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Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

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# The Dodd-Frank Act

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Commentary and **Insights**

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Skadden

## **Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates**

# Dear Clients and Friends:

The Dodd-Frank Act, approved by the U.S. House of Representatives on June 30, 2010, is expected to be approved by the Senate and signed by President Obama shortly. The Act spans over 2,300 pages and affects almost every aspect of the U.S. financial services industry. The objectives ascribed to the Act by its proponents in Congress and by the President include restoring public confidence in the financial system, preventing another financial crisis, and allowing any future asset bubble to be detected and deflated before another financial crisis ensues.

The Dodd-Frank Act effects a profound increase in regulation of the financial services industry. The Act gives U.S. governmental authorities more funding, more information and more power. In broad and significant areas, the Act endows regulators with wholly discretionary authority to write and interpret new rules.

The coming months and years will reveal the answers to important questions that will determine how effectively this increased regulatory presence will advance the Act's objectives: Will talent and capital flow to pockets of finance that the new regulations do not reach? Will new financial products make the regulations irrelevant? Will the Act have unintended consequences on nonfinancial companies? Will U.S. firms lose business to foreign competitors? Will the regulations stifle innovation? Will the availability of credit be impaired by increased uncertainty and costs?

We examine the Dodd-Frank Act and the business implications expected to flow from it, based on the text approved by the House of Representatives. If the Act is approved by the Senate, some of the provisions might be changed by subsequent legislation implementing "technical corrections." Our analysis covers the following aspects of the Act:

**Oversight and Systemic Risk.** The Act gives regulators new resolution authority, creates a new council to monitor and address systemic risk, and changes the mandate of the Federal Reserve.

- **Orderly Liquidation Authority.** Regulators will receive new authority under the Act to take control of and liquidate troubled financial firms if their failure would pose a significant risk to the financial stability of the United States. We explore the types of financial companies subject to this authority, the elements of the systemic risk determination, and the mechanics and funding of the liquidation process.
- **Key Measures to Address Systemic Risk.** Under the Act, for the first time, the mitigation of systemic risk and the maintenance of system-wide financial stability will be regulatory objectives. Our analysis covers the powers of the new Financial Stability Oversight Council established to fulfill these objectives and their application to financial firms, including nonbank financial companies.
- **Federal Reserve Emergency Credit.** We describe the Act's limitation of the Federal Reserve's authority to extend credit in "unusual and exigent circumstances" to participants in facilities with broad-based eligibility.

**Financial Institutions.** The Act imposes significant new regulations on banking organizations. In addition, for the first time, the Act will allow the Federal Reserve to regulate companies other than banks — such as insurance companies and investment firms — if they predominantly engage in financial activities and are selected for regulation by the Council based on an evaluation of their balance sheets, funding sources, and other risk-based criteria. We explore the reach and scope of the new federal regulations, which will extend to the entire holding company structure of these "nonbank financial companies." In this area, we consider the following impacts of the Act:

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- **Regulation of Banking Organizations.** The Act effects numerous, significant changes in the regulation of banking organizations. We explore these changes, including creation of the Consumer Financial Protection Bureau, enhancement of supervision of large institutions and nonbank affiliates, and establishment of additional capital regulations.
  - **Volcker Rule.** The “Volcker Rule” is embodied in the Act’s limitations on insured depository institutions and their affiliates conducting “proprietary trading” and investing in hedge funds and private equity funds. We describe these limitations, as well as provisions of the Act that will force these institutions to move much of their derivatives activities to nonbank affiliates and to comply with new capital and support standards.
  - **Private Fund Investment Advisers.** We describe the Act’s impacts on advisers to hedge funds and private equity funds, which include new requirements for registration, recordkeeping, and reporting, as well as the effect of the “Volcker Rule” on the ability of certain types of firms to sponsor or invest in hedge funds and private equity funds.
  - **Insurance Companies.** The Act will potentially subject some of our largest and most well-respected insurance companies to designation as nonbank financial companies and oversight by the Federal Reserve for the first time. We explore these developments and the functions of the new Federal Insurance Office created by the Act to monitor the industry, along with related provisions designed to promote uniformity among the states in market regulation of specified types of insurance.
  - **Supervision of Payment, Clearing and Settlement.** We describe the greater role that the Act assigns to the Federal Reserve in the supervision of systemically important financial market utilities and payment, clearing and settlement activities conducted by financial institutions.

**Capital Markets.** The Act brings significant changes to the rules that affect the process of financing business enterprises. We explore these changes in the following areas:

- **Derivatives and Swaps Clearinghouses.** The Act imposes a new regulatory regime on over-the-counter derivatives, which includes clearing, exchange trading and other requirements intended to increase transparency, liquidity and efficiency, and to decrease systemic risk. We describe the mechanisms established to satisfy these objectives and some of their anticipated effects on current market practices. We also evaluate the potential for the new regulations — coupled with new implementation and monitoring responsibilities placed on regulators — to produce market dislocations, increase the cost of certain swap transactions, and adversely affect certain types of investment funds and structured finance transactions.
- **Securitization.** Under the Act, issuers or originators of asset-backed securities generally will be required to retain at least five percent of the credit risk associated with the securitized assets. We describe these provisions of the Act and explore their potential impact on the securitization field.
- **Credit Rating Agencies.** Credit rating agencies will enter into an entirely new regime of regulation under the Act. We summarize the new substantive standards, disclosure obligations, and private litigation rules applicable to rating agencies.
- **Investor Protection and Securities Enforcement.** The Act enhances the SEC’s enforcement program and investor protection mission by establishing a new whistleblower bounty program, providing the SEC with new enforcement authority, and permitting the SEC to impose a “fiduciary

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duty” on broker-dealers that provide retail investment advice. We consider the implications of these changes and conclude that the Act will make the SEC a stronger and potentially more assertive agency.

**Governance and Compensation.** The Act authorizes the SEC to adopt rules giving nominating shareholders access to the company’s proxy. In addition, the Act requires enhanced disclosure of executive compensation and gives shareholders the right to a “say-on-pay” vote on executive compensation.

**Consumers.** A new governmental authority, the Bureau of Consumer Financial Protection, is endowed by the Act with broad power to regulate retail financial products and services. We describe the responsibility of the Bureau and offices within it to supervise and examine specified types of institutions and to establish and enforce rules related to consumer finance. We also describe the Act’s new prohibitions or restrictions on certain lending practices.

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We recognize the vital importance of the Dodd-Frank Act to our clients and friends. We hope that you find these materials to be informative and helpful in understanding and adapting to the impending changes in the regulatory landscape and meeting the business challenges expected to arise from the Act.

We will continue to monitor, analyze and report on this (and related) legislation and the new regulations that it will engender. If you have a particular interest in any of the issues discussed here, please call the author or your usual Skadden, Arps contact.



