantial challenge to creating an effective and credible resolution regime, since almost all of the world's largest financial companies have significant cross-border activities.

July 2011 OLA Rules

- On July 15, 2011, the FDIC published in the Federal Register final rules implementing certain provisions of OLA (the "OLA Rules"), which address the following topics:

  - Subpart A – General and Miscellaneous Provisions, which includes definitions and addresses the treatment of insurance company subsidiaries, the recoupment of compensation from senior executives and directors, and provisions clarifying the treatment of fraudulent and preferential transfers.

  - Subpart B – Priorities, which addresses the priority of expenses and unsecured claims, claims in respect of impaired rights of setoff, obligations of bridge financial companies, and the payment of "additional amounts" to certain similarly situated creditors.

  - Subpart C – Receivership Administrative Claims Process, which addresses the receivership claims process, the treatment of contingent claims, and the treatment of secured claims.

Key Issues Clarified by the OLA Rules

- **QFCs Carved-out from OLA Rules.** The OLA Rules make clear that its provisions generally do not apply to qualified financial contracts ("QFCs").

  - Certain provisions of the OLA Rules that could have otherwise been interpreted as applying to QFCs have specifically exempted QFCs from their scope, including the

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[3] See http://www.fdic.gov/regulations/reform/lehman.html.

provisions regarding the FDIC's power to transfer assets free from certain rights of setoff and requiring the FDIC's consent prior to foreclosing on collateral.

- While not as broad as some commenters had suggested, these QFC carve-outs appear adequate to clarify that the statutory safe harbors for QFCs prevail notwithstanding anything to the contrary in the OLA Rules.[4]

- **Harmonization with the Bankruptcy Code.** The OLA Rules include provisions intended to harmonize the treatment of secured creditors under OLA with that under the Bankruptcy Code, as required by Section 209 of the Act.

  - The OLA Rules provide a definition of the "adequate protection" that must be given to secured creditors in circumstances where the value of their security could be impaired by the FDIC's actions as receiver. However, as discussed below, there is no clear way for secured creditors to challenge the FDIC's determination that "adequate protection" has been provided.

  - The OLA Rules provide that the FDIC will exercise its power to avoid certain fraudulent and preferential transfers in a way that is consistent with a trustee's power to avoid similar transfers under the Bankruptcy Code. These rules correct a drafting error in the Act which could have been interpreted as permitting the FDIC to avoid certain security interests that could not be avoided under the Bankruptcy Code.

- **Recoupment of Compensation from Directors and Senior Executives.** The OLA Rules provide that the FDIC may file an action to recover the compensation of any senior executive or director who is determined to have been "substantially responsible" for the failed condition of a covered financial company ("CFC"). "Substantially responsible" is defined as such person having failed to act with the care that an ordinarily prudent person would have given the circumstances.

  - Certain senior executives and directors, including the chairman of the board, CEO, president, CFO and anyone responsible for the strategic or policymaking decisions of the CFC, are presumed to be substantially responsible under the OLA Rules.

  - Exempted from this presumption of substantial responsibility are senior executives and directors who joined a CFC no more than two years prior to the appointment of the FDIC as receiver for the purpose of turning it around during a time of crisis.

Key Issues Raised by the OLA Rules

- **Setoff.** With respect to setoff rights, the OLA Rules and the Act appear to be at odds, with the OLA Rules purporting to permit the FDIC to transfer assets of a CFC free from any setoff

[4] The Act generally exempts QFCs from otherwise applicable provisions of OLA other than the special regime providing the FDIC as receiver with a limited power to transfer QFCs to specified third parties or, if not transferred, permitting counterparties to terminate, set off, net exposures and foreclose on any collateral held by the counterparty. The Act, § 210(c)(8)–(11).

rights. By contrast, the Act would appear to permit the FDIC to transfer assets of a CFC free from only common law setoff rights, meaning that contractual setoff rights would be respected.[5] Legal staff at the FDIC indicated in a recent conversation that, in their preliminary view, OLA and the OLA Rules do not allow the FDIC to impair contractual setoff rights but instead only permit the impairment of common law setoff rights by an FDIC transfer that destroys mutuality.

Key Issues Not Addressed by the OLA Rules

- **No Rules Implementing the "Minimum Recovery" Requirement.** The OLA Rules lack any provisions specifying how the "minimum recovery" requirement will be satisfied by the FDIC or how creditors may challenge the FDIC's determination that such a requirement has been satisfied.
  - The Act provides that creditors must receive at least what they would have received had the CFC been liquidated in proceedings under chapter 7 of the Bankruptcy Code, the so-called "minimum recovery" requirement.[6] This provision is in contrast to numerous provisions that diverge procedurally and substantively from the Bankruptcy Code, making its interplay with such provisions difficult to predict in the absence of clarifying rules.
  - The FDIC staff memorandum accompanying the OLA Rules noted that several commenters "repeatedly" emphasized the importance of the "minimum recovery" requirement but did not explain the absence of rules clarifying its application. There is a concern that the FDIC does not consider the chapter 7 liquidation value to be a "floor" for recovery by creditors, despite the seemingly clear statutory language.
- **No Rules Addressing the FDIC's Ability to Nullify Affiliate Cross-defaults.** These important powers are unique to the Act and could significantly alter creditors' rights and expectations. Substantial discretion has been granted to the FDIC in exercising these powers, and the issues implicated are extremely complex, making clarifying rules that much more important.
  - The Act allows the FDIC to prevent counterparties to contracts of affiliates that are guaranteed by a CFC from exercising contractual rights to terminate such agreements based solely on the insolvency of that CFC, so long as the guarantee is transferred to a bridge financial company or solvent third party or "adequate protection" is otherwise provided.

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[5] "Setoff—Subject to the other provisions of this title, any transferee of assets from a receiver, including a bridge financial company, shall be subject to such claims or rights as would prevail over the rights of such transferee in such assets under applicable noninsolvency law." The Act, § 210(a)(1)(G)(iii) (emphasis added). Cf. N.Y. U.C.C. § 9-404.

[6] The Act, § 210(a)(7)(B).

- The provision is premised on the theory that counterparties of CFC affiliates would be "no worse off" as a result of the exercise of this power—they would either have the benefit of a solvent entity's guarantee of the affiliate's obligations or other "adequate protection."

- It is unclear what protections of the counterparties' interest would be "adequate," other than the transfer of the related guarantee. Many commenters asked the FDIC to clarify this issue by rule.

- **No Rules Addressing the Treatment of Broker-Dealers.** The OLA Rules do not clarify the interplay between OLA and SIPA, where the FDIC acts as receiver under OLA and the Securities Investor Protection Corporation ("SIPC") acts as liquidator under SIPA, in the resolution of a systemically significant broker-dealer.

  - The FDIC staff memorandum accompanying the OLA Rules states that such rules will be addressed in a separate rulemaking prepared jointly with the SEC.

  - In particular, the FDIC staff memo notes that SIPC's subrogation claim will be treated as an "amount owing to the [United States]" for purposes of the priorities of unsecured claims, a category receiving a super-priority in the payment of unsecured creditor claims. It is not clear how such priority relates to SIPC's status as a subrogee to "customer" claims under SIPA.

- **No Rules Ensuring Fair Treatment of Non-U.S. Creditors.** Commenters urged the FDIC to adopt a rule that it will not exercise powers under OLA in a way that discriminates against non-U.S. creditors, especially when exercising its authority to treat similarly situated creditors differently. The OLA Rules do not include such a provision.

- **No Rules Permitting a Challenge of FDIC Determinations.** The administrative claims process provided under the Act and the OLA Rules provides for an entirely individual determination of claims and offers no means for creditors to challenge determinations made by the FDIC other than in a subsequent court process.

  - In addition to challenging the FDIC's determination of a final claim amount, secured creditors of a CFC and counterparties to affiliates of a CFC that have had their cross-defaults nullified may also wish to challenge the FDIC's determination of whether "adequate protection" has been provided. Further, creditors may wish to challenge their recoveries on the basis that they did not receive their "minimum recovery" amount.

  - Many creditors will be similarly situated (e.g., creditors under a syndicated loan facility or, more generally, all general unsecured creditors), but will have claims amounts and related matters determined on an individual basis.

- The absence of any means within the administrative claims process for challenging such determinations on a collective basis may mean that a creditor's only option is to raise such issues in an individual court challenge to the FDIC's final claims determination, which will be heard *de novo* by the court.

- As a result, the FDIC faces the prospect of defending itself in court against challenges by numerous creditors, many of whom will be raising issues in common. In addition to the administrative burden and expense for the FDIC to defend itself against potentially each creditor of a CFC in separate suits, the individual nature of the claims process raises the possibility of similarly situated creditors receiving different recoveries as a result of divergent outcomes in court.

Recapitalizations of Failed Financial Companies under OLA

- There has been a concern expressed by market participants and by regulators abroad that liquidations under OLA will be value destroying (i.e., result in a greater loss to creditors than is necessary) and unable to preserve operations critical to the functioning of markets. As a result, market participants and the FDIC have engaged in a dialogue aimed at developing value-maximizing means of exercising power under OLA that better preserve vital operations of a CFC.

- One such approach is to "recapitalize" a CFC in proceedings under OLA by:

  - transferring vital and viable components of the failed company to a bridge financial company;

  - replacing management responsible for the failure of the financial company; and

  - exchanging debt claims against the CFC for equity in the bridge financial company in partial or full satisfaction of such claims.[7]

- The result would be a solvent financial company owned by the former creditors of the CFC. Because such recapitalizations would occur in proceedings under OLA, the FDIC would have all powers available to it under OLA, including the transfer of some but not all liabilities of the CFC, the ability to nullify certain cross-defaults in the obligations of its affiliates, and other powers for protecting markets.

- Similar recapitalization proposals (called "bail-ins") have been better received in Europe, where industry and regulators are more focused on avoiding the failure of financial companies.

  - One key difference between the OLA "recapitalization" proposal and European bail-in approaches is that a recapitalization would occur only after the failed company has been placed into receivership. By contrast, bail-in proposals tend to advocate an exchange of

[7] See www.fdic.gov/regulations/laws/federal/2011/11c16Ad73.pdf.

debt for equity on the eve of insolvency for the purpose of avoiding the insolvency of the financial company.

- The FDIC, in staff memoranda and meetings with market participants, has indicated that it views recapitalization as a viable resolution technique that is currently available to it under OLA and the Federal Deposit Insurance Act ("FDIA"). The FDIC indicated in its accompanying staff memorandum that it did not need to make any changes to the OLA Rules in connection with the recapitalization proposal, as any exchange of debt for equity in the bridge would be accomplished pro rata and in accordance with the priorities established under the OLA Rules.

V. RESOLUTION PLANS (ALSO KNOWN AS "LIVING WILLS")

Generally

- Section 165(d) of the Act requires SIFIs to submit to the FDIC and the Fed, and to periodically update, a resolution plan—a detailed strategic analysis of how they could be resolved under the Bankruptcy Code in a manner that mitigates serious adverse effects to the financial stability of the United States.

- Regulators are required to finalize rules implementing Section 165(d) by January 21, 2012. On April 22, 2011, the FDIC and the Fed jointly issued a proposed rule that would implement the Act's resolution plan provision. While the FDIC announced at a recent board meeting that it expects issue final rules by the end of August 2011, the issuance is expected to slip to later in 2011.

- The resolution plan requirement is intended in part to address concerns about institutions that are "too big to fail," by facilitating the ability of regulators to conduct advance resolution planning.

- However, the resolution plan provision and the proposed rule could be used to require SIFIs to restructure their operations or reduce their size by divesting certain operations or subsidiaries. This view has been reinforced by statements made by former FDIC Chairwoman Sheila Bair and General Counsel Michael Krimminger to the effect that they expect the largest financial companies will have to restructure in order to be able to submit credible resolution plans.

The Proposed Rule

- **Covered Financial Companies.** The proposed rule would require annual filings of living wills by:

    - all BHCs with at least $50 billion in total global consolidated assets,

    - FBOs with at least $50 billion in total global consolidated assets, and

    - all nonbank SIFIs designated by the Council for enhanced supervision by the Fed (each, a "Covered Company").

    - It is estimated that approximately 26 BHCs and 98 FBOs would be required to file resolution plans under the proposed rule.

- **Contents.** Resolution plans would have to set forth credible plans for the rapid and orderly resolution of the Covered Company under the Bankruptcy Code that would substantially mitigate serious adverse effects to the financial stability of the United States, and would include detailed descriptions of the Covered Company's resolution strategy, governance, organization and financial information.

  - Resolution plans for FBOs would focus primarily on the FBO's U.S. operations and their interconnectedness with the FBO's foreign operations, and would also address how the U.S. resolution plan integrates into the FBO's global resolution plan.

  - The FDIC has made clear that resolution plans may not rely on any special powers available under OLA.

- **Timing.** Each Covered Company would be required to file its resolution plan within 180 days after the effective date of a final rule, and annually thereafter within 90 days of the calendar year-end. An interim resolution plan would have to be filed within 45 days after any event, occurrence or change that results in, or could reasonably be foreseen to have, a material effect on the company's existing resolution plan.

- **Effect of Submitting Deficient Plan.** The FDIC and the Fed would jointly review the plan for credibility and to identify any deficiencies.

  - Failure to remedy deficiencies would permit the FDIC and the Fed to jointly impose additional capital, leverage or liquidity requirements, or restrict the growth, activities or operations of the Covered Company or its subsidiaries.