**Eric J. Friedman**  
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the 1990s, the number of people in the United States who are employed in the service sector has increased from 55 to 75 percent. The number of people in the manufacturing sector has decreased from 22 to 15 percent, and the number of people in the agricultural sector has decreased from 1 to 0.5 percent. The number of people in the health care sector has increased from 10 to 15 percent.

The increase in the number of people in the service sector has been driven by a number of factors. One major factor is the growth of the service economy. The service economy is the part of the economy that provides services to other businesses and individuals. It includes a wide range of industries, from retail and food services to health care and education.

Another major factor is the decline of the manufacturing sector. The manufacturing sector has been hit hard by globalization and automation. Many manufacturing jobs have been lost to other countries, and many manufacturing jobs have been replaced by machines.

The decline of the manufacturing sector has led to a shift in the labor force. Many workers who were previously employed in manufacturing have moved into the service sector. This has led to an increase in the number of people in the service sector.

The increase in the number of people in the service sector has also led to a change in the types of jobs available. Many of the new jobs in the service sector are in the health care and education sectors. These jobs are often more stable and better paying than many of the jobs in the manufacturing sector.

The increase in the number of people in the service sector has also led to a change in the skills required for these jobs. Many of the new jobs in the service sector require a higher level of education and training than many of the jobs in the manufacturing sector.

The increase in the number of people in the service sector has also led to a change in the way that these jobs are performed. Many of the new jobs in the service sector are performed in a more customer-oriented way than many of the jobs in the manufacturing sector.

The increase in the number of people in the service sector has also led to a change in the way that these jobs are organized. Many of the new jobs in the service sector are organized in a more flexible way than many of the jobs in the manufacturing sector.

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## Glossary

the 1990s, the number of people in the UK who are aged 65 and over has increased from 10.5 million to 13.5 million, and the number of people aged 75 and over has increased from 4.5 million to 6.5 million (Office for National Statistics 2000). The number of people aged 65 and over is expected to increase to 16.5 million by 2020, and the number of people aged 75 and over to 8.5 million (Office for National Statistics 2000).

There is a growing awareness of the need to address the needs of older people, and the need to ensure that they are able to live independently and actively in their own homes. This has led to a number of initiatives, including the development of the National Framework for Older People (Department of Health 1999) and the National Strategy for Older People (Department of Health 2000). The National Framework for Older People sets out the government's commitment to older people, and the National Strategy for Older People sets out the government's strategy for addressing the needs of older people.

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# Orderly Liquidation Authority

(This is a summary of this topic. For more in-depth information, see [“Analysis of the Orderly Liquidation Authority, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.”](#))

Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010) (the “Dodd-Frank Act” or the “Act”), titled “Orderly Liquidation Authority,” creates a new federal receivership process pursuant to which the FDIC may serve as receiver for large, interconnected financial companies, including broker-dealers, whose failure poses a significant risk to the financial stability of the United States.<sup>1</sup> This article provides an overview and summary of the key provisions of this new liquidation regime.

## Entities Subject to the Act: Financial Companies

Only entities that are “financial companies” are eligible to be placed into receivership under the Act. There are four categories of financial companies. The first category includes “bank holding companies,” as defined in section 2(a) of the BHCA.<sup>2</sup> Under this definition, a bank holding company includes any company that has control over any bank or over any company that is or becomes a bank holding company by virtue of the BHCA.<sup>3</sup>

The second category of financial company includes nonbank financial companies supervised by the Board of Governors, including nonbank financial companies that the Council has determined must be supervised by the Board of Governors.<sup>4</sup> See [“Key Measures to Address Systemic Risk.”](#) Nonbank financial companies are companies “predominantly engaged in financial activities.”<sup>5</sup> A company satisfies this definition if it and all of its subsidiaries derive either 85% of their annual gross revenues or 85% of their consolidated assets from activities that are “financial in nature” or incidental to a financial activity, or from the ownership or control of one or more insured depository institutions.<sup>6</sup>

The third category of financial company includes subsidiaries of the two foregoing categories of financial companies, other than subsidiaries that are insured depository institutions or insurance companies.<sup>7</sup> The fourth category includes brokers and dealers that are registered with the SEC and that are members of the SIPC.

## Initiating the Receivership Process: “Systemic Risk Determination”

To be placed into receivership under the Act, a financial company must be a “covered financial company.” A covered financial company is a financial company as to which a “systemic risk determination” has been made.<sup>8</sup> On their own initiative, or at the request of the Secretary of the Treasury, the FDIC (or in the case of a covered broker or dealer, the SEC, and, in the case of an insurance company, the Director

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<sup>1</sup> Act § 204(a).

<sup>2</sup> Act §§ 102(a)(1) & 12 U.S.C. § 1841(a).

<sup>3</sup> A company “has control over a bank or a company,” pursuant to section 2(a) of the BHCA, if (a) it directly or indirectly has the power to vote 25% or more of any class of voting securities of the bank or company; (b) it controls in any manner the election of a majority of directors or trustees of the bank or company; or (c) the Board of Governors determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company. 12 U.S.C. § 1841(a)(2).

<sup>4</sup> Act § 102(a)(4).

<sup>5</sup> Act §§ 102(a)(4)(A)(ii) & 102(a)(4)(B)(ii).

<sup>6</sup> Act § 102(a)(6).

<sup>7</sup> Act § 201(a)(11)(iv).

<sup>8</sup> Act § 203.

of the Federal Insurance Office) and the Board of Governors must make a written recommendation regarding whether a financial company presents systemic risk.

Upon receipt of the above-referenced recommendation with respect to a financial company other than an insurance company, the Secretary — in consultation with the President of the United States — must seek appointment of the FDIC as receiver if the Secretary determines, among other things, that:

- the company is in default or in danger of default;
- the default of the financial company would have a serious adverse effect on the financial stability of the United States;
- no viable private sector alternative is available to prevent the default;
- the effect on the claims or interests of creditors, counterparties and shareholders of the financial company and other market participants of proceedings under the Act is appropriate, given the impact that any action under the Act would have on the financial stability of the United States; and
- an orderly liquidation would avoid or mitigate such adverse effects.<sup>9</sup>

Insurance companies cannot be placed into receivership under the Act. If a systemic risk determination is made with respect to an insurance company, the insurance company may be liquidated or rehabilitated only pursuant to state law proceedings. However, if the appropriate state agency fails to commence state law proceedings within 60 days of a systemic risk determination, then the FDIC may act in place of such agency and pursue relief under state law.

A financial company is in default or in danger of default if (i) a bankruptcy case has been, or likely will promptly be, commenced with respect to the financial company; (ii) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion; (iii) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or (iv) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the ordinary course of business.<sup>10</sup>

Following such determinations, the Secretary must notify the financial company and the FDIC. If the directors and officers of the company consent to the FDIC's appointment as receiver, the Secretary will appoint the FDIC as receiver, and the directors and officers are absolved of liability to stakeholders for such acquiescence.<sup>11</sup> If the directors and officers do not consent, then the Secretary is required to file a sealed petition with the United States District Court for the District of Columbia for an order authorizing the Secretary to appoint the FDIC as receiver. The Court is directed to hold a confidential hearing at which the company may oppose the petition. The Court's task at the hearing is limited to deciding whether the Secretary's determinations were "arbitrary and capricious," a standard that is very deferential to the Secretary and effectively presumes the validity of the Secretary's determinations.<sup>12</sup>

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<sup>9</sup>Act § 203(b). In the case of covered brokers and dealers, the FDIC will serve as receiver, but the SIPC will serve as trustee. Upon appointment as trustee, the SIPC must file an application for a protective decree under SIPA. Assets retained by the broker or dealer and not transferred to a covered financial company must be administered pursuant to SIPA. See Act § 205(a).

<sup>10</sup>Act § 203(c)(4).

<sup>11</sup>Act § 207.

<sup>12</sup>Act § 202(a)(1)(A)(iii).

If the Court finds that the determinations were not arbitrary and capricious, it must authorize the Secretary to appoint the FDIC as receiver.<sup>13</sup> If the Court finds that the determinations were arbitrary and capricious, it is required to provide the Secretary with a written statement explaining the Court's rationale, and must afford the Secretary an immediate opportunity to amend and refile the petition. If the Court does not make any ruling within 24 hours of receiving the petition, the petition will be granted by operation of law, the Secretary will appoint the FDIC as receiver, and liquidation under the statute will be commenced automatically.<sup>14</sup> The Act provides for highly expedited appeals of the Court's rulings.

### Basic Elements of the Liquidation Process

Once the FDIC is appointed receiver of a covered financial company, it assumes virtually complete control over the liquidation process, the role of the courts in the core receivership process ends, and only limited avenues exist for challenging the various ancillary decisions that the FDIC may make in pursuing the liquidation. As receiver, the FDIC succeeds to all rights, titles, powers and privileges of the company and its assets, and of any stockholder, member, officer or director of the company. The FDIC may conduct all aspects of the company's business and may liquidate and wind up the affairs of the company in such manner as the FDIC deems appropriate.<sup>15</sup>

Notably, the Act grants the FDIC broad authority to arrange for the sale of selected assets of a covered financial company to one or more private acquirers, subject to any applicable antitrust laws and other applicable agency review. Similarly, the FDIC may arrange for the acquisition of a covered financial company by one or more private acquirers, subject to the same antitrust and other regulatory qualifications. In connection with any sale or merger, the FDIC can arrange for the acquirer to assume selected contracts and liabilities, including outstanding derivatives contracts. The FDIC may facilitate such transactions without advance notice to, input from or consent of creditors, shareholders or contract counterparties.

The FDIC also is empowered to create a "bridge financial company" to succeed to selected assets and liabilities of the covered financial company or covered broker dealer.<sup>16</sup> A bridge company can be created without court approval and without notice to, input from or consent of any creditors or shareholders.<sup>17</sup> The bridge company need not be funded with capital or surplus (though the aggregate amount of liabilities assumed by a bridge company may not exceed the aggregate amount of assets that are transferred to it). Once created, the bridge company is to be managed by a board of directors appointed by the FDIC. A bridge company is not meant to have perpetual existence, but is a temporary creation designed to serve as a "bridge" to a permanent transaction with a private acquirer. Accordingly, a bridge company established under the Act terminates two years after it is granted its charter, although the FDIC has the discretion to extend such status for up to three additional one-year periods.<sup>18</sup>

While affording the FDIC virtually unfettered control in these matters, the Act does identify several principles that guide the FDIC's conduct. For instance, in disposing of assets, the FDIC must use best

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<sup>13</sup>As noted above, in broker-dealer liquidations, the FDIC is appointed as receiver, but SIPC must also appoint a trustee. Act § 205.

<sup>14</sup>Act § 205.

<sup>15</sup>Act § 210(a)(1).

<sup>16</sup>Act § 210(h)(2).

<sup>17</sup>Act § 210(e).

<sup>18</sup>Act § 210(h).

efforts to maximize returns, minimize losses and mitigate the potential for serious adverse effects to the financial system.<sup>19</sup> In deciding upon a course of action, the FDIC also must determine that such action is necessary for the financial stability of the United States, and not for the purpose of preserving the company; ensure that the shareholders of the covered financial company do not receive payment until after all other claims are fully paid; and ensure that unsecured creditors bear losses in accordance with the priority-of-claim provisions. The FDIC may not take an equity interest in or become a shareholder of the covered financial company or any covered subsidiary.<sup>20</sup>

The FDIC is given several other powers, which can be grouped into three main categories: resolution and payment of claims; disposition of existing contracts and similar obligations; and recovery of pre-receivership fraudulent conveyances and preferential transfers.

**Claims Resolution and Payment.** The FDIC is given unilateral authority to review claims and to make determinations either allowing or disallowing them. A claimant wishing to contest such a determination must file suit with the district court for the district where the principal place of business of the covered financial company is located.<sup>21</sup> The Act also identifies the priorities in which claims may be paid: the costs of the receivership are afforded first priority, with claims owed to the United States coming next, followed by other claims against the covered financial company. The Act requires that all claimants who are similarly situated be treated in a similar manner, but permits the FDIC to deviate from this principle as necessary to maximize the value of the assets of the covered financial company; to initiate and continue operations essential to implementation of the receivership or any bridge financial company; to maximize the present value return from the sale or other disposition of the assets of the company; or to minimize the amount of any loss realized upon the sale or other disposition of the assets of the company.<sup>22</sup>

**Disposition of Existing Contracts and Related Obligations.** The Act provides that the FDIC may, within a reasonable period of time, disaffirm or repudiate any contract or lease to which the financial company is a party where continued performance is too burdensome or such repudiation would otherwise promote orderly administration. With few exceptions, damages for such repudiation are limited to actual, direct and compensatory damages.<sup>23</sup> Alternatively, the FDIC may determine to transfer its rights and obligations under a contract or lease to an acquirer of the covered financial company's assets, notwithstanding any contractual provisions which excuse a counterparty from performing by reason of the company's insolvency, the appointment of a receiver, and similar circumstances.<sup>24</sup>

**Fraudulent Conveyances and Preferential Transfers.** Finally, the FDIC has the power under the Act to sue to avoid fraudulent transfers, preferences and improper setoffs.<sup>25</sup> The statutory definitions of fraudulent transfers (transfers made, while a company is insolvent, for less than reasonably equivalent value) and preferences (payments to or for the benefit of a creditor that allow the creditor to receive more than it would receive in a liquidation) are almost identical to the statutory definitions of these terms contained in the United States Bankruptcy Code.<sup>26</sup>

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<sup>19</sup> Act § 210(a)(9)(E).