  - The continued failure to remedy a deficient plan within two years after having been subjected to such restrictions would permit the FDIC and the Fed to jointly order the Covered Company to divest assets or operations as necessary to facilitate its orderly resolution.

Key Issues

- **Role of OLA and Other Resolution Regimes.**

  - Given that resolution plans must address insolvency scenarios during times of market stress, and that OLA was created because the Bankruptcy Code was viewed as inadequate to protect the U.S. economy from the failure of systemically important financial companies during periods of market stress, it may be challenging for a Covered Company to produce a "credible" resolution plan that avoids serious adverse effects on U.S. financial stability under the Bankruptcy Code alone and that does not rely on OLA.

    - The proposed rule would also prohibit a resolution plan from assuming that the government will provide any "extraordinary support." It is unclear whether certain forms of government involvement—such as providing access to the Fed's discount window or other lending facilities—would qualify as "extraordinary support."

  - A footnote in the preamble to the proposed rule notes that entities subject to insolvency regimes other than the Bankruptcy Code should conduct their analysis according to the applicable insolvency regime.

   - While somewhat unclear, this may mean that the resolution plans for Covered Companies or their subsidiaries that are FBOs, regulated banks, broker-dealers, insurance companies, etc., should be created based on their applicable insolvency regimes, notwithstanding that the proposed rule refers to the Bankruptcy Code only and does not clearly address how a resolution plan should treat entities or operations that are subject to an alternative insolvency regime.

   - Some commenters have noted that the statutory focus on resolution under the Bankruptcy Code limits the practical utility of resolution plans for SIFIs.

- **Use of Resolution Plans.**

  - Under the proposed rule, a Covered Company's resolution plan would have no binding effect on any party with responsibility for the company's resolution (e.g., a trustee under the Bankruptcy Code or a receiver under OLA). The FDIC noted that the information in a resolution plan will be a "vital element" in the FDIC's planning for the resolution of a Covered Company under OLA, although we understand that the FDIC will conduct its own, separate resolution planning process to prepare for resolution under OLA.

  - Although styled as a plan for addressing the insolvency of a Covered Company, resolution planning would also be a powerful regulatory tool allowing the FDIC and the Fed to examine a Covered Company's structure and interconnections in depth and, potentially, to require restructuring and simplification.

- **Burden.** Compliance with the broad information requirements of the Proposed Rule is expected to require extensive, time-consuming work by Covered Companies.

  - The FDIC estimates that it will take an average of 12,400 hours for a Covered Company to prepare its initial resolution plan; for the largest Covered Companies, this burden is likely to be greater by orders of magnitude.

  - Companies can expect to undergo an iterative process with regulators in preparation of credible resolution plans and will be subject to ongoing monitoring for compliance.

- **Timing.** Under the proposed rule, initial resolution plans would be required to be submitted by all Covered Companies within 180 days. Subsequently, Covered Companies would be required to submit plan annually within 90 days of the calendar year-end.

  - As a result, each of the over 124 estimated Covered Companies would submit their resolution plans during the same time period, with regulators required to review each plan for completeness within 60 days. Commenters have suggested staggered deadlines, so that all plans are not due at the same time.

  - Commenters have also suggested a transitional, phase-in period, with a pilot program for large, complex U.S.-headquartered banking organizations.

- **Deficiency.** Because the consequences for a Covered Company of its resolution plan being found not "credible" can be severe (e.g., increases in capital and liquidity requirements, leverage limits, activities limits, forced divestitures), commenters have suggested that the determination of what is "not credible" should evolve over time and have urged an iterative, multi-year process for defining "credible" and "deficient."

- **Confidentiality and Disclosure.**

    - Covered Companies would be permitted to request confidential treatment of their resolution plans and credit exposure reports, but the proposed rule would rely on preexisting rules implementing the Freedom of Information Act to determine whether to grant confidential treatment.

        - Some regulators have intimated that certain portions of the resolution plans should be made publicly available.

    - Further, public companies will need to consider whether any information contained in a resolution plan, or a regulators' finding that a plan is not "credible," would need to be disclosed.

- **International Coordination.**

    - From an international perspective, a significant challenge in addressing the potential failure of a large financial company is that regulators can often only resolve institutions incorporated within their jurisdictions and not those incorporated elsewhere.

        - Moreover, there is a potential for problems as a result of a mismatch in regulatory timing or requirements, particularly when the United States, as is the case here, has released detailed proposals in advance of corresponding proposals in Europe and the United Kingdom.

    - Ideally, FBOs would only be required to prepare a U.S. chapter that is part of a global resolution plan, rather than a separate plan for U.S. regulators describing worldwide operations.

        - Some commenters have also suggested that the $50-billion threshold should apply with respect to FBOs on the basis of the assets of their U.S., rather than worldwide, operations.

    - In addition, U.S. ring fence laws may impede the development of global resolution plans by tying up assets needed to satisfy creditors of the home office.

        - Ring fence laws provide for separate estates for branches and agencies of non-U.S. banks. For example, New York's ring fence law includes in such estate any assets of the New York branch, wherever they are located, and any assets of the bank located in New York. Most non-U.S. banks have substantial assets in

New York (e.g., U.S.-dollar deposits) that could thus be tied up in the New York branch liquidation.

- The proceeds of the branch's estate are used first to satisfy claims of creditors of the branch (and often then to satisfy the claims of creditors of branches in other states) before ultimately being returned to the home office of the non-U.S. bank.

VI. OVER-THE-COUNTER DERIVATIVES REGULATION

Overview

- Title VII of the Act repeals existing restrictions on the substantive Federal regulation of OTC derivatives and establishes substantially parallel regulatory regimes for swaps involving single non-exempt securities, loans and narrow-based security indices—to be administered by the SEC—and swaps involving other financial interests and commodities—to be administered by the CFTC.

- Once implemented, Title VII will result in a comprehensive re-engineering of the OTC derivatives market, including mandatory clearing and electronic trading of a wide range of standardized contracts, extensive regulation of dealers and major market participants, limitations on the ability of banks and others receiving Federal assistance to engage in derivatives dealing activities, and significantly broadened restrictions on the size of positions that may be maintained in listed and unlisted commodity derivatives.

Rulemaking Status and Effective Dates

- Although Title VII contemplated a general effective date of July 16, 2011, most of the required rulemakings have not been finalized and, in some cases, remain to be proposed. As of July 18, 2011, the CFTC had published 52 advance notices of proposed rulemaking or proposed rules, 2 interim final rules, 6 final rules, one proposed interpretative order, one final order and a no-action letter out of a total of 122 rulemakings required by the Act. The SEC had published 14 proposed rules, 4 interim final rule, 3 exemptive orders and a no-action letter out of a total of 59 rulemakings required by the Act.

- The CFTC and SEC have indicated that they expect to complete their rulemaking under Title VII by year-end 2011, although compliance dates may be delayed beyond that time on a rule-by-rule basis.

- The CFTC and SEC have adopted a series of exemptive orders, rules and no-action positions providing temporary relief from compliance obligations under provisions of the Act that are, in one way or another, dependent on final rulemaking.

- As a result, only certain provisions of the Act are currently in effect. These include (1) certain anti-fraud and anti-manipulation provisions; (2) certain restrictions on, and requirements applicable to, transactions with persons who do not qualify as eligible contract participants ("ECPs"); (3) requirements for persons clearing security-based swaps for customers; (4) amended core principles for derivatives clearing organizations and designated contract markets; (5) interim recordkeeping and reporting rules; and (6) limitations on exercise of contractual rights to renegotiate or terminate transactions based on the Act.

Covered Derivatives

- The broad definitions of "swap" and "security-based swap" cover the most widely traded types of OTC derivatives, such as interest rate swaps, commodity swaps, total rate of return swaps and credit default swaps. This definition also covers most foreign exchange ("Fx") products (other than spot and exchange-traded contracts), although the Treasury has proposed limited exemptions for certain physically settled Fx swaps and forwards.

- Jurisdiction is split between the CFTC (for "swaps") and the SEC (for "security-based swaps"). Swaps on broad-based security indices and many exempted securities (other than municipal securities) will be regulated by the CFTC. So-called "mixed swaps" are subject to joint jurisdiction.

- Subject to broad CFTC and SEC anti-evasion authority, certain common derivatives are excluded, including: (1) spot contracts, (2) puts, calls and other options on securities, (3) securities forward and repurchase agreements, (4) indexed debt securities and depository instruments, (5) futures (including security futures) and (6) nonfinancial commodity forwards "intended" to be physically settled.

- The SEC and CFTC have proposed further definitions of swap, security-based swap and related terms, with final rules expected by the fourth quarter of 2011. The proposed rules clarify exclusions for a range of instruments, including certain insurance contracts, commercial forward transactions involving non-financial commodities, consumer and small business rate protection transactions, commercial contracts with price escalation features, and certain loan participations.

- Several key issues remain unresolved or unclear. These include:

  - Definitional issues, such as the distinction between swaps and futures, as well as the distinction between swaps and security-based swaps, on the one hand, and securities options and securities forwards, on the other hand;

  - The application of Title VII to inter-affiliate transactions; and

  - The extraterritorial application of Title VII.

SD and MSP Regulation

- **SD Definitions.**

  - The SD definitions encompass any person who is a dealer or market maker in swaps or security-based swaps or who "regularly enters into [swaps/security-based swaps] with counterparties as an ordinary course of business for its own account," but not someone who enters into swaps/security-based swaps other than as part of a regular business.

  - Exceptions to this definition apply in the case of (1) IDIs to the extent that it offers to enter into a swap with a customer in connection with the origination of a loan with that

customer and (2) a person engaging in a *de minimis* quantity of swap/security-based swap dealing in connection with transactions with or on behalf of its customers. In both cases, proposed rules by the CFTC and the SEC have narrowly interpreted these exceptions, and commenters have raised concerns that the exceptions will, as a result, be of limited utility.

- ○ The CFTC and SEC have preliminarily proposed that inter-affiliate transactions involving swaps and security-based swaps that represent allocations of risk within a corporate group should not be considered for SD registration purposes.

- **MSP Definitions.**

  - ○ There are three independent bases upon which a significant, non-SD participant in the swap/security-based swap markets would be subject to registration and regulation as an MSP under the agencies' proposed rules.

    - ▪ *Substantial Position Test.* Any non-SD who maintains a "substantial position" in any major category of swaps/security-based swaps will be regulated as an MSP.

      - – Positions held for "hedging or mitigating commercial risk" and positions held by an ERISA plan for the "primary purpose of hedging or mitigating any risk directly associated with the operation of the plan" are both excluded for purposes of the Substantial Position Test.

      - – The proposed rules would: (1) determine the existence of substantial positions on the basis of a two-prong test that measures an entity's current exposure (the "aggregate uncollateralized outward exposure") and potential future exposure (the "aggregate potential outward exposure"), based on an asset category-specific discounted measure of notional exposure, with limited netting permitted to be taken into account in calculated exposures; (2) establish separate "substantial position" thresholds to each of six identified major categories of swaps and security-based swaps at levels ranging from $1 billion to $6 billion; and (3) define a swap or security-based swap as hedging or mitigating commercial risk if it is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise.

    - ▪ *Substantial Counterparty Exposure Test.* Any non-SD whose outstanding swaps or security-based swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets," calculated without regard to swap and security-based swap categories, respectively, will also be regulated as an MSP.

      - – Under the proposed rules, substantial counterparty exposure would be determined as the sum of an entity's aggregate uncollateralized outward exposure and aggregate potential outward exposure, <u>without</u> excluding hedging positions.

- *Highly Leveraged Financial Entity Test*. Any non-SD "financial entity" that is "highly leveraged relative to the amount of capital it holds" and maintains a "substantial position" in swaps or security-based swaps (whether or not such swaps or security-based swaps are held for hedging purposes) would also be regulated as an MSP, unless the financial entity is "subject to capital requirements" established by a Federal banking regulator.[8]

  – The proposed rules would define "highly leveraged" as a ratio of total liabilities to equity in excess of 8-to-1 or 15-to-1 (the exact ratio is subject to further comment) and apply the same "substantial position" thresholds as under the Substantial Position Test. "Financial entity" would be defined to include any SD, MSP, commodity pool, private fund, ERISA or governmental plan and any person predominantly engaged in activities in the business of banking or that are financial in nature.

- The proposed rules leave a number of significant issues open, raise a number of additional significant issues and include a number of computational and conceptual anomalies. For example, the CFTC and SEC have proposed to aggregate exposures at the parent level for MSP purposes, which, left unmodified, could lead to cascading and duplicative MSP registrations, including at each intermediate and ultimate parent of an SD. Additionally, the proposal would not recognize collateral as a reduction to aggregate potential outward exposure and would, for certain purposes, add threshold amounts to aggregate uncollateralized outward exposure, significantly inflating actual credit exposures. The application of the definition to inter-affiliate transactions and the scope of the entities that would be treated as U.S. persons under the proposal also remain unclear.

- **SD/MSP Registration and Cross-border Application**. SDs and MSPs must register with and be examined by the CFTC, the SEC or both, depending on the scope of their activities.

  - The scope of the registration obligation applicable to non-U.S. SDs and MSPs remains unclear.

    - Significantly, there are no explicit exemptions or exceptions for foreign banks or other entities subject to comparable regulation, and existing exemptions pursuant to Rule 15a-6 under the Exchange Act and Part 30 of the CFTC Regulations will not, by their terms, apply.

    - The CFTC has indicated that, while the mere use of a U.S. market facility (e.g., a U.S. clearinghouse) would not require registration, registration will likely be required for non-U.S. SDs and MSPs who transact with U.S. counterparties.