<sup>20</sup> Act § 206.

<sup>21</sup> Act § 210(a).

<sup>22</sup> Act § 210(b).

<sup>23</sup> Act § 210(c).

<sup>24</sup> Act § 210(c)(13).

<sup>25</sup> Act §§ 210(a)(11)(A), 210(a)(11)(B) & 210(a)(12), respectively.

<sup>26</sup> Compare Act §§ 210(a)(11)(A) & (B) with 11 U.S.C. §§ 547 & 548, respectively.

## Provisions for Paying for the Process

The Act prevents the use of taxpayer funds to pay for the receivership process. It provides that “no taxpayer funds shall be used to prevent the liquidation of any financial company”; “taxpayers shall bear no losses from the exercise of any authority under this title”; “creditors and shareholders must bear all losses in connection with the liquidation of a covered financial company”; and that the FDIC shall not take an equity interest in any covered financial company.<sup>27</sup> Moreover, the Act provides that “[a]ll funds expended in the liquidation of a financial company under this title shall be recovered from the disposition of assets of such financial company,” or shall be recouped via assessments on other financial companies.<sup>28</sup>

While the Act contemplates the financial sector ultimately being responsible for the costs of a liquidation if assets are insufficient, the Act affords means by which the FDIC can incur interim debt obligations to fund a liquidation, which can later be recovered through assessments on the financial sector. Specifically, upon its appointment as receiver, the FDIC is authorized to issue obligations to the Secretary to fund the liquidation in an amount not to exceed, during the first 30 days of the receiver’s appointment, 10% of a financial company’s total consolidated assets and, thereafter, 90% of the fair value of the total consolidated assets of each covered financial company that are available for repayment. No debt provided pursuant to the 90% limit, however, may be incurred unless the Secretary and the FDIC agree to a specific plan and schedule to achieve repayment of such debt.<sup>29</sup>

The FDIC is required to charge “one or more risk-based assessments” if necessary for it to pay in full the obligations issued by the FDIC to the Secretary within 60 months of the date of issuance of the obligations, or a later date if an extension is necessary to avoid a serious adverse effect on the financial system.<sup>30</sup> These assessments first must be made against any claimant that received additional payments from the FDIC pursuant to its authority to treat some creditors more favorably than others, as described above. Any assessment against a claimant must be in an amount equal to the difference between the aggregate value the claimant received from the FDIC on its claim under the Act, on the one hand, and the value the claimant was entitled to receive solely from proceeds of the liquidation of the covered financial company, on the other hand.<sup>31</sup>

If the funds recouped from claimants are insufficient to satisfy the obligations to the Secretary, then the FDIC may assess “eligible financial companies” and certain other financial companies.<sup>32</sup> “Eligible financial companies” include any bank holding company with total consolidated assets equal to or greater than \$50 billion and any nonbank financial company supervised by the Board of Governors.<sup>33</sup> Assessments must be imposed on a “graduated basis,” with financial companies having greater assets being assessed at higher rates, and pursuant to a “risk matrix” that ties a particular financial company’s assessment to an array of factors relating to its size and relative risk to the financial sector.<sup>34</sup>

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<sup>27</sup> Act §§ 212(a), 212(c), 204(a) & 206(5), respectively.

<sup>28</sup> Act § 212(b).

<sup>29</sup> Act § 210(n).

<sup>30</sup> Act § 210(o)(1)(B).

<sup>31</sup> Act § 210(o)(1)(D)(i).

<sup>32</sup> Act § 210(o)(1)(D)(iii).

<sup>33</sup> Act § 210(o)(1)(A).

<sup>34</sup> Act §§ 210(o)(2) & 201(o)(4).

Funds raised by the FDIC through borrowings from the Secretary and through assessments on the financial sector are to be deposited into the Treasury in a separate fund known as the “Orderly Liquidation Fund.”<sup>35</sup> Amounts in the Fund are available to the FDIC to carry out its responsibilities under the Act, including the payment of principal and interest on obligations it issues to the Secretary.<sup>36</sup> However, the FDIC may utilize amounts in the Fund with respect to a covered financial company only after the FDIC has developed an orderly liquidation plan that is acceptable to the Secretary.<sup>37</sup>

While the Act contains broad prohibitions on the use of taxpayer funds to finance a liquidation, the FDIC may, “in its discretion” and as “necessary or appropriate,” make available to the receivership funds for the orderly liquidation of a covered financial company.<sup>38</sup> All such funds are afforded priority in payment.<sup>39</sup> Similarly, the FDIC may provide funding to facilitate transfers to or from a bridge financial company. Lastly, a bridge financial company is authorized to obtain its own financing, including financing secured by liens on assets that already are subject to liens.<sup>40</sup>

### **Special Provisions Regarding Derivatives**

The Act contains several provisions that afford special protections to parties to certain derivatives agreements (which are called “qualified financial contracts” under the Act), including repurchase agreements, securities contracts, forward contracts, commodity contracts and swap agreements and, in each instance, specifically defined classes of counterparties.<sup>41</sup> Consistent with special protections afforded under other insolvency regimes, the Act provides that selected non-debtor counterparties to such agreements are free to exercise their contractual rights to terminate, close-out and liquidate their positions upon the insolvency of their counterparties.<sup>42</sup>

However, the Act contains important limitations on the typical contractual rights of derivatives counterparties. First, the Act prohibits a protected party from terminating, liquidating or netting out its position solely by reason of the appointment of the FDIC as receiver or the financial condition of the financial company in receivership until 5:00 p.m. Eastern Time on the business day following the date of appointment of the FDIC. A protected party also is precluded from exercising any such contractual rights after it has received notice that its qualified financial contract has been transferred to another financial institution — including a bridge financial company.<sup>43</sup> The Act requires that the FDIC notify a protected party of any such transfer by 5:00 p.m. Eastern Time on the business day following the date of appointment of the FDIC.<sup>44</sup>

Other limitations on the rights of derivatives counterparties relate to so-called “walkaway” clauses. In a typical derivatives contract, when the contract is terminated, the party who is “out of the money” must pay the party who is “in the money.” A walkaway clause overrides this provision by affording the nondefaulting party the right to walk away from a termination payment it otherwise would owe the defaulting party. It

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<sup>35</sup>Act §§ 210(n)(1) & 201(n)(2).

<sup>36</sup>Act § 210(n)(1).

<sup>37</sup>Act § 210(n)(9).

<sup>38</sup>Act § 204(d).

<sup>39</sup>Act § 204(d).

<sup>40</sup>Act § 210(h).

<sup>41</sup>Act § 210(c)(8); 11 U.S.C. §§ 555, 556, 559, 560 & 561; 12 U.S.C. § 1821(e)(8).

<sup>42</sup>Act § 210(c)(8); 12 U.S.C. § 1821(e)(8); 11 U.S.C. §§ 555, 556, 559, 560 & 561.

<sup>43</sup>Act § 210(c)(9)(D).

<sup>44</sup>Act § 210(c)(10)(A).

also may give the nondefaulting party the right to suspend periodic payments it otherwise may owe to the defaulting party under the contract, an option the defaulting party may exercise in lieu of termination in the hope that favorable market movements will reduce any amount owed to the defaulting party. The Act provides that no walkaway clause shall be enforceable in a qualified financial contract of a covered financial company in default. It further states that a counterparty may suspend a payment or delivery obligation for only one day following appointment of the FDIC as receiver.<sup>45</sup> Thereafter, the counterparty must perform.

### **Possible Consequences to Directors and Management**

The Act contains several provisions that may result in severe consequences to the management of covered financial companies placed into receivership. First, the Act provides, in several sections, that management responsible for the condition of the financial company will be severed from its employment.<sup>46</sup> Additionally, those responsible for the financial condition of the financial company may be made to bear economic consequences consistent with their responsibility.<sup>47</sup> The Act also provides that any payment made to, or for the benefit of, an insider, or any obligation incurred to or for the benefit of an insider, under an employment contract and not in the ordinary course of business, may be avoided as a fraudulent transfer if the covered financial company received less than reasonably equivalent value in exchange for such payment or transfer.<sup>48</sup>

Finally, the Act outlines the circumstances under which culpable management may be banned from the financial services industry for a term of at least two years.<sup>49</sup> Specifically, the Act provides that management may be banned if the FDIC determines that:

- management directly or indirectly (a) violated any (i) law or regulation, (ii) final cease-and-desist order, (iii) condition imposed in writing by a Federal agency in connection with any action, application, notice or request by the company or such senior executive or (iv) written agreement with such agency; (b) engaged or participated in any unsafe or unsound practice in connection with any financial company; or (c) committed or engaged in any act, omission or practice which constitutes a breach of fiduciary duty;
- by reason of such violation, practice or breach, management has received financial gain or other benefit and such violation, practice or breach contributed to the failure of the company; and
- such violation, practice or breach involves management's personal dishonesty or demonstrates willful or continuing disregard for the safety and soundness of the company.<sup>50</sup>

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<sup>45</sup>Act § 210(c)(8)(F).

<sup>46</sup>Act §§ 206(4) & 210(a)(1)(C)(ii).

<sup>47</sup>Act §§ 204(a)(3), 210(f) & 210(s).

<sup>48</sup>Compare 11 U.S.C. § 548(a)(1)(B) with Act § 210(a)(11).

<sup>49</sup>Act § 213(c)(1).

<sup>50</sup>Act §§ 213(b), 213(c) & 12 U.S.C. § 1818(e).





# Key Measures to Address Systemic Risk

The Dodd-Frank Act extends the focus of banking regulators beyond the financial condition of individual institutions to include systemic risk as a supervisory consideration, along with tools to minimize the likelihood of the collapse of a firm that previously would have been regarded as too big to fail. In the event that a large institution does become troubled, the Act also equips regulators with new powers to facilitate the process of managing such failure. It establishes the “Financial Stability Oversight Council” (“FSOC” or the “Council”) to bring together the principal financial regulators for the purposes of monitoring and managing systemic risk.<sup>1</sup>

The key consequence of these changes, for financial firms that are not otherwise regulated by the Board of Governors, is that the Council and the Board of Governors will have the authority to require reports and examine any financial services firm in order to identify those firms that may pose any systemic risk. Any nonbank financial firm determined by the Council to pose systemic risk will become subject to Board of Governors supervision and a range of potential “enhanced prudential” supervision requirements for its business.

The key consequence for larger banking organizations with \$50 billion or more in assets (subject to Board of Governors discretion to raise that threshold) is that they can be made subject to “enhanced prudential” requirements above and beyond the current bank regulatory requirements.

Both nonbank financial companies and bank holding companies subject to enhanced prudential supervision authority will be required to provide prior notice for any nonbank acquisition involving a financial firm with assets of \$10 billion or more. In addition, supervised nonbank financial companies will be required to obtain approval to acquire 5% or more of the voting stock of a banking organization.

A cap on the absolute size of any nonbank financial company supervised by the Board of Governors or any banking or thrift organization will prohibit any merger, acquisition, or other business combination involving any such company if the resulting company would hold more than 10% of the total liabilities of all banking and thrift organizations and nonbank financial companies supervised by the Board of Governors.

A key consequence for financial firms, without regard to whether they are under Board of Governors supervision, is the ability of the Council to designate an “activity” (*i.e.*, a product or practice) as systemically risky and require that all federal regulatory agencies draft rules to address the activity.

Additional measures to address systemic risk include the special insolvency regime established by Title II of the Act for firms determined to pose systemic risk (see “[Orderly Liquidation Authority](#)”), authority in exigent circumstances for the Federal Reserve and the FDIC to create programs to extend credit or to guarantee the obligations of solvent firms (see “[Federal Reserve Emergency Credit](#)”), and authority for the Federal Reserve to supervise systemically important financial market utilities and payment, clearing and settlement activities conducted by financial institutions. See “[Supervision of Payment, Clearing and Settlement](#).”

## Financial Stability Oversight Council

The FSOC is chaired by the Secretary of the Treasury. Its 10 voting members include the heads of the Board of Governors, Office of the Comptroller of the Currency (“OCC”), FDIC, SEC, CFTC, Federal

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<sup>1</sup> Act § 111.

Housing Finance Agency, National Credit Union Administration, the newly formed Bureau of Consumer Financial Protection and an independent member with insurance expertise appointed by the President and confirmed by the Senate. The Council also has five non-voting members, including the directors of the newly created Federal Insurance Office and Office of Financial Research (the "OFR"), a state insurance commissioner, a state banking supervisor, and a state securities commissioner. The work of the Council is to be supported by the OFR, which is housed within the Treasury.

The Act states that the Council is to identify risks to the financial stability of the United States, promote market discipline, and respond to emerging risks in the U.S. financial system. Its key powers will be the designation of a nonbank financial company for special supervision by the Board of Governors and the designation of business practices for special regulation by the federal financial and state insurance regulators.