    - The CFTC also requested comment on whether swap dealing activity with or by non-U.S. affiliates of U.S. persons is within its jurisdiction.

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[8] Note also that the MSP definition includes an explicit exception intended to address certain captive consumer financing entities' activities in swaps (but not security-based swaps).

- While the Act includes a provision that allows SDs to register with respect to specified categories of swaps/security-based swaps or specified activities in connection with swaps/security-based swaps, the proposed rules do not expressly address the scope of the SD designation in the context of global banks operating through their foreign branch networks.

- **Capital.** SDs and MSPs will be subject to risk-based capital requirements. Generally, the Federal banking agencies have proposed these requirements for SDs and MSPs that are banks, the CFTC has proposed them for nonbank SDs and MSPs, and the SEC's rule proposals are still forthcoming.

  - Under the proposed rules, banks and subsidiaries of BHCs are permitted to use existing capital standards, with foreign banks (but not their subsidiaries or other affiliates) permitted to use home country capital standards.

  - The CFTC has proposed that SDs and MSPs that are FCMs would be required to comply with existing CFTC capital requirements, subject to the use of approved proprietary models for market and credit risk charges.

  - The CFTC has also proposed that SDs and MSPs that are not FCMs or subsidiaries of BHCs would be subject to a minimum capital requirement of $20 million in tangible net equity after accounting for standardized market and credit risk charges.

- **Business Conduct Standards.** The Act requires registered SDs and MSPs to adhere to extensive business conduct standards.

  - *Internal Business Conduct Standards.*

    - CFTC. The CFTC's proposed rules would, *inter alia*, require (1) establishment of informational barriers between clearing and trading personnel and between research and trading personnel; (2) implementation of specific, prescriptive policies and procedures relating to risk management and monitoring of trading and position limits; and (3) broad recordkeeping rules, including recording of oral communications. Commenters have expressed concerns that these proposed rules would, if adopted, unduly disrupt internal operations and adversely affect customer service.

    - SEC. To-date, the SEC has only proposed that SDs and MSPs would be required to establish and maintain policies and procedures reasonably designed to address conflicts of interest, risk management and other duties required by the Act.

  - *External Business Conduct Standards.*

    - Generally. Both the CFTC and the SEC have proposed to require that SDs and MSPs "know their counterparty," verify counterparty status as an ECP or a "Special Entity" (e.g., a municipality, pension plan or endowment), disclose material risks and conflicts of interest and provide daily marks. The proposed

rules also would require a SD (and an MSP, under the CFTC's proposal) to have a reasonable basis to believe that any recommendation it makes to any counterparty concerning a swap or trading strategy involving swaps is "suitable" for the counterparty's particular needs and financial condition. The CFTC, but not the SEC, has also proposed a requirement for disclosure of scenario analysis for certain swaps, as well as broad front running prohibitions, confidentiality requirements and best execution standards.

- Advisers to Special Entities. The Act requires an SD that is an adviser to a Special Entity to undertake a duty to act in the best interests of the Special Entity. While both the CFTC and SEC proposals provide that an SD would be deemed an adviser if it makes a recommendation to a Special Entity, the SEC proposal would also include a safe harbor. Under the SEC proposal, an SD would not be deemed an adviser under the safe harbor if (1) the Special Entity represents in writing that it will not rely on recommendations provided by the SD and will instead rely on advice from a qualified independent representative, (2) the SD has a reasonable basis to believe that the Special Entity is advised by a qualified independent representative, and (3) the SD discloses to the Special Entity that it is not undertaking to act in the best interests of the Special Entity. To the extent an SD avoids being deemed to be acting as an adviser to a Special Entity, it also avoids the special duties required of such an adviser, compliance with which might then trigger fiduciary status under ERISA. The CFTC and SEC have also noted that an SD must separately consider whether it is subject to registration as a commodity trading adviser under the CEA or investment adviser under the Advisers Act as a result of its activities in swaps or security-based swaps, respectively.

- Requirements for SD/MSP Counterparties to Special Entities. The Act requires that an SD/MSP counterparty to a Special Entity have a reasonable basis to believe that the Special Entity has a qualified independent representative. The SEC's proposal would include a safe harbor to the independence test. The representative would be deemed to be independent of the SD/MSP under the SEC's proposed safe harbor if, within the past year, the representative (1) is not and was not an associated person (such as an affiliate) of the SD/MSP and (2) has not received more than 10% of its gross revenues directly or indirectly from the SD/MSP or its affiliates. In contrast, the CFTC's proposal includes a new, three-prong independence test that would require, for example, a determination as to whether or not a "material business relationship" exists between the representative and the SD/MSP.

- Reliance on Written Representations. Many of these proposed requirements—including know your counterparty, verification of counterparty eligibility, institutional suitability and requirements relating to pension plans, municipalities and other Special Entities—require an SD or MSP to verify certain information about its counterparty. The CFTC's proposal would require an SD or MSP to have a "reasonable basis" to believe that its counterparty's sufficiently detailed representations are reliable; thus, imposing an affirmative diligence requirement

for satisfaction of these obligations. The SEC's proposal, in contrast, proposes two alternative standards and requests comment on which alternative to adopt. Under the first standard, an SD or MSP could rely on a representation unless it knows that the representation is not accurate (i.e., a subjective standard). Under the second standard, an SD or MSP would need to make further inquiry to verify the accuracy of a representation if the SD or MSP has information that would cause a reasonable person to question its accuracy (i.e., an objective standard).[9]

Push Out Requirement

- The Act includes the controversial so-called "push-out" provision, which will, starting in July 2013 (subject to a transition period, as described below) prohibit certain forms of Federal assistance—including broadly available and fully collateralized programs such as the Fed discount window and FDIC insurance—from being provided to SDs and MSPs.[10]

- While the scope and effect of this prohibition will be far-ranging, it appears to be limited in three key ways:

  - First, while the push-out provision will prohibit actual Federal assistance to SDs and MSPs, it does not prohibit swaps/security-based swap activities from being conducted in an entity that is eligible for, but not receiving, Federal assistance.

  - Second, the prohibition will not affect non-swap/security-based swap derivatives activities. As noted above, certain derivatives, such as security options and futures and certain exempt FX transactions, will not constitute swaps or security-based swaps.

  - Third, the push-out provision contains several exceptions for IDIs.

    - Most significantly, an IDI that limits its swap and security-based swap activities to (1) hedging and risk mitigating activity and (2) dealing in certain types of swaps (including swaps on interest rates, foreign currency, precious metals, government securities and investment grade debt securities, but not swaps on commodities, most types of equity securities or below investment grade debt)[11]

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[9] The SEC does not clarify whether information known to individuals other than those with knowledge of the relevant security-based swap transaction would be disregarded for these purposes.

[10] The push-out provision also includes provisions regarding (1) exceptions from this prohibition for certain entities in conservatorship or receivership (as well as FDIC bridge banks), (2) use of taxpayer funds in the receivership or insolvency of SDs or MSPs, (3) prudential standards for a bank or BHC that is or seeks to become an SD or MSP and (4) authority for the Council to prohibit IDIs who are SDs or MSPs from accessing Federal assistance on a case-by-case basis.

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

will not be subject to the prohibition on Federal assistance.[12] Credit default swaps will be permitted under this exception only if cleared or if entered into as part of hedging or risk mitigating activity.

- The prohibition will also not prevent an IDI from having a swaps entity affiliate so long as (1) such IDI is part of a bank or thrift holding company supervised by the Fed and (2) the swaps entity affiliate complies with Sections 23A and 23B of the Federal Reserve Act and such other requirements as the CFTC or SEC, as applicable, and the Fed may determine appropriate.

- The Federal banking agencies will be permitted to establish a transition period for up to 2 years (with the possibility of an extension for up to one additional year) for IDIs, and the prohibition on Federal assistance will apply only to swaps entered into after the end of such transition period. This transition period appears to begin upon effectiveness of the push-out prohibition in July 2013.

- These exceptions for IDIs do not, by their terms, apply to an uninsured U.S. branch of a foreign bank, thus giving rise to the potential unintended consequence of inequitable treatment of foreign banks. It remains unclear how push-out will apply to (1) foreign banks with uninsured U.S. branches that use or need to retain the ability to use the Fed discount window and (2) head offices (e.g., in the case of dealing activities booked to a head office by personnel employed at a U.S. branch).

- The regulators have not yet provided any guidance or proposed any rules regarding the application of the swap push-out requirement.

Mandatory Clearing Requirement

- The Act gives authority to the CFTC and SEC (as applicable), either upon application by a clearinghouse to clear a swap/security-based swap, or upon their own initiative, to require designated swaps to be cleared.

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

  - It remains unclear how broadly the SEC and CFTC will construe the clearing requirement with respect to, e.g., illiquid tenors within a category of swap/security-based swap or will attempt to "standardize" transactions by requiring clearing. The CFTC's final rules

[12] The push-out provision excludes from the definition of "swaps entity" a MSP that is an IDI. However, in light of the combined impact of the Volcker Rule's prohibition on proprietary trading and the activities that are and are not permitted to an IDI under the push-out provision, the practical impact of this exclusion seems likely to be minimal.

indicate that the scope of the CFTC's requirement will be determined on a case-by-case basis.

- It also remains unclear whether the mandatory clearing requirement will apply to inter-affiliate transactions and what accommodations the Commissions will make in the context of cross-border transactions.

- Existing swaps/security-based swaps will, under the Act, be grandfathered from the mandatory clearing and trading requirements (subject to the reporting requirements noted below).

- A limited exception to this requirement applies to a defined category of non-financial end users. Specifically, this exception will be available to a person (and under specified conditions, an affiliate of a person) who (1) is not a "financial entity" (defined broadly, but excluding certain captive consumer financing entities), (2) is using swaps/security-based swaps to hedge or mitigate commercial risk and (3) notifies the CFTC or SEC, as applicable, of "how it generally meets its financial obligations associated with entering into non-cleared [swaps/security-based swaps]." Public companies and their subsidiaries must also have board approval to enter into uncleared swaps and security-based swaps.

  - Market participants have also expressed concerns regarding the limited scope of the end user exception and the proposed transaction-by-transaction reporting requirement.

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

  - Even if a swap is not required to be cleared, an end user (or other non-SD/MSP counterparty) may both require that a swap/security-based swap be cleared and designate the clearinghouse to which the swap/security-based swap is to be submitted.

Ownership and Governance of Clearinghouses

- The Act requires the CFTC and SEC to promulgate rules with respect to clearinghouses they deem necessary or appropriate "to improve the governance of [clearinghouses], or to mitigate systemic risk, promote competition, or mitigate conflicts of interest."

- The CFTC and SEC have each proposed rules that would: (1) impose a 20% individual equity ownership limit and 40% aggregate voting equity ownership limit, unless individual ownership in the clearinghouse is otherwise limited to 5%; (2) permit a clearinghouse to seek a waiver of the ownership restrictions from the CFTC (the SEC does not offer a similar option for a waiver); and (3) under the CFTC's proposal, impose composition restrictions on a clearinghouse's risk committee that would mandate public director and customer participation, prohibit participation by staff of the clearinghouse and limit to 55% the representation of clearing members.

- Commenters have raised concerns that (1) the proposed aggregate voting equity cap would have an adverse impact on investment by those most likely to back new clearing initiatives,

(2) the proposed requirements would concentrate ownership in non-member-owners who do not share the same risk management incentives as members who bear the ultimate risk of loss and (3) the proposed limitation of clearing member representation on risk committees would create an expertise gap.

<u>Margin for Cleared Swaps</u>

- **Clearing Member Registration**. To accept margin for cleared swaps or security-based swaps, an entity must register with the CFTC as an FCM or with the SEC as a broker-dealer, respectively. These requirements apply regardless of whether the clearinghouse on which the swap is cleared is registered with the CFTC or SEC. CFTC staff have also informally indicated that clearing members of a foreign clearinghouse registered with the CFTC must register as FCMs.

- **Segregation of Collateral**. The CFTC has also proposed requiring a legal segregation with operational commingling model for cleared swap collateral, under which a cleared swap customer's collateral would not be permitted to secure any trades but the cleared swaps of that particular customer. These rules are designed to limit a customer's credit risk to other customers of the FCM and to the FCM.

    - Market participants have expressed concern that the CFTC's proposal would, if adopted, increase costs to clearing members and, directly and indirectly, to clearing customers. They have also observed that, by increasing reliance on the return of individual customer collateral and sequestering assets that would otherwise be available to meet losses, the proposal could increase systemic risk in the case of a default that occurs in the context of a major financial shock.

<u>Mandatory Exchange and SEF Trading Requirements</u>

- **Trading Requirements**. Entities that are not ECPs will be required to trade swaps and security-based swaps on exchanges. Swaps and security-based swaps subject to the mandatory clearing requirement will also be required to be traded on an exchange or a SEF, unless no exchange or SEF makes the swap/security-based swap "available to trade."

    - Although the proposed rules do not provide specific metrics for determining when a swap/security-based swap is made available for trading, the SEC and CFTC have indicated that the mere listing of a swap/security-based swap for trading is not sufficient. However, if one SEF makes a swap/security-based swap available to trade, all "economically equivalent" swaps/security-based swaps would be deemed "available to trade." The proposed rules do not contain metrics for determining whether a swap/security-based swap is "available to trade" or "economically equivalent" to another swap/security-based swap. In response to requests for comment, commenters have generally suggested high trading volume thresholds for whether a swap/security-based swap is "available to trade" and a stringent fungibility test for economic equivalence.