The Council also is responsible for granting exceptions with respect to derivatives activities and for designating "systemically important financial market utilities and payment, clearing and settlement activities."<sup>2</sup>

### **Nonbank Financial Companies Subject to Enhanced Prudential Standards**

The Council can designate a nonbank financial company, as defined below ("NFC"), for special supervision by the Board of Governors under certain "prudential standards." We refer to any such NFC as a "Supervised Nonbank Company."

To designate an NFC for special supervision, the Council must determine, with at least a two-thirds vote (including the Secretary of the Treasury, the Council's Chairperson), that the firm's financial distress or its nature, size, scale, concentration, interconnectedness, or mix of activities would pose a threat to the financial stability of the United States.

The Council may take into consideration a variety of factors in determining whether to subject an NFC to prudential supervision, including:

- the extent of the leverage of the company;
- the extent and nature of the off-balance-sheet exposures of the company;
- the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- the importance of the company as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the U.S. financial system;
- the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;

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<sup>2</sup> The Council would also facilitate information sharing and coordination among its members, recommend general supervision priorities and principles, monitor the financial services marketplace to identify potential threats to financial stability, identify gaps in regulation, and make recommendations to the agencies to apply new or heightened standards and safeguards for risky financial activities or practices.

- the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse;
- the nature, scope, size, scale, concentration, interconnectedness and mix of the activities of the company;
- the degree to which the company is already regulated by one or more primary financial regulatory agencies;
- the amount and nature of the financial assets of the company;
- the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and
- any other risk-related factors that the Council deems appropriate.

Such a decision is subject to procedural protections and rights of appeal.

A “nonbank financial company” or “NFC” is a company that “predominantly” engages in financial activities.<sup>3</sup> As a result, an insurance company, an investment adviser, or a fund, as well as other types of companies engaged in financial services, could become subject to supervision by the Board of Governors.

Similar standards apply to a determination with respect to a foreign NFC, but several are modified to focus on the firm’s U.S. operations.<sup>4</sup> Such a determination also must take into consideration competitive equality between U.S. firms and those based in the relevant country, as well as supervision by the company’s home country regulator.

Any bank holding company with \$50 billion or more in assets which received funding under the TARP program and subsequently sold its bank or thrift subsidiary would be deemed a Supervised Nonbank Company under the supervision of the Board of Governors.<sup>5</sup> The so-called Hotel California provision would prevent the recipients of the TARP largesse from seeking to avoid supervision through such a divestiture.

The Council also may cause the financial activities of a company that does not predominantly engage in financial services to become subject to supervision by the Board of Governors and enhanced prudential standards. This authority is available upon a determination that material financial distress related to the company’s financial activities would pose a threat to the financial stability of the United States. Exercise

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<sup>3</sup> Act § 102(a)(4)(C). An entity meets this test if either 85% of its consolidated annual gross revenues or 85% of its consolidated assets relate to activities that are “financial in nature” or to the ownership of one or more insured depository institutions. In defining what activities are “financial in nature,” the Act references Section 4(k) of the BHCA. Section 4(k) is the laundry list of activities permissible for financial holding companies. Section 4(k) includes a wide range of activities generally regarded as financial, such as extending credit, dealing in securities, underwriting insurance, and providing investment advice. But there are also a number of less obvious activities that could be deemed “financial in nature” under section 4(k), such as data processing, management consulting and finder services.

<sup>4</sup> A foreign nonbank financial company includes any firm organized overseas that is “predominantly engaged” in U.S. financial services. The definition specifically notes that this “includes: firms that operate through a branch in the U.S.,” and appears thereby to include any non-U.S. firm that operates either through a subsidiary or without any U.S. presence, provided that it would meet the predominantly engaged test. Act § 102(a)(4)(A).

<sup>5</sup> Act § 117.

of this authority requires somewhat higher procedural hurdles than the designation of an NFC as a Supervised Nonbank Company. Under this authority, in appropriate circumstances, the Council could bring under supervision, for example, the automobile financing arm of an automobile manufacturer. The Board of Governors is authorized to require reports from, conduct examinations of, and bring enforcement action against, a Supervised Nonbank Company and, as noted below, must establish certain enhanced prudential standards that would apply to such a firm.

### **Bank Holding Companies Subject to Enhanced Prudential Standards**

The Act requires that enhanced prudential standards established by the Board of Governors for Supervised Nonbank Companies apply to any bank holding company with assets of \$50 billion or more.<sup>6</sup> The Act does not define such institutions, but refers to them in various places as “large interconnected bank holding companies,” and as “a company described in Section 165(a).”<sup>7</sup> This article refers to them as “Supervised Bank Holding Companies.”

As described below, the Board of Governors has authority that permits the prudential standards to be tailored to particular institutions, subject to certain limits, and is given the authority to raise the \$50 billion asset floor with respect to certain of the prudential standards. The authority permits the Board of Governors to exclude institutions by setting the floor sufficiently high from coverage of those particular standards and underscores the wide latitude that Congress has entrusted to the Board of Governors.

### **Board of Governors Supervision and Enhanced Prudential Standards**

The Board of Governors is required to adopt and implement enhanced prudential standards for Supervised Nonbank Companies and “large interconnected bank holding companies.” The enhanced prudential standards are for the purpose of preventing or mitigating risk to the financial stability of the United States. As a general matter, the Council has a role in making recommendations on such standards but the establishment of such standards is reserved to the Board of Governors.

The Act specifies subjects for enhanced prudential standards, but provides limited substantive requirements to guide the Board of Governors’ exercise of its discretion in the development of these standards. The subjects of enhanced prudential standards include risk-based capital and leverage, liquidity, risk management, resolution plan, credit exposure and concentration limit requirements. The Board of Governors is also authorized, but not required, to impose requirements related to contingent capital, enhanced public disclosure, short-term debt limits and such other subjects as it deems appropriate. The Act also provides for annual “stress tests” of covered firms and for risk committees for publicly traded Supervised Nonbank Companies and publicly traded bank holding companies with \$10 billion or more in assets.

The enhanced prudential standards must be stricter than those applicable to organizations without systemic importance and more stringent for companies that meet or exceed certain enumerated considerations related to size and complexity of business. The enhanced prudential standards may be tailored to particular institutions subject to certain limits.<sup>8</sup>

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<sup>6</sup> Act § 165(a).

<sup>7</sup> Act §§ 115(a) & 166(b).

<sup>8</sup> Act § 165(b)(1)-(3).

Certain of the prudential standards are notable for the authority they grant to the Board of Governors. If the resolution plan submitted by a covered firm is rejected and the Board of Governors imposes more stringent requirements upon a firm, it also may require that the firm divest certain assets or businesses in order to facilitate an order resolution in the event of bankruptcy.