- ○ The proposed rules do not, however, address the application (or non-application) of the mandatory trading requirement to inter-affiliate trades, bundled trades and other trades not susceptible to multilateral trading.

- **Regulation of SEFs**. The CFTC and SEC have proposed to permit order book and request for quote ("RFQ") systems to qualify as SEFs. The SEC has also proposed that other trading platforms, including those operated by inter-dealer brokers, might also qualify. Single dealer systems would not qualify as SEFs under either proposal. Other significant features of the SEF proposals include:

  - ○ *Number of RFQ Recipients.* While the CFTC would require RFQ senders to request quotes from at least 5 recipients, the SEC would permit the sender to choose to RFQ only one recipient.

  - ○ *Resting Bids and Offers*. The CFTC proposal would prohibit "violating" resting bids and offers. Similarly, the SEC would require equal or better priced resting orders to receive priority over responses to RFQs.

  - ○ *All-to-All Functionality*. Both the CFTC and the SEC propose to require all SEFs (even RFQ SEFs) to operate an "all-to-all" display functionality.

  - ○ *15-Second Delay*. The CFTC would impose a 15-second delay on execution of a customer's order against the SD's own order or crossed with the order of another customer of the SD, during which time the original customer's order is to be posted on the SEF. Because this requirement could interfere with the proper functioning of the RFQ execution paradigm, commenters have suggested that it should be limited to central order book execution platforms.

  - ○ *Block Trades.* Under the proposed rules, the CFTC would allow block trades to be executed off-SEF, but the SEC would not. (As noted above, the SEC would, however, permit an RFQ to be forwarded to a single recipient.)

  - ○ *Impartial Access*. SEFs would be required to provide impartial access. The SEC, but not the CFTC, has construed this requirement similarly to other contexts, such as securities alternative trading systems, where only fair, objective and not unreasonably discriminatory participation criteria are required.

  - ○ *Restrictions on SEF Models.* Market participants have expressed concern that a restrictive approach to SEF execution modalities (e.g., all-to-all displays, minimum number of RFQ recipients, mandatory integration of resting bids and orders), which are not supported by the statutory text, may disadvantage end users and discourage participants from executing swaps on SEFs, ultimately frustrating the Act's objective of encouraging broader use of SEFs.

Ownership and Governance of Exchanges and SEFs

- The Act requires the Commissions to promulgate rules with respect to exchanges and SEFs as necessary or appropriate "to improve the governance of [exchanges and SEFs], or to mitigate systemic risk, promote competition, or mitigate conflicts of interest."

- Under the proposed rules, the CFTC would impose a 20% individual equity ownership limit on certain "enumerated entities."[13] The SEC would impose a similar 20% individual equity ownership limit on all exchange/SEF participants.

- In addition, the CFTC would expand the role of public directors on the board of an exchange or SEF by mandating that the board be composed of at least 35% public directors and requiring substantial public director representation on the nominating committee, disciplinary panel, regulatory oversight committee, and membership and participation committee. Similarly, the SEC would expand the role of independent directors on the board of an exchange or security-based SEF by mandating that the board be majority independent and by requiring substantial independent director representation on various committees.

- Entities that anticipate registering as SEFs and enumerated entities have expressed concerns that the proposed ownership limits and the SEC's proposed 51% independent director requirement could inhibit the formation of SEFs and other new entrants and interfere with effective commercial and risk management processes.

Margin for Non-Cleared Swaps

- The Act requires regulators to impose both initial and variation margin requirements for SDs and MSPs on uncleared swaps/security-based swaps. These requirements are to be established in order to "help ensure the safety and soundness" of the SD or MSP.

- The Federal banking agencies have proposed uncleared swap margin rules for SDs and MSPs that are banks or otherwise subject to oversight by these Federal banking agencies. The CFTC has proposed uncleared swap margin rules for SDs and MSPs not regulated by a Federal banking agency; the SEC has yet to propose such rules.

    - *Initial Margin Levels.* Proposed margin levels would be set at a confidence interval (99%; 10-day horizon) implying margin levels considerably higher than (in some cases multiples of) current market practice, with only cash and Treasury and agency securities permitted as collateral. Market participants have raised concerns that this proposed calibration of margin levels is excessive and punitive, going well beyond the level necessary to achieve the Act's purposes.

    - *Variation by Counterparty Type.* Both the Federal banking agencies and the CFTC would impose different regulatory requirements among counterparties depending on whether the counterparty is an SD or MSP, a high- or low-risk financial entity or a non-financial entity.

[13] Defined to include any BHC with $50 billion or more in consolidated assets, any nonbank financial company designated as systemically significant, any affiliate of such a BHC or nonbank financial company, any SD, any MSP, or any associated person of an SD or MSP.

The CFTC has proposed a full exception for non-financial entities. In contrast, the Federal banking agencies have proposed an unmargined threshold for non-financial entities to be set by the individual SD or MSP (at levels consistent with its internal credit risk management policies and parameters).

- *Segregation.* The proposed rules would require an SD or MSP to offer segregation of initial margin with an independent third party custodian. Initial margin for transactions between SDs/MSPs would be required to be segregated. It is unclear what level of independence will be required for custodians of segregated initial margin. Moreover, concerns have been expressed that the proposed margin levels, in conjunction with mandatory segregation requirements, will, if adopted, tie up very substantial amounts of liquidity in the financial system; amounts estimated in some quarters in the trillions of dollars.

- *Extraterritorial Scope.* The Federal banking agencies have proposed to apply U.S. margin requirements to transactions by separately incorporated foreign subsidiaries of U.S. persons (registered as SDs or MSPs) with other foreign persons, even when the subsidiary does not have a guarantee from its U.S. parent. Commenters have expressed concerns that such exterritorial application of U.S. margin requirements could give rise to serious competitive disparities and harm the efficiency of the global swap markets and the international regulatory cooperation upon which that efficiency depends.

- *Inter-Affiliate Transactions.* The margin proposals do not provide any exceptions for inter-affiliate transactions. Left unaddressed, this would result in significant increased costs and liquidity demands to common risk management activities.

Trade Reporting and Public Disclosure

- **Reporting to Swap Data Repositories**. The Act establishes a new category of registered entity, swap data repositories ("SDRs"), to collect and maintain swap/security-based swap transaction data and make such data available to regulators and the public.

  - The CFTC and SEC have proposed rules for swap/security-based swap data reporting to a registered SDR. These proposed rules would designate an SD, if one counterparty is an SD, as the reporting party. If neither counterparty is an SD but one counterparty is an MSP, the MSP would be responsible for reporting. In all other situations, the counterparties would decide which one will be the reporting party. The parties would be required to report transaction data to the SDR in real-time, even if the transaction would be eligible for delayed public reporting.

  - The SEC has proposed to require reporting of any transaction (1) with a U.S. person, (2) executed through means of U.S. interstate commerce or (3) cleared through a clearinghouse with its principal place of business in the U.S. Notwithstanding the other proposed rules regarding the allocation of reporting obligations, U.S. persons are required under the SEC's proposed rules to report cross-border transactions, even if the U.S. counterparty is not an SD or MSP. The CFTC has not proposed similarly specific rules regarding cross-border transactions, but has requested comment on these issues.

- **Public Disclosure**. The CFTC and SEC also have proposed to require real-time public dissemination of specified swap/security-based swap data (including asset class, price and clearing status) by SDRs or other real-time disseminators, subject to the following delays for "block trades":

  - *CFTC*. Under the CFTC's proposed rule, a standardized swap with a notional size greater than the greater of (1) the 95th percentile of transaction sizes in the relevant swap category or (2) five times the largest of the mean, median or mode transaction size in that swap category would be subject to a 15-minute reporting delay, at which time notional size would be reported using a rounding convention. Market participants have expressed concerns that the CFTC's metrics for determining the appropriate block trade thresholds and delays are methodologically troubling as a result of insufficient consideration of the liquidity characteristics of swaps.

  - *SEC*. The SEC's proposed rule would require a security-based swap with a notional size greater than an as-yet-unspecified threshold to have its price and other transaction data reported publicly in real time, except that the security-based swap's notional size would be subject to delayed reporting 8 to 26 hours after execution. Notably, this reporting delay would not be available to large equity total rate of return swap trades. Market participants have expressed concerns that the SEC's proposal to disseminate pricing information in real time will also negatively affect liquidity, and that the SEC's proposed prohibition on real-time reporting delays for equity total rate of return swaps appears to be based on the flawed assumption that these products would be used to evade securities reporting requirements.

<u>Position Limits</u>

- **CFTC**. Under the Act, the CFTC is required to directly set speculative position limits on futures and options on physical commodities and economically equivalent swaps. Under the CFTC's proposed rule, 28 futures contracts and options and economically equivalent swaps would be subject to new position limits, including certain key contracts on metals and energy.

  - *Hedge Exemption*. In order for an SD to qualify for a "bona fide" hedge exemption from the CFTC's position limits, it will need to demonstrate that any given futures position or OTC derivatives position hedged by futures serves as a hedge against a specific OTC derivatives transaction with a counterparty that is itself hedging a commercial risk under the narrow definition of "bona fide" hedging included in the Act.[14]

  - *Aggregation Exemption*. The proposed rules would also significantly limit existing exemptions from the aggregation of positions, which would have implications for large financial institutions and asset managers. For example, the proposed rule would eliminate or narrow exceptions that currently permit (1) eligible entities to avoid

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[14] The Act defines "bona fide" hedging to cover positions that represent a substitute for transactions made or to be made in a physical marketing channel and that reduce commercial risk.

aggregating positions that are under the control of independent account controllers and (2) certain commodity pool operators and other participants in commodity pools to disaggregate positions held via passive interests in pools from directly held positions in certain circumstances.

  - *Non-U.S. Positions*. It is not yet clear whether and how commodities positions held outside the United States will be analyzed and aggregated under the proposed rules.

- **SEC**. The Act also permits the SEC to impose position limits on security-based swaps and aggregate swaps positions with stock and stock futures positions, but it has not acted on this authority.

Anti-Fraud and Anti-Manipulation

- The Act expands the power of the CFTC and the SEC to address disruptive and manipulative practices by market participants.

- **Anti-Disruptive Measures**. The CFTC has proposed an interpretative order to provide guidance with respect to each of the following practices prohibited under the Act: (1) violating a bid or offer; (2) intentionally or recklessly disregarding the orderly execution of transactions during the closing period; and (3) engaging in activity that is, is of the character of or is commonly known to the trade as "spoofing."

- **Anti-Manipulative Measures**. The CFTC and SEC have separately proposed (and, in the case of the CFTC, adopted) rules implementing provisions of the Act that prohibit market manipulation.

  - *CFTC*. The CFTC has adopted an anti-manipulation rule for swap, commodity and futures transactions that parallels SEC Rule 10b-5 (except that disclosure of material information is not required except where necessary to make a statement made not misleading). It has also adopted a rule that prohibits any manipulation of swap, commodity or futures prices, even if such manipulation does not occur in the course of a transaction.

  - *SEC*. The SEC's proposed rule would apply existing securities anti-manipulation rules, including Exchange Act Section 10(b), Rule 10b-5 thereunder, and Securities Act Section 17(a), to security-based swaps and, in particular, to payments, deliveries or exchanges that occur during the lifetime of a security-based swap. The SEC has also proposed to expand regulation of manipulative behavior to cover misconduct to trigger, avoid or affect the value of ongoing payments or deliveries throughout the life of a security-based swap.

VII. CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION

Regulation of Incentive Compensation at Financial Institutions

- Proposed rules under Section 956 of the Act were released jointly by the Federal regulators in April 2011, and contain five key components:
  - Requirements specifically applicable to "larger covered financial institutions" (i.e., those covered financial institutions with $50 billion or more in total consolidated assets), including:
    - a mandatory deferral of at least 50% of incentive compensation for a minimum of three years (with vesting to occur no faster than ratably over three years) for executive officers of a larger covered financial institution; and
    - a requirement that the board of directors of a larger covered financial institution identify those individuals who "present particular loss exposure" to the institution and approve their incentive-based compensation arrangements.
  - A prohibition on incentive-based compensation arrangements for executive officers, employees, directors or principal shareholders ("Covered Persons") that would encourage inappropriate risks by providing excessive compensation.
    - The proposed rules define "excessive compensation" by reference to existing regulations under the FDIA, which look to factors including (1) the combined value of all benefits received by the Covered Person; (2) the compensation history of the Covered Person and other individuals with comparable expertise at the covered financial institution; (3) the institution's financial condition; (4) comparable compensation practices at comparable institutions and the complexity of the institution's operations and assets; (5) for postemployment benefits, the projected total cost and benefit to the institution; and (6) any connection between the individual and any fraudulent act, breach of trust or fiduciary duty or insider abuse with regard to the institution.
  - A prohibition on incentive-based compensation arrangements for Covered Persons that would expose the institution to inappropriate risks by providing compensation that could lead to a material financial loss.
    - The proposed rules state that in order to satisfy this requirement, incentive compensation arrangements must (1) balance risk and financial reward, (2) be compatible with effective controls and risk management and (3) be supported by strong corporate governance.
  - A requirement that covered financial institutions implement policies and procedures for incentive-based compensation arrangements that are commensurate with the size and complexity of the institution to help ensure compliance with the proposed rules' requirements and prohibitions.

- ○ A requirement that covered financial institutions provide annual reports on incentive compensation structures to the institution's appropriate Federal regulator.