The concentration limit imposes a capital limitation on the total credit exposure of any firm to another at 25% of the firm's capital and surplus, or such lower amount as the Board of Governors may establish.<sup>9</sup>

A Supervised Nonbank Company is not subject to the full panoply of regulation by the Board of Governors under the BHCA that applies to a bank holding company, such as the limits on the type of non-banking activities a bank holding company may conduct. However, the Board of Governors could choose to require a Supervised Nonbank Company to transfer financial businesses to an intermediate holding company apart from its nonfinancial businesses.<sup>10</sup>

A Supervised Nonbank Company is also subject to the limits on director interlocks among banking firms, as if it were a banking organization.<sup>11</sup>

The Board of Governors is also authorized to implement regulations that provide for a series of early remediation consequences for a Supervised Nonbank Company or a Supervised Bank Holding Company in declining health (similar to the Prompt Corrective Action requirements applicable to banks). The Board of Governors could require such a company to terminate an activity, to modify an activity, or to sell assets.<sup>12</sup>

### Supervisions of M&A Activity

The Act places several limits on the M&A activity of a Supervised Nonbank Company or Supervised Bank Holding Company. First, a Supervised Nonbank Company is treated as if it were subject to the BHCA for the purchase of shares of a bank, requiring that it secure prior approval of the Board of Governors to acquire more than 5% of the common stock of a banking organization.<sup>13</sup>

A Supervised Nonbank Company or a Supervised Bank Holding Company may acquire the voting stock of any firm engaged in financial services with assets of \$10 billion or more only after providing prior notice to the Board of Governors, except as provided in Section 4(c) of the BHCA. Section 4(c)(6) of the BHCA exempts the acquisition of up to 5% of the voting stock of any firm from prior notice. Thus, any investment or acquisition that exceeds 5% of the voting stock of such a firm must come under one of the other exemptions or be subject to prior notice to the Board of Governors.<sup>14</sup> The standard applied to such a notice is that applied under the BHCA to a nonbank acquisition by a bank holding company that is not a financial holding company, with the added requirement that the Board of Governors consider the extent to which the transaction would result in more concentrated risks for "global" or U.S. financial stability or the U.S. economy.<sup>15</sup> For financial holding companies that have been permitted to acquire any financial firm other than a bank or thrift, without prior approval, this effects a significant loss of flexibility and speed in making investments in, and acquisitions of, other financial firms.

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<sup>9</sup> Act § 165(e).

<sup>10</sup> Act § 167.

<sup>11</sup> Act § 164.

<sup>12</sup> Act § 166.

<sup>13</sup> Act § 163(a).

<sup>14</sup> Act § 163(b). See also 12 U.S.C. 1843(c).

<sup>15</sup> Act § 163(b)(4).

The Act imposes a new limit on the size of any single banking organization or Supervised Nonbank Company. Current law imposes a cap on the percentage of nationwide bank deposits that can be held by a single banking organization. The Act revises the deposit cap and creates a new cap based on total liabilities less regulatory capital of all banking and thrift organizations, and all Supervised Nonbank Companies. The Act prohibits a merger or acquisition by any banking organization or any Supervised Nonbank Company if the total consolidated liabilities of the resulting company would exceed 10% of the aggregate consolidated liabilities of all banking organizations and Supervised Nonbank Companies. The Board of Governors is charged with adopting implementing regulations and guidance.<sup>16</sup>

### **Supervision of Financial Activities and Practices**

The Council has the power to recommend that federal financial agencies apply special standards for financial practices that the Council determines pose a risk of “significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies or the financial markets of the United States.”<sup>17</sup> The agencies are required either to apply the recommended standards or to provide a written explanation for doing otherwise.

In making such a recommendation, the Council could act with a majority vote of its members, and the approval of the Secretary of the Treasury is not required, in contrast to the vote required to designate an NFC as a Supervised Nonbank Company. The practical effect of this authority could result in the adoption of broad-based rules governing products such as collateralized debt obligations, subprime loans, or particular accounting, marketing, or compensation practices.

### **Early Remediation and Orderly Liquidation**

The Board of Governors is authorized to determine that a Supervised Nonbank Company or a Supervised Bank Holding Company poses a grave threat to the financial stability of the U.S., with the approval of two-thirds of the Council members. Upon any such determination, the Board of Governors may limit the ability of the company to enter into merger transactions, restrict the ability of the company to offer a financial product, require the company to terminate one or more activities, or impose conditions on the manner in which the company conducts activities. The Board of Governors also may limit the ability of the company or to sell or transfer assets or off-balance sheet items to unaffiliated parties.

The special insolvency regime created by the Act for large firms that pose a risk to the stability of the financial system was created to address the insolvency of firms such as Supervised Nonbank Companies or Supervised Bank Holding Companies, although that regime is made applicable to institutions only in special circumstances. [See “Orderly Liquidation Authority.”](#)

### **Federal Reserve Credit and Payment and Clearing System Supervision**

The Act also amends the authority of the Federal Reserve to extend credit to nonbank, private parties in unusual and exigent circumstances, and authorizes the FDIC, in the event that a liquidity event is determined to exist, to create a widely available program to guarantee the obligations of solvent-insured depository institutions or holding companies. [See “Federal Reserve Emergency Credit.”](#)

The Act also provides the Federal Reserve with authority to supervise systemically important financial market utilities and payment, clearing and settlement activities conducted by financial institutions. [See “Supervision of Payment, Clearing and Settlement.”](#)

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<sup>16</sup>Act § 622.

<sup>17</sup>Act § 120.

# Federal Reserve Emergency Credit

The Dodd-Frank Act amends Section 13(3) of the Federal Reserve Act, which provides authority to the Board of Governors to extend credit to nonbank, private parties in “unusual and exigent circumstances.” The Act would allow for this emergency lending only to participants in facilities with broad based eligibility, rather than to aid or assist a specific firm on a one-off basis. This represents a significant restriction on the prior authority that the Board of Governors used in the autumn of 2008.

## Establishment of Emergency Lending Programs

The Act requires that the Board of Governors establish policies and procedures governing emergency lending under Section 13(3). The Board of Governors is required to consult with the Treasury Secretary in its establishment of such policies and procedures, which should ensure that the purpose of any emergency lending program or facility is to provide liquidity to the financial system, not to aid an insolvent company or a single failing company, and that the security for emergency loans is sufficient to protect taxpayers from loss. The Board shall require a Federal Reserve Bank to assign a lendable value to all collateral for a loan executed under Section 13(3). The establishment of emergency lending programs or facilities would require prior approval of the Treasury Secretary and may not exist indefinitely. The Board’s policies and procedures must ensure that any such programs or facilities are terminated in a “timely and orderly fashion.”<sup>1</sup>

The Board of Governors would be required to report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House on any loan or financial assistance authorized under Section 13(3). This report must be provided within seven days of authorization and must include:

- justification for the exercise of authority;
- the identity of the recipient;
- the date, amount and form of the assistance; and
- the material terms of the assistance.<sup>2</sup>

In addition to the initial report provided to these Congressional committees, the Board of Governors shall provide written monthly updates on any outstanding loan or financial assistance.