- As contemplated by the statutory language of the Act, the term "covered financial institution" includes not only depository institutions and their holding companies, but also registered broker-dealers, credit unions, investment advisers, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. Institutions with less than $1 billion in total consolidated assets are excluded.

- There remain a number of key uncertainties regarding the proposed rules under Section 956, including their application to foreign institutions (see below), their application to controlled groups with more than one covered financial institution member, the specific technical aspects of the mandatory deferral requirement and timing issues with regard to the rules' ultimate effective date.

- The proposed rules contemplate that the final rules' effective date will be six months after publication; the SEC's website currently indicates that final rules are expected to be adopted by the end of 2011.

- **Application to foreign private issuers**. The scope of the proposed rules' applicability to FBOs (i.e., whether the rules apply only to those institution's U.S. entities, operations and/or employees) remains unclear due to certain technical inconsistencies and ambiguities in the operative provisions of the proposed rules. Many commenters have requested further clarification of this issue.

Governance and Executive Compensation Provisions

- Many of the Act's other governance and executive compensation provisions have yet to be implemented. Of the Act's key provisions in this area, only the "Say on Pay" and related rules have been finalized. Proposed rules have been issued with respect to the new compensation committee independence rules, but are not expected to come into effect until sometime in 2012, as described below.

  - ○ "*Say on Pay*" *and* "*Say When on Pay*." As of January 21, 2011, all domestic public companies are required to hold a non-binding "Say on Pay" vote to approve executive compensation disclosed in the proxy statement on at least a triennial basis. At the first shareholder meeting following January 21, companies also provided for (or will provide for) a non-binding shareholder vote regarding whether the "Say on Pay" vote should occur on an annual, biennial or triennial basis. Companies will be required to hold this "Say When on Pay" vote at least once every six years. As of early July 2011, according to a Dow Jones Newswire article, 39 of 2,532 companies holding "Say on Pay" votes had failed to obtain majority approval from their shareholders.[15]

[15] See http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=201107071939dowjonesdjonline000609 &title=few-us-public-companies-failed-new-say-on-payvotes.

- "*Say on Golden Parachutes*." As of April 25, 2011, domestic public companies must include a non-binding "Say on Golden Parachutes" vote in any proxy statement seeking shareholder approval for a merger or similar corporate transaction, together with disclosure (in both quantitative and narrative form) regarding any compensation arrangements that the issuer has with its named executive officers or the named executive officers of the other party in the corporate transaction that relate to the transaction. Soliciting target companies must also disclose (but do not need to hold an advisory vote regarding) arrangements between the acquiring company and the target's named executive officers. The disclosure is also required in certain other regulatory filings, such as registration statements on Forms S-4 and F-4 and Schedule 14D-9, though no shareholder advisory vote is required in these other cases.

- *Compensation Committee and Consultant Independence*. The Act requires national securities exchanges to impose new independence standards on compensation committee members of all issuers with listed securities (including foreign private issuers, unless they make certain disclosures to their shareholders). The types of relationships the exchanges are required to consider in adopting their listing standards include requirements similar to those currently required for audit committee members (relating to fees received by the director and affiliations that the director has with the issuer). The Act also requires the exchanges to establish independence standards for compensation consultants, legal counsel and other advisers and requires proxy disclosure regarding conflicts of interest raised by the work of compensation consultants that take into account, at a minimum, certain factors specified in the Act. Proposed rules published by the SEC in April 2011 did not add substantively to the statutory requirements. The rules are currently expected to be finalized by the end of 2011; the national securities exchanges will then have up to one year to implement the rules through new listing standards.

- *Clawbacks*. The Act requires issuers with listed securities (potentially including foreign private issuers) to establish a clawback policy in the event of an accounting restatement that would recover incentive-based compensation received during the three-year period preceding the date of the restatement by any current or former executive officer of the issuer "in excess of what would have been paid to the executive officer under the accounting restatement." No deadline for implementation is specified in the Act. The SEC has not yet issued any proposed rules (although its website currently states that it expects to propose and adopt rules by the end of 2011). The final rules will be subject to implementation by the national securities exchanges.

- *Executive Compensation and Hedging Policy Disclosure*. The Act also requires the SEC to issue regulations requiring:

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

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

- disclosure in any proxy statement regarding whether directors or employees are permitted to hedge compensatory equity grants or stock otherwise held, directly or indirectly, by them.

○ No deadline for implementation is specified in the Act for these rules and the SEC has not yet issued any proposed regulations (although its website currently states that it expects to propose and adopt rules by the end of 2011). Additionally, a bill to repeal the "pay disparity ratio" provision of the Act was passed by the House Committee on Financial Services in June 2011; however, it appears unlikely that, even if the bill is passed by the House, it would be passed by the Senate.

- Application to foreign private issuers

  ○ Concrete guidance regarding the applicability of many of the Act's executive compensation and corporate governance provisions to foreign private issuers remains largely unavailable due to the current lack of proposed rules.

VIII. SECURITIZATION AND CREDIT RATING AGENCY REFORM

- The SEC and Federal banking agencies proposed rules to implement the Act's risk retention requirement on March 30, 2011.
  - The agencies later extended the original comment period to August 1, 2011, in response to reactions that the proposed rules were voluminous, detailed and in need of extensive revision.
  - The proposed rule requires risk retention of 5% of any asset-backed securities ("ABS") transaction (registered or not). Retention may be in one of the following forms:
    - Vertical slice – 5% of each class of ABS issued;
    - Horizontal slice/residual interest – first-loss tranche equal to 5% of "par value" of all ABS issued (or funded cash reserve in the same amount);
    - "L-shaped retention" – 2.5% of each class of ABS issued plus 2.5% residual (somewhat unclear what the point of this alternative is);
    - Representative sample – 5% random selection from a pool of at least 1,000 assets to be securitized;
    - Seller's interest in an ABS master trust;
    - 100% liquidity coverage provided by a bank for asset-backed commercial paper conduits; or
    - Unaffiliated third-party purchase and retention of 5% residual in commercial real estate ABS.
  - The proposal includes a requirement for a "premium capture cash reserve" in addition to the 5% retention requirement.
    - The reserve would capture proceeds of excess spread being monetized as either an interest-only tranche or a premium tranche. The proceeds representing excess spread would stay in the reserve during the life of the ABS transaction and would bear the first losses on assets.
    - The capture of excess spread premium is not required or even mentioned by the Act; SEC staff asserts that up-front monetization of excess spread reduces the incentives otherwise provided by the 5% risk retention options. This has proven one of the more controversial components of the proposal.
  - The agencies have taken a very conservative approach to implementing the exemptions required by the Act.

        - ABS backed solely by "qualified residential mortgages," whose requirements would include:
            - 80% maximum loan to value ratio for purchase loans/20% cash down payment;
            - borrower not 30 or more days past due on any debt obligation at origination; and
            - loan documents must incorporate loss mitigation servicing provisions (criticized as unrelated to credit quality of loan and not required by the Act).
        - ABS backed solely by qualifying commercial loans are exempt from risk retention:
            - requirements for qualifying loans would include specified minimum financial requirements that have been criticized as not reflecting market practice.
        - ABS backed solely by qualifying commercial real estate loans are exempt from risk retention:
            - requirements for qualifying loans include specified minimum financial requirements and loan terms that have been criticized as not reflecting market practice.
        - ABS backed solely by qualifying automobile loans.
    - The proposed rule places the risk retention requirement on "securitizers" of ABS
        - The rule would define a "sponsor" of an ABS transaction (as defined in current Regulation AB) as the securitizer.
        - Commenters have pointed out that in some ABS transaction types, no one meets the Act's definition of "securitizer" or the person who would logically have the risk retention requirement (<u>e.g.</u>, the manager of a collateralized debt obligation "<u>CDO</u>") does not, and therefore cannot, satisfy the requirement even if it is willing to retain risk.
- One overriding concern is that the Act's very broad definition of "asset-backed security" could require risk retention and other rules to be applied to structured credit transactions that are not asset securitizations.

<u>Review of Assets Underlying ABS by Issuers and Third-party Diligence Providers</u>

- In January 2011, the SEC adopted a rule requiring issuers of SEC-registered ABS to review the underlying assets and disclose the nature of that review and the issuer's findings and conclusions.

- "Issuer" in this rule means depositor or sponsor.

- The rule as adopted requires the review to be "designed and effected to provide reasonable assurance that the disclosure regarding the pool assets...is accurate in all material respects," a requirement that is not imposed by the Act and was not part of the rule as initially proposed

- The disclosure must describe how any assets included in the pool deviate from the disclosed criteria and which transaction party decided to include them nonetheless.

- An issuer may engage an unaffiliated third party to perform the review, but the third party must consent to be named an expert unless the issuer adopts the third party's findings as its own.

- This rule becomes effective for SEC-registered ABS transactions that close after December 31, 2011.

<u>Repurchase History and Representations and Warranties in ABS</u>

- Also in January 2011, the SEC adopted a rule that requires securitizers of ABS to disclose historical information on asset put-backs on an ongoing basis.

  - The rule applies to issuers, sponsors, underwriters and depositors of ABS that are registered or unregistered, including CDOs, GSE-issued or guaranteed securities, and municipal ABS. It applies to U.S. entities that securitize assets offshore and to non-United States securitizers who offer securities in the United States.

  - However, it only applies if the underlying transaction agreements require the securitizer to repurchase or replace assets for breaches of representations and warranties.

  - The rule requires securitizers to disclose, in an SEC-mandated tabular format by asset class and originator: (1) total assets securitized, (2) how many were subject to repurchase demands, (3) how many of those were repurchased, and (4) how many requests are pending or disputed or were withdrawn or rejected.

  - The SEC has created a new EDGAR form for these disclosures to be used by all securitizers. Issuers of SEC-registered ABS must also make disclosures in prospectuses and their Form-D filings.

  - The initial filing must include data for the three years ending December 31, 2011. Anyone who securitized assets with a repurchase covenant during those three years and has the ABS outstanding at the end of 2011 must file by February 14, 2012.

  - Thereafter, each quarter's repurchase activity (or inactivity) must be reported within 45 days of the quarter's end.

- At the same time, the SEC adopted a rule that requires nationally recognized statistical rating organizations ("NRSROs") to include in any ABS rating report a description of the representations, warranties and enforcement mechanisms available to investors and how they differ from those in similar ABS issuances.
  - The rule applies to all rated ABS, whether or not offered publicly in the United States.
  - The disclosure must be included in preliminary ratings reports and "pre-sale reports" as well as final reports.
  - The requirement will become effective for rating reports issued on or after September 26, 2011. The NRSROs are in the process of benchmarking representations and warranties for deals of different types.

Increasing Supervision, Transparency and Integrity of Credit Ratings

- On June 8, 2011, the SEC proposed certain rules and amendments intended to increase transparency and improve the integrity of credit ratings as required by the Act. The SEC has scheduled the rules to be finalized and adopted between August and December of 2011. Under the proposed rules, each NRSRO would be, among other things:
  - required to file an annual report with the SEC containing a description and an assessment of the effectiveness of its internal controls;
  - prohibited from permitting employees who participate in the NRSRO's sales or marketing to also be involved in determining or monitoring credit ratings or developing or approving rating procedures;
  - required to conduct a "lookback" review in cases in which former employees participating in determining a credit rating were subsequently employed for one year by an entity subject to that credit rating or by the issuer, underwriter or sponsor of a product subject to that credit rating;
  - required to publicly disclose additional information on the historical performance of its credit ratings on a uniform basis so users can evaluate the accuracy of the NRSRO's ratings and compare the performance of different rating agencies; and
  - required to establish standards of training, experience and competence for credit analysts.

Removal of Credit Ratings References and Substitute New Credit-worthiness Standards

- On October 4, 2010, the SEC adopted a final rule removing from Regulation FD the specific exemption provided to credit rating agencies for disclosure made to them for the purpose of determining or monitoring a credit rating. This has not significantly affected the provision of information to rating agencies because issuers may still rely on the Regulation FD exception for disclosures made under a confidentiality agreement.

- On February 25, 2011, the SEC proposed rules and amendments to remove certain credit rating references under Securities Act and Exchange Act rules and forms.
  - The proposed rules would remove references to investment grade ratings in Form S-3, F-3, S-4 and F-4, as well as Schedule 14A and Rule 134, 138, 139, and 168 safe harbors, which are substituted with a standard that the issuer must have a minimum $1 billion of non-convertible, SEC-registered securities for cash during the prior three years, as measured within 60 days of the date it files the registration or proxy statement (or, in the case of Rules 138, 139 and 168, when it seeks to rely on the rule's safe harbor).
- On March 9, 2011, the SEC proposed rules to remove references to credit ratings from certain '40 Act rules and forms.
  - The rule would omit the references to credit ratings in rules 2a-7 and 5b-3, and propose a new rule 6a-5 to establish a credit worthiness standard. References in certain relevant forms will also be eliminated or removed.
- On May 9, 2011, the SEC proposed revisions to remove credit ratings from Regulation M, Broker-Dealer Net Capital Rule and other Exchange Act rules.
  - The exemption in Regulation M permitting issuers and underwriters to purchase investment-grade securities during distribution would be removed and substituted with other factors of evaluation verified by an independent third party, which could not be counsel to the underwriter or issuer or an affiliate of theirs.
  - The NRSRO rating standard in the broker-deal net capital rules would be substituted with a requirement that commercial paper, nonconvertible debt securities or preferred stock would qualify for the lower haircuts if the broker-dealer determines that the investment has only a "minimal amount of credit risk" based on written policies and procedures designed to assess credit and liquidity risks.
- The Internal Revenue Service (the "IRS") and Treasury adopted certain final and temporary regulations effective on July 6, 2011 to remove references to credit ratings and credit agencies or functionally similar terms in their existing regulations.
- On July 19, 2011, the CFTC adopted final rules regarding removal of references to credit ratings from the CFTC regulations.
  - The CFTC has removed the reference to highly-rated commercial paper or long term debt instruments in CFTC Regulation 1.49, and substituted it with the standard that customer funds be placed only in a foreign depository that has in excess of $1 billion of regulatory capital.
  - The CFTC has removed the reference to "investment rating" in CFTC Regulation 4.24 and has substituted it with the phrase "credit-worthiness."