The information on the identity of participants in an emergency lending program, amounts borrowed, and identifying details concerning assets or collateral that is provided to Congress is subject to confidential treatment upon request of the Chairman of the Board of Governors.<sup>3</sup> This information shall be available only to the Chairpersons of the noted Congressional committees or Ranking Members.

## GAO Audit

The Act provides that the Comptroller General of the United States may conduct reviews of the Board of Governors, a Federal Reserve Bank or a credit facility established by the Federal Reserve. These

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<sup>1</sup> Act § 1101(a)(6) (to be codified at 12 U.S.C. § 343(A)).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

reviews may include onsite examinations and are to be solely for assessing the following with respect to a credit facility or covered transaction:

- the operational integrity, accounting, financial reporting, and internal control governing the credit facility or covered transaction;
- the effectiveness of the security and collateral policies established for the credit facility or covered transaction;
- whether the credit facility or conduct of a covered transaction inappropriately favors one or more specific participants over other institutions; and
- the policies governing the use, selection or payment of third-party contractors by or for any credit facility or to conduct any covered transaction.<sup>4</sup>

A “covered transaction” is defined by the Act as any open market transaction or discount window advance that meets the definition in Section 11(s) of the Federal Reserve Act.<sup>5</sup>

The Comptroller General is required to provide a report to Congress detailing the results of its review within 90 days of completing such review. In addition to detailing the Comptroller General’s findings and recommendations, the report shall provide recommendations for either legislative or administrative action, as the Comptroller General may deem appropriate. The details of the Comptroller General’s reports shall be confidential until one year after the effective date of termination by the Board of Governors of the authorization of the credit facility. At this time, the Comptroller General may release a redacted version of its report.

The Act also requires the Board of Governors to disclose information concerning the borrowers and counterparties participating in emergency credit facilities, discount window lending programs, and open market operations. This information must be disclosed one year after the effective date of termination by the Board of Governors of the authorization of the credit facility or two years after the calendar quarter in which a covered transaction was conducted and should include:

- identifying details about each borrower, participant or counterparty;
- amount borrowed or transferred;
- interest rate or discount paid; and
- information regarding collateral pledged or assets transferred.<sup>6</sup>

To facilitate public access to information regarding loans made under the emergency lending programs, the Board of Governors shall place on its website a link to a webpage that will contain information that will be made available to the public for no fewer than six months following the release of such information. The information contained on this public webpage shall include:

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<sup>4</sup> Act § 1102(a) (to be codified at 31 U.S.C. § 714).

<sup>5</sup> *Id.*

<sup>6</sup> Act § 1103(b) (to be codified at 12 U.S.C. § 248b(s)).



- the Comptroller General's reports;
- annual financial statements prepared by an independent auditor for the Board; and
- reports to Congressional committees under Section 13(3) of the Federal Reserve Act.<sup>7</sup>

The Act also directs the Government Accountability Office to conduct a one-time audit of financial assistance provided by the the Board of Governors from December 1, 2007, through the date of enactment.

### **Guarantee Programs of the Federal Deposit Insurance Corporation**

At the request of the Treasury Secretary, the FDIC and the Board of Governors shall determine when a liquidity event exists. A determination of the existence of a liquidity event must be submitted in writing and contain an evaluation of the evidence that led to the determination.

The Act provides that once a determination that a liquidity event exists is made, the FDIC shall create a widely available program to guarantee the obligations of solvent insured depository institutions or holding companies. These guarantees may not include the provision of equity. The Treasury Secretary shall determine the maximum amount of debt outstanding that the FDIC may guarantee in consultation with the President.

Policies and procedures governing the issuance of guarantees shall be established by the FDIC in consultation with the Treasury Secretary. The terms and conditions shall be established by the FDIC with the concurrence of the Treasury Secretary.

To fund the guarantee program, the FDIC may charge fees and assessments to all program participants. Any excess funds collected shall be deposited into the General Fund of the Treasury. If necessary, the FDIC may borrow funds from the Treasury Secretary in order to issue guarantees. The FDIC may also impose a special assessment in order to address any insufficiency in the funding of the program. The FDIC is prohibited from borrowing from the Deposit Insurance Fund.

The FDIC has existing authority to establish a debt-guarantee program under the Federal Deposit Insurance Act. This existing authority may not be used to establish a guarantee program for which the Act provides authority.

In the event of default by an insured depository institution or holding company in any FDIC debt-guarantee program, the FDIC shall appoint itself as receiver for the institution. In the event of default by a company that is not an insured depository institution, the FDIC shall require consideration of whether a determination to resolve the company should be made and that the company file a petition for bankruptcy if the FDIC is not appointed receiver pursuant to the Act within 30 days of the default.<sup>8</sup> If the FDIC is not appointed receiver, it may file a petition for involuntary bankruptcy on behalf of the company.

The Comptroller General shall review and report to Congress on the determination of the FDIC and the Board of Governors that a liquidity event exists.

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<sup>7</sup> Act § 1103(a) (to be codified at 12 U.S.C. § 225b).

<sup>8</sup> Act § 1106(c) (to be codified at 12 U.S.C. § 1823(c)(4)(G)).

### **Joint Resolution of Congress**

Prior to the FDIC issuing any guarantees, a joint resolution of approval must be passed by Congress. Requests for resolutions of authority are to be considered by Congress in an expedited fashion. The Act provides that if a request is received by the Senate while it is adjourned or recessed for more than two days, the Senate shall convene no later than the second calendar day after receipt. Congress must move to proceed to consideration of the joint resolution between four and seven days after the date of receipt of the request. The Act further provides that debate on the joint resolution shall be limited to 10 hours.

In instances where the House acts on the joint resolution prior to Senate action, the joint resolution of the House shall not be referred to committee and the procedure in the Senate shall be as if no joint resolution was received from the House.

### **Supervision and Regulation Policy**

The Act provides that a second Vice Chairman of the Board of Governors shall be appointed and shall be designated to serve as the Vice Chairman for Supervision. The Vice Chairman is to develop policy recommendations for the Board of Governors regarding supervision and regulation of depository institution holding companies and other financial firms and oversee supervision and regulation of these entities. The Vice Chairman shall report to Congress semi-annually regarding the efforts of the Board of Governors with respect to the supervision and regulation of these entities.

The Act further provides that the Board of Governors shall be responsible for identifying issues related to the financial