Rating Agency Expert Consents

- The Act invalidated SEC Rule 436(g), which had exempted NRSROs from being deemed "experts" under the securities laws. The effect, which was immediate, was to require rating agencies to file consents to being named as experts as part of any registration statement that included references to their ratings.
  - The NRSROs promptly announced that they would not consent, creating an impasse that stopped some deals in their tracks.
  - Although the effect was not limited to asset-backed transactions, the SEC and the securities bar agreed on the circumstances in which a consent would be required for rating references in offerings of non-asset-backed securities (and when they would not, despite the repeal of Rule 436(g)). As a result, the effect on non-asset-backed offerings was minimal.
  - However, Regulation AB requires disclosure if the issuance of any class of SEC-registered ABS is conditioned on receipt of a rating—which as a practical matter is always the case. On July 22, 2010, the SEC issued a no-action letter permitting ABS issuers to omit ratings information for six months so that transactions could proceed while the issue was sorted out. With no resolution in sight, on November 23, 2010, the SEC extended that no-action position indefinitely.
  - The House Financial Services Committee has now proposed to restore SEC Rule 436(g).

Still to Come

- The SEC has yet to propose rules implementing Section 621 of the Act.
  - This provision prohibits underwriters of ABS and their affiliates from engaging in "any transaction that would involve or result in any material conflict of interest with respect to any investor."
  - There are exceptions for hedging and underwriting positions, but the scope of the prohibition could be extremely broad and interfere with a number of typical and non-abusive practices, including some entirely unrelated to an underwriter's securitization activity.
  - The SEC has scheduled its rule proposal to be made by the end of July and the rule finalized and adopted by the end of 2011.
- The SEC has recently stated it is "re-evaluating" its proposal to overhaul Regulation AB (made in April 2010) in light of the Act.
  - Chairman Schapiro has indicated that the SEC is likely to repropose some of those rules, including modifications to shelf eligibility for ABS and imposition of SEC disclose requirement on un-registered ABS offerings.

IX. INVESTOR PROTECTION

Extraterritorial Jurisdiction of the Antifraud Provisions of the Federal Securities Laws

- The Supreme Court's June 2010 decision in Morrison v. National Australia Bank held that Section 10(b) actions under the Exchange Act extend only to purchases and sales of securities in the United States, or of securities listed on U.S. exchanges. Morrison was a so-called "F-cubed" case, involving a foreign plaintiff who bought a foreign defendant's shares on a foreign exchange, with alleged U.S. conduct contributing to the fraud as a jurisdictional link.
    - In setting forth this "transactional" test for Section 10(b), the Supreme Court went far beyond the facts in Morrison and dramatically constricted the scope of liability as compared to the prior "conduct-effects" test. The conduct-effects test allowed for liability when U.S. conduct that was "more than merely preparatory" caused losses to investors abroad, or, as alleged in Morrison, when fraudulent conduct abroad had "substantial effects" in the United States or on U.S. citizens.
    - In Section 929P of the Act, Congress restored the conduct-effects test for actions brought by the SEC and the DOJ, using language referring to subject matter jurisdiction. But because Morrison also held that Section 10(b)'s extraterritorial reach is a question of statutory reach, not subject matter jurisdiction, there is some debate as to whether Congress effectively overruled Morrison on this point. While the statutory language is unclear, legislative history is unambiguous, and there would seem to be no warrant to attribute to Congress an intention to create subject matter jurisdiction over a non-existent cause of action. Accordingly, most experts believe that the SEC and DOJ can safely proceed in bringing cases under the conduct-effects provisions of the Act.
    - In Section 929Y of the Act, Congress directed the SEC to conduct a study for Congress on whether, and to what extent, the conduct-effects test should be restored for private rights of action. This study is due to Congress by January 2012. In our view, the SEC (perhaps by a split vote) is likely to conclude that the conduct-effects test should be restored, though applied in a way that would preclude "F-cubed" actions on facts similar to those presented in Morrison.
- For the time being, Morrison's transactional test is unquestionably valid for private rights of action and has resulted in the dismissal of many Section 10(b) cases—mostly in the Southern District of New York—that might have survived under the traditional conduct-effects test.
    - In Cornwell v. Credit Suisse, the Southern District of New York ("SDNY") first established that the nationality of the investor is irrelevant under Morrison, dismissing claims by a so-called "F-squared" plaintiff—a U.S. plaintiff who bought a foreign defendant's stock on a foreign exchange.

- Morrison's transactional test provides that Section 10(b) applies only to (1) "transactions in securities listed on domestic exchanges" and (2) "domestic transactions in other securities." Read literally, the first prong of the test leaves open the possibility that a securities purchase on a foreign exchange could give rise to Section 10(b) liability if the same security were also listed on a U.S. exchange, either for actual trading or represented by American Depositary Receipts ("ADRs"). But lower courts have rejected this argument as inconsistent with the spirit of Morrison. Accordingly, plaintiffs attempting to establish Section 10(b) liability under Morrison's first prong must have purchased their securities on a U.S. exchange.

- Morrison's second prong, which allows for Section 10(b) liability for "domestic transactions in other securities," has been invoked where plaintiffs purchased securities over-the-counter rather than on an exchange. However, the Supreme Court provided little guidance on determining when over-the-counter "purchases" and "sales" are made in the United States, leaving lower courts to work out the details.

  - SDNY judges, beginning in Plumbers Union Local No. 12 Pension Fund v. Swiss Reinsurance Co., have indicated that they will focus on whether an individual incurs an "irrevocable liability" in the United States to deliver or pay for the security.

  - While exchange-traded ADRs appear to satisfy the transactional test, over-the-counter ADRs must pass the "irrevocable liability" bar. Notably, courts have not made any distinction between sponsored ADRs—which reflect an issuer's active participation with a U.S. depositary in creating the ADR facility—and unsponsored ADRs in the context of over-the-counter ADR transactions.

  - In Quail Cruises Ship Mgm't Ltd. v. Agencia de Viagens CVC Tur Limitada, the Southern District of Florida held that the location of a closing—if wholly unrelated to the rest of the transaction and clearly designed to opt into another country's securities laws—cannot be used to satisfy Morrison's transactional test.

- In the SEC's high-profile case against Goldman Sachs trader Fabrice Tourre, SEC v. Tourre, the SDNY judge has dismissed the Section 10(b) claims relating to CDO note purchases executed by two foreign institutions with Goldman's U.K. affiliate, while allowing claims relating to a U.S. institution's purchases to proceed. (Because this action predates the Act, the non-retroactivity of Section 929P meant that the SEC's claims were subject to the transactional test, not the conduct-effects test.)

  - The SEC did not sufficiently allege how the foreign institutions' transactions were "domestic" in terms of Morrison. Accordingly, the court did not consider the SEC's argument that Goldman and Tourre had wrongly circumvented Section 10(b) by arranging much of those transactions from New York, but formally executing them through a foreign agent.

  - The court also held that Regulation S, under which Goldman sold the CDOs, has no bearing on the analysis of Section 10(b) claims. By comparison, the Central District of California opined in Stackhouse v. Toyota Motor Co. that Reg. S's definition of "offshore transaction" might be relevant to discerning what the Supreme Court meant by "domestic transactions."

  - The court refused to entirely dismiss the SEC's claims via Section 17(a) of the Securities Act, which covers fraud in connection with "offers" or "sales." Because Section 17(a), after Morrison, no longer applies to "sales that occur outside the United States," the court dismissed the Section 17(a) "sale" prong claims relating to the foreign institutions. But on the "offer" prong of Section 17(a), the SEC adequately alleged that Tourre made "domestic offers" to the foreign institutions, which the court defined as (1) an "attempt or offer" in the United States "to dispose of" securities or security-based swaps or (2) a "solicit[ation]" in the United States of "an offer to buy" securities or securities-based swaps. Tourre's calls and emails from New York to the foreign institutions satisfied this test.

- Securities-based swaps that reference foreign securities now fall outside the reach of Section 10(b) liability. In Elliott Assocs. v. Porsche Automobil Holding SE, the SDNY judge held that the "economic reality" is that securities-based swaps are the "functional equivalent" of trading the underlying shares on a foreign exchange.

Fiduciary Standard for Brokers, Dealers and Investment Advisers

- Section 913 of the Act requires that the SEC conduct a study evaluating existing standards of care with respect to brokers, dealers and investment advisers providing personalized investment advice and recommendations to retail customers about securities and gives the SEC discretionary rulemaking authority after considering the findings of its study.

- On January 21, 2011, the SEC released its study and recommendations on the standard of conduct applicable to investment advisers and broker-dealers. The study recommends that the SEC exercise its rulemaking authority under the Act to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers, and the harmonization of certain other areas where investment adviser and broker-dealer laws and regulations differ.

  - The study recommends that the SEC define "personalized investment advice" to include, at a minimum, "recommendations" as defined in existing broker-dealer regulations (where it has been interpreted very broadly), and exclude "impersonal investment advice" as used under the Advisers Act.

  - The study recommends that the SEC define "retail customers" to include individual retail customers and groups of retail customers. It also notes that the SEC could consider extending the uniform fiduciary standard to cover persons other than retail customers who could benefit from additional investor protections.

- Pursuant to the Act, the new standard would be at least as high as the fiduciary duty standard currently applied to investment advisers under the Advisers Act and, notably, would provide for violations of the standard not involving scienter and create a major potential for regulatory enforcement.
  - The study provides that existing guidance under the Advisers Act (including through case law and enforcement actions) regarding fiduciary duty would continue to apply to both investment advisers and broker-dealers.
  - Pursuant to amendments to the Exchange Act and the Advisers Act required by the Act, (1) receipt of compensation based on commission or other standard compensation for the sale of securities would not violate the new standard if adopted, and (2) a broker or dealer would not be required to have a continuing duty of care or loyalty to the customer after providing personalized investment advice about securities.
- The Advisers Act standard is a principles-based fiduciary duty standard, which includes two components:
  - the duty of loyalty would require that an investment adviser or broker-dealer provide full and fair disclosure about material conflicts of interest. The study recommends that (1) the SEC develop a uniform approach to disclosure, (2) the SEC consider the appropriateness of imposing an outright prohibition on certain material conflicts of interest and (3) broker-dealers be required to disclose their conflicts of interest for principal trades, but without being subject to the same notice and consent procedures as investment advisers under the Advisers Act; and
  - the duty of care would require that investment advisers and broker-dealers meet specified professional standards. The study recommends that the SEC provide detailed guidance as to an expected minimum standard of conduct.
- The study also suggests that the regulatory requirements related to providing investment advice about securities to retail customers that are applicable to investment advisers and broker-dealers be harmonized, including recommendations with respect to (1) advertising and customer communication rules, (2) rules governing the use of finders and solicitors and disclosure of the conflict of interest associated with their compensation structure, (3) supervisory requirements, (4) the disclosure requirements of the respective registration forms, (5) Federal licensing and continuing education requirements for investment adviser representatives and (6) retention of communications and agreements related to an adviser's business.
- The study also considers eliminating the exclusion from registration for broker-dealers under the Advisers Act, but ultimately concludes that the cost of doing so would exceed the benefits.

- Given the level of disagreement at the SEC with the study and the fact that implementation of any of the recommendations will require detailed rulemaking and public comment, the ultimate practical ramifications remain to be seen.

Whistleblower Bounty Program

- The Act added new Section 21F to the Exchange Act, establishing a framework that directs the SEC to pay rewards to eligible whistleblowers who voluntarily provide the SEC with original information about a violation of the U.S. securities laws that leads to a successful enforcement action. If the SEC recovers a monetary sanction exceeding $1,000,000, it is to award to qualifying whistleblowers, in aggregate, 10% to 30% of the penalties and disgorgements collected in an SEC enforcement action or in certain "related actions."[16] On May 25, 2011, the SEC adopted final rules implementing the new program. The rules are effective August 12, 2011.

- The rules define a "whistleblower" as an individual (and not a company or other entity) who, acting alone or with others, provides information that "relates to a possible violation of the Federal securities laws (including any rules or regulations thereunder) that has occurred, is ongoing, or is about to occur."
    - Neither the Act nor the rules require a whistleblower to make use of his or her company's internal compliance programs before reporting a possible violation to the SEC. In response to concerns in comments that the rules as proposed would undercut internal compliance programs, the SEC adopted a number of provisions intended to encourage would-be whistleblowers to report information through internal company channels before reporting to the SEC. In particular, if a whistleblower uses the company's internal compliance program and the company investigates and reports the results of the investigation to the SEC, all information that the company provides to the SEC will be deemed to have been provided by the whistleblower. Also, voluntary participation in a company's internal compliance program is a factor that may increase the amount of an award.[17]

- To receive an award, a whistleblower must "voluntarily" provide "original information" to the SEC – that is, information that comes from the whistleblower and has not been provided by another party.

- The rules define when a whistleblower's submitted information has led to a "successful enforcement" action.

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[16] A "related action" includes Federal and state criminal proceedings, as well as proceedings brought by appropriate regulatory agencies or self-regulatory organizations.

[17] The rules also provide that, if a whistleblower reports information internally and reports the information to the SEC within 120 days thereof, the report to the SEC will be considered to have been made the date of the earlier internal report.

- In cases where a whistleblower submits information that is specific, credible and timely enough to cause the SEC to begin a new examination or investigation, reopen a closed investigation, or focus on different conduct as part of a current examination or investigation, the information will be considered to have led to successful enforcement if a successful judicial or administrative action is brought by the SEC based at least in part on the reported conduct.

- For conduct already subject to examination or investigation by the SEC or another overseeing body, information will be considered to have led to successful enforcement if it "significantly contributes" to the success of the action.

SEC Proposes Amendments to Disqualify "Bad Actors"

- On May 25, 2011, the SEC proposed amendments to Rule 506 of Securities Act Regulation D. Regulation D is a widely used exemption that provides a safe harbor for the sale of securities without registration under the Securities Act to accredited investors and a small number of other investors. The Act requires the SEC to adopt rules that disqualify felons and other "bad actors" from participating in such offerings. The proposed amended rules would essentially mirror disqualification rules under other SEC regulations.

- Under the proposed amendments, the Rule 506 exemption would not be available if

  - the issuer, an affiliated issuer, or a director, officer or predecessor of the issuer;

  - a 10% beneficial owner of any class of equity securities of the issuer; or

  - a promoter connected with the issuer in any capacity, or a person that directly or indirectly receives remuneration for the solicitation of purchasers in connection with the offering (or any general partner, director, officer or director of such person)

  were subject to certain disqualifying conditions, including:

  - a criminal conviction in connection with the purchase or sale of securities or arising out of ahe conduct of an underwriter or broker-dealer;

  - a court injunction or restraining order in connection with the purchase or sale of securities or arising out of the conduct of an underwriter or broker-dealer;

  - a final order of Federal or state regulators such as banking, credit union or insurance regulators that bar persons from engaging in the business of securities, insurance, banking or similar activities or associating with entities regulated by the regulator; or are based on violations of law or regulations that prohibit fraudulent, manipulative or deceptive conduct; or

  - an SEC disciplinary order covering activities such as suspensions or revocations of registration as a broker-dealer or imposing limitations on activities of a broker-dealer.

- The proposed amendments contain a timeline for a disqualifying event that includes a look-back period from between five and ten years, depending on the event being considered.
- The proposed amendments include a carve-out, pursuant to which the Rule 506 exemption will remain available if the issuer can establish that it did not know, and in the exercise of reasonable care could not have known , that a disqualified person was participating in the offering.
- The proposed amendments have several problematic features, including:
  - Under the proposed amendments, the Rule 506 exemption would not be available if a disqualified person is an "officer" of the issuer (or a solicitor), but "officer" has been defined broadly by the SEC to include a number of individuals who do not necessarily serve a policy-making function.
  - The proposed amendments would apply the limitations on the Rule 506 exemption to each sale, but issuers may not receive real-time information about a relevant participant in the offering becoming disqualified (e.g., if a 10% beneficial owner is convicted of a crime relating to the purchase or sale of a security). Accordingly, issuers may not know at the outset whether there are any disqualified persons participating in a transaction, and it may be even more difficult to determine if a person becomes a disqualified person during the course of an offering.

Municipal Securities Rulemaking Board

The Act amended the Exchange Act to require "municipal advisers" to register with the SEC and to grant the MSRB regulatory jurisdiction over such persons. It defined "municipal advisers" generally to include persons who solicit municipalities or provide advice to municipalities or guarantors of municipalities regarding municipal financial products or the issuance of municipal securities. Broker-dealers acting as underwriters and registered investment advisers providing investment advice are excluded from the definition of "municipal adviser."

The SEC has enacted a temporary rule regarding the registration of municipal adviser firms and has proposed permanent rules under which both municipal adviser firms and individuals associated with such firms would be required to register. Pursuant to its authority under the Act, the MSRB has:

- extended its fair dealing rule to cover the actions of municipal advisors and proposed related interpretive guidance;
- proposed a fiduciary duty rule and related interpretive guidance applicable to municipal advisers;
- proposed a "pay to play" rule that applies to municipal advisers and to extend to municipal them its restrictions on gift giving;
- proposed to require each municipal adviser firm to establish a supervisory structure; and
- seated a Board of Directors with a majority of public members and three municipal advisers.

X. PRIVATE FUND REFORMS

Registration and Compliance Deadlines

- Although July 21, 2011, is the effective date for the repeal of the "15-client exemption" pursuant to the Act, the SEC has extended the registration and compliance deadline for advisers currently exempted from registration in reliance on the "15-client exemption." Such advisers will have until March 30, 2012, to become registered, unless they qualify for one of the new exemptions, described below.
  - The SEC noted that, because an initial application for registration can take up to 45 days to become effective, new registrants should file their complete Form ADV by no later than February 14, 2012. A new registrant should begin preparing its Form ADV well in advance of this date, especially given the significant additional information required by the SEC's final rules (see below).
- All currently registered advisers must file a Form ADV amendment confirming SEC-registration eligibility by March 30, 2012. Advisers no longer eligible, such as mid-sized advisers (see below), have until June 28, 2012, to withdraw their SEC registration.

Exemptions from Advisers Act Registration after the Act

- The Act eliminates the "15-client exemption" under the Advisers Act, which exempts from registration advisers who (1) during the course of the preceding 12 months have had fewer than 15 clients, (2) do not hold themselves out to the public as investment advisers, and (3) do not provide advisory services to funds registered as investment companies under the '40 Act. The Act will therefore require advisers to hedge funds and private equity funds that currently rely on this exemption from registration to register as investment advisers under the Advisers Act, unless a new exemption applies.
- As required by the Act, the SEC has adopted final rules providing new exemptions from registration under the Advisers Act including an exemption for advisers that act solely as advisers to private funds (defined as an issuer that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the '40 Act) and have aggregate regulatory assets under management ("R-AUM" (as defined below)) in the United States of less than $150 million (the "Private Fund Adviser Exemption").
  - For U.S. advisers, all of the adviser's clients must be private funds and the adviser must count all assets under management even if the adviser has non-U.S. offices with management responsibilities.
  - For non-U.S. advisers, all the adviser's U.S. clients must be private funds and the adviser need only count assets it manages at a place of business in the United States.
- The Act also exempts from registration a non-U.S. adviser that (1) has no place of business in the United States; (2) during the preceding 12 months has had (a) in total, fewer than 15 clients and investors in the United States in private funds advised by such investment adviser

and (b) aggregate AUM attributable to clients and investors in the United States in private funds advised by such investment adviser of less than $25 million; and (3) neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to any investment company registered under the '40 Act ("Foreign Private Adviser Exemption").

- While more narrow in its eligibility than the Private Fund Adviser Exemption, the Foreign Private Adviser Exemption, if available to a non-U.S. adviser, will be preferable to the Private Fund Adviser Exemption, because Foreign Private Advisers are not subject to the reporting requirements for so-called "exempt reporting advisers" (described below).

- Definition of Client. For purposes of the Advisers Act, fund advisers have generally been able to count each fund as a single client, rather than looking through each fund to the individual fund investors (so long as the fund receives investment advice based on its investment objectives, rather than the separate investment objectives of its investors). This has been particularly important for fund advisers counting the number of their clients for purposes of the "15-client exemption." While the fund itself and not the individual investors in a fund is still considered the adviser's client, for purposes of the Foreign Private Adviser Exemption, an adviser will need to count both the fund and investors in the fund toward its 15 client/investor limit. Also, it should be noted that certain disclosure and antifraud requirements also apply to a fund's investors under the Advisers Act, specifically section 206(4)-8, which prohibits advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors.
  - Advisers must look through nominee and similar arrangements, total return swaps or similar instruments, as well as master-feeder structures, to the beneficial owners in determining who the actual investors are in a fund. In addition, advisers must now count as clients persons for whom the adviser provides advisory services without receiving compensation. However, "knowledgeable employees," as defined in Rule 3c-5 under the '40 Act, can be excluded in determining the number of U.S. investors.

- As required by the Act, the SEC has also exempted advisers solely to "venture capital funds," which the SEC has defined as a private fund that (1) holds no more than 20% of the fund's capital commitments in "non-qualifying investments" (other than short-term holdings), (2) does not borrow or otherwise incur leverage in excess of 15% of the fund's capital contributions and uncalled committed capital, with any such borrowing or leverage (excluding certain guarantees by the fund of qualifying portfolio company obligations) being for a non-renewable term of no longer than 120 calendar days, (3) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances, (4) represents itself as pursuing a venture capital strategy to investors and (5) is not registered under the '40 Act and has not elected to be treated as a business development company.

Calculating R-AUM for Purposes of the New Exemptions

- To provide a uniform calculation of an adviser's AUM when determining its eligibility for an exemption from registration, the rules, as finally adopted, define the term Regulatory-AUM. The calculation is determined on the basis of gross assets under management and includes any proprietary assets, assets managed without compensation and assets of non-U.S. clients, all of which an adviser may currently exclude from the calculation of its AUM. Furthermore, in the case of private funds, the calculation must include uncalled capital commitments, and must be based on the market value of the assets or fair value where market value is unavailable.

Mid-sized Advisers

- Currently, U.S. advisers, who do not advise any '40 Act funds, must have at least $25 million of AUM to register with the SEC. U.S. advisers with less than $25 million in R-AUM are subject to regulation/registration by the state in which they have their principal place of business.

- While the Act maintains this threshold, it also creates a new group of "mid-sized" adviser and shifts primary regulation of this group to the states. An investment adviser that (1) has R-AUM between $25 million and $100 million and (2) is required to be registered with the state in which it has its principal office, and is subject to examination as an investment adviser by such state (all states except Minnesota, New York and Wyoming are considered by the SEC to subject advisers to examination), is prohibited from registering with the SEC unless the investment adviser is an adviser to an investment company registered under the '40 Act, or a company which has elected to be a business development company under the '40 Act. However, such an adviser may register with the SEC if it would otherwise be required to register with 15 or more states.

Family Office Exclusion

- The SEC has also adopted a rule defining a "family office," which is excluded from the definition of investment adviser under the Advisers Act and therefore not subject to registration or SEC regulation under the Advisers Act.

  - The final rule defines "family office" as any firm that (1) has no clients other than "family clients," (2) is wholly owned by "family clients" and controlled (directly or indirectly) exclusively by "family members" and/or "family entities" and (3) does not hold itself out to the public as an investment adviser.

  - Family clients include (1) family members and former family members; (2) key employees of the family office; (3) non-profits and charities funded exclusively by one or more family clients; (4) estates of current and former family members or key employees; (5) certain trusts; (6) entities wholly owned by, and operated for the sole benefit of, family clients; and (7) existing investments by former key employees.

- The final rules also define other key terms of this exclusion.

Reporting Requirements

- Exempt Reporting Advisers. The Act requires the SEC to establish reporting requirements as necessary and appropriate for venture capital fund advisers and private fund advisers who are nonetheless exempt from registration with the SEC in reliance on one of the new exemptions ("Exempt Reporting Advisers"). The reporting requirements, however, do not apply to exempt foreign private advisers.
  - Under the SEC's final rule, Exempt Reporting Advisers must complete selected portions of the SEC's revised Form ADV. As a result, Form ADV serves as both a registration and a reporting form, and is publicly available on the SEC's website. Exempt Reporting Advisers are required to file their initial Form ADV between January 1 and March 30, 2012 and subsequent to that within 60 days of relying on an exemption that requires such reporting.
  - Exempt Reporting Advisers must complete the following seven items in Part 1A of the Form ADV: 1. (Identifying Information), 2.B. (SEC Reporting by Exempt Advisers), 3. (Form of Organization), 6. (Other Business Activities), 7. (Financial Industry Affiliations and Private Fund Reporting), 10. (Control Persons), 11. (Disclosure Information), and the corresponding Schedules A, B, C and D. Exempt Reporting Advisers are not required to complete and file other items in Part 1A or prepare a client brochure.
  - The same updating requirements currently imposed on SEC registrants apply to Exempt Reporting Advisers with respect to those Form ADV items Exempt Reporting Advisers must complete (e.g., annually or immediately).
- Proposed Reporting by Registered Advisers to Private Funds – Form PF. Pursuant to Title IV of the Act, the SEC and the CFTC have jointly proposed rules that would require SEC-registered investment advisers (and commodity pool operators and commodity trading advisers registered with the CFTC who are also registered with the SEC as investment advisers) that advise one or more private funds (defined as an issuer that would be an investment company but for section 3(c)(1) or 3(c)(7) of the '40 Act) to file a Form PF with the SEC. This form is intended to provide information that will allow the Council to monitor the potential for systemic risks to financial stability. The information on Form PF would not be made public and would be exempt from disclosure in response to FOIA requests.

- ○ Form PF would require disclosure of AUM (including certain breakdowns thereof) and other fund-specific data, including: (1) gross and net asset value of each private fund, (2) monthly and quarterly fund performance data, (3) each fund's total borrowings, along with a breakdown of the fund's borrowings among domestic and international financial institutions and non-financial institutions, (4) identities of creditors to which any of the adviser's funds owes an amount equal to at least 5% of such fund's net asset value, (5) total number of beneficial owners and (6) percentage of ownership of the five beneficial owners having the largest equity interests for each fund.

- ○ Additionally, private fund advisers with an aggregate of $1 billion or more in qualifying private equity fund, hedge fund and liquidity fund AUM ("Large Private Fund Advisers") would be required to complete additional information on Form PF based on fund type, including, among others, information pertaining to: (1) fund borrowings and guarantees, (2) the debt of controlled portfolio companies (including debt-to-equity ratios and debt maturity profiles), (3) persons providing bridge financing to portfolio companies and the amount of such financing, (4) investments in financial industry portfolio companies, (5) events of default on any fund debt or portfolio company debt during the reporting period and (6) a breakdown of the fund's investments by industry and geography.

- ○ As proposed, registered advisers required to file Form PF must do so by March 31, 2012, and annually thereafter or, if the adviser is a Large Private Fund Adviser, by January 15, 2012 and quarterly thereafter.[18]

- Changes to Form ADV. The SEC amended Form ADV to require advisers to provide additional information about three areas of operation: (1) private funds advised, (2) advisory activity, including business practices and (3) non-advisory activity, including financial industry affiliations.

Accredited Investor/Qualified Client Standard

- Effective upon enactment, the Act changed the $1 million natural person net worth threshold for "accredited investors" under the Securities Act to $1 million excluding the value of the investor's net equity in his or her primary residence.

- The Act also requires that all dollar amount tests used by the SEC as a factor in making determinations under the Advisers Act, such as a net asset threshold, be adjusted for inflation not later than one year after enactment and every five years thereafter.

  - ○ Pursuant to this provision, the SEC has issued an order to increase the dollar thresholds for a "qualified client" under the Advisers Act to $1 million (from $750,000) for the AUM test and $2 million (from $1.5 million) for the net worth test.

[18] As was the case with other proposed rules under Title IV of the Act, it is possible that the SEC will extend the compliance date when it adopts final rules in this area.

- The SEC also proposed related amendments to Rule 205-3 (regarding performance fees) that would: (1) provide that the SEC will issue an order every five years adjusting for inflation the amounts of the AUM and net worth tests of the rule; (2) exclude the value of a natural person's net equity in his or her primary residence from the determination of whether a person meets the net worth test for the definition of "qualified client"; and (3) modify the transition provisions of the rule to (a) grandfather performance fee arrangements that were permissible at the time the adviser and client entered into their advisory contract and (b) provide that, if an adviser was previously exempt from registration pursuant to section 203, the new Rule 205-3 would not apply to contractual arrangements entered when the adviser was exempt from registration.

Studies

- The Act required that a number of studies and reports be conducted, one of which was a study by the Comptroller General of the feasibility of forming a self-regulatory organization ("SRO") to oversee private funds. In its report, the Comptroller General concluded that the creation of an SRO was possible but it would require legislation and would not be without challenges.

XI. TAX ISSUES

The Act raises tax issues that fall principally into four categories.

- The Act requires or encourages financial institutions to restructure the conduct of their business in ways that are likely to result in the transfer of customer positions from one legal entity to another. These transfers raise tax issues including:
  - For customers, the transfer of a swap portfolio from one legal entity to another may give rise to a taxable event that could accelerate income or give rise to losses of limited current deductibility paired with future income.
  - For swap dealers, issues include (1) a re-evaluation of current "global dealing" or transfer pricing arrangements, and other international tax rules, to ensure that the same income is not taxed in multiple jurisdictions without appropriate offsets; (2) documentation, reporting and withholding tax compliance issues; and (3) typical tax issues associated with moving businesses from one legal entity or jurisdiction to another.
- The Act requires mandatory clearing and trading of certain swaps through central swap clearinghouses, including SEFs. These raise tax issues that are either novel or have received little attention for many years:
  - For customers, it is possible that a cleared or traded swap would be subject to the mandatory mark-to-market and "60/40" holding period rules (gain or loss is 60% percent long-term capital gain and 40% short-term capital gain) of section 1256. Section 1601 of the Act excludes certain swaps from section 1256, but the scope of the exemption is the subject of debate. Attention to that issue has also brought to light questions about the scope of section 1256 for pre-Act contracts like certain cleared energy swaps. A related question is whether the tax rules will be different for swaps traded through SEFs rather than through traditional commodities or securities exchanges. The IRS is expected to issue guidance on these issues later this year.
  - For both dealers and customers, there is concern that the clearing of swaps and related changes to standard market terms for swaps may increase the number of swaps that are deemed to have embedded loans. Embedded loans would give rise to new reporting and withholding tax issues, among others.
  - Other special aspects of clearing through a central clearinghouse also raise tax issues, for example whether the clearing of existing swaps gives rise to a taxable event and whether variation margin should be treated for tax purposes as collateral, as with over-the-counter swaps, or as settlement, which would effectively put the swap on mark-to-market for tax purposes. Mark-to-market tax treatment would be a radical change of tax accounting for asset managers of various kinds. The tax treatment of variation margin may depend on the choice of clearinghouse.
  - The Act may affect the resolution of a long-standing tax issue as to whether and when a credit default swap is treated as insurance or a guarantee for tax purposes, if the IRS

gives deference to CTFC and SEC rules (currently in proposed form) that address the distinction between credit default swaps and insurance.

- The Volcker Rule's prohibition on the conduct of proprietary trading by Banking Entities within the United States could give rise to tax questions about whether the restructured proprietary trading activities are subject to or exempt from U.S. taxation. The Volcker Rule limits on sponsoring or investing in hedge funds or private equity funds will require restructuring of those funds, which will also raise tax issues.

- A fourth set of tax issues have to do with the new forms of hybrid capital that will be permitted under Basel III and rules to be issued by the Fed. It is possible that there will need to be changes to U.S. tax rules in order to permit hybrid instruments to be treated as debt, which is necessary in order to allow coupons to be deducted and to be paid without being subject to U.S. withholding tax. While other jurisdictions are currently considering changes to their rules, it is believed to be unlikely that Congress would do so and it is uncertain how Treasury and the IRS will rule on new forms of hybrid capital. There are consequently potential competitive issues for U.S. financial institutions and for the U.S. operations of non-U.S. financial institutions.

XII. SPECIALIZED DISCLOSURE PROVISIONS

In General

- Title XV of the Act includes three provisions that establish disclosure requirements for Exchange Act reporting companies engaged in specified types of business. The provision on mine safety took effect immediately, while the other two provisions (on conflict minerals and resource extraction payments) require implementing rules, which the SEC was required under the Act to adopt by April 15, 2011.

- The SEC proposed rules in December 2010 under all three provisions, but none of these rules have become final, and the current expectation is for final rules by year-end 2011. The Act provides that the rules for conflict minerals will take effect for the first fiscal year commencing after their adoption, and for resource extraction payments, for the first fiscal year ending not less than one year after their adoption.

Conflict Minerals

- Section 1502 of the Act relates to certain minerals that have reportedly been traded to finance armed conflict in the Democratic Republic of Congo (the "DRC," formerly known as Zaire).

    - The minerals initially specified under the Act are columbite-tantalite (coltan), cassiterite, gold and wolframite. Together with their derivatives (which include tungsten and tin), the four minerals are very widely used in electronic components, lighting, jewelry and other products. The SEC estimates that roughly 6,000 companies (or about 40% of reporting companies) will be required to provide disclosures under Section 1502.

- Under Section 1502 as the SEC has proposed to implement it, each Exchange Act reporting company will have to determine whether the specified minerals are necessary to the functionality or production of products the company manufactures or contracts to manufacture. If they are, the company must conduct a "reasonable country of origin inquiry" to determine whether the minerals originated in the DRC or one of its nine adjoining countries. If the inquiry concludes that the minerals did not originate in the ten countries, the company must disclose its conclusion, and describe the inquiry, in its annual report and on its website.

- If the country of origin inquiry concludes that the minerals did originate in the ten countries, the company must prepare a Conflict Minerals Report (including an independent private sector audit) that describes the provenance of the minerals and whether they are "DRC conflict-free." Frequently the country of origin inquiry will be inconclusive, or will determine that the minerals come from recycled or scrap sources; the company must also prepare a Conflict Minerals Report in those cases. The Conflict Minerals Report must be furnished as an exhibit to the company's annual report on Form 10-K or Form 20-F and posted on its website.

Mine Safety

- Section 1503 of the Act applies to any reporting company that is an operator of a coal or other mine in the United States. Such a company must disclose, in its quarterly and annual reports and in current reports on Form 8-K, certain information relating to health and safety, including mining-related fatalities and specified violations of health or safety standards.

Resource Extraction Payments

- Section 1504 of the Act applies to reporting companies engaged in the commercial development of oil, natural gas or minerals. Under the SEC's proposed implementing rules, such a company must provide, in an exhibit to its annual report on Form 10-K or Form 20-F, detailed information relating to payments to foreign governments (including their departments, agencies and majority-owned companies) or to the U.S. Federal government for the purpose of the commercial development of oil, natural gas or minerals, or the acquisition of a license for any such activity.

XIII. CONSUMER PROTECTION

Overview

- Three significant developments in the area of consumer protection since the signing of the Act are:
    - the establishment of the Consumer Bureau and the preparations the Consumer Bureau has made to exercise the authority and power transferred to it on July 21, 2011;
    - the Consumer Bureau's recently announced bank supervision program, effective as of July 21, 2011; and
    - the OCC rulemaking on the agency's preemptive authority over "state consumer financial laws."

Establishment of the Consumer Bureau

- The Act created the Consumer Bureau in order to regulate consumer financial products and services, as well as providers of such products and services. However, over the past year, the Consumer Bureau has announced few significant rules or regulations for two main reasons:
    - First, the Consumer Bureau's authority to enforce existing consumer protection laws was not transferred to it until the designated transfer date, July 21, 2011.
    - Second, the absence of a director of the Consumer Bureau has impeded its progress. Until a director is confirmed by the Senate, the Consumer Bureau is not able to perform certain powers established by the Act, such as supervising nondepository institutions and prohibiting unfair, deceptive or abusive practices in connection with consumer financial products and services. Therefore, the Consumer Bureau has focused on hiring staff and creating its organizational structure.
- President Obama recently announced his nomination of former Ohio Attorney General Richard Cordray as director of the Consumer Bureau. Pending confirmation of the director, the Secretary of the Treasury and his designee (currently, Professor Elizabeth Warren, Special Adviser to the Secretary of the Treasury on the Consumer Bureau) have authority to carry out certain functions of the Consumer Bureau as of July 21, 2011, such as prescribing rules, issuing orders, and producing guidance related to the Federal consumer financial laws that were within the authority of other Federal agencies.

The Consumer Bureau's Bank Supervision Program

- One of the most important powers the Consumer Bureau has is supervising and examining, with respect to Federal consumer financial laws, banks, savings associations, and credit unions with total assets in excess of $10 billion. The Consumer Bureau has already announced preliminary details on its bank supervision program, which will include periodic

examinations by Consumer Bureau staff and a year-round supervision program for the largest banks within its jurisdiction.

Threshold for Preemption of State Consumer Financial Laws

- The Act will also affect the examination and supervision of national banks and Federal savings associations and their compliance with state consumer financial laws to which they now may be subject. The Act codifies the Barnett standard as the appropriate test for preemption analysis, changes the process by which the OCC makes preemption determinations of state consumer financial laws, eliminates the OCC's preemption of state law for national bank subsidiaries, agents, and affiliates, and harmonizes national bank and Federal savings association preemption rules. The OCC has published a final rule implementing this mandate. State attorneys general and the Treasury objected to the rule on the grounds that the OCC:
  - interprets the Barnett standard too broadly, as embodying the whole of conflict preemption law rather than a narrower formulation that would preempt state consumer financial laws only when they "prevent or significantly interfere" with the exercise of a national bank's powers;
  - retains all prior preemption determinations made under the OCC's "obstruct, impair or condition" standard; and
  - provides for the preemption of a broad category of state consumer financial laws based on existing precedent as opposed to determining preemption on a "case-by-case" basis as provided for under the Act.
- In the preamble accompanying its final rule, the OCC rejected most of these arguments, explaining that:
  - a number of authorities—including statutory language, legislative history, Federal court interpretations of virtually identical preemption language in other contexts, and statements by the provision's sponsors—support the OCC's interpretation that the Act does not create a stand-alone "prevents or significantly interferes" standard, but rather incorporates Barnett's conflict-preemption standard; and
  - the case-by-case requirement applies to future preemption determinations, not to actions and regulations in effect before the Act's effective date.
- The OCC further stated that the prior "obstruct, impair or condition" language was intended to reflect the Barnett standard, but noted that to the extent that an existing preemption precedent relied exclusively on this language as the basis for a determination, the precedent's validity will need to be reexamined for consistency with the Barnett conflict-preemption analysis.

- Especially in light of the controversy over the OCC's rulemaking, it is widely expected that the OCC's preemption standards are likely to be litigated, and the issues ultimately decided in Federal court.

XIV. INSURANCE REFORMS

- The Act establishes the FIO within the Treasury, the first office in the Federal government focused on insurance. The FIO has authority to:
    - monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system;
    - recommend to the Council that it designate an insurer, including the affiliates of such insurer, as an entity subject to regulation as a nonbank financial company supervised by the Fed; and
    - gather information about the insurance industry, including access to affordable insurance products by minorities, low- and moderate-income persons and underserved communities.
- On May 13, 2011, the Treasury announced the creation of the Federal Advisory Committee on Insurance, comprising members of state and tribal insurance regulators and industry experts, to advise and present recommendations to the FIO.

* * *

If you have any questions, please feel free to contact any of your regular contacts at the firm or the individuals named on the attached contact list.

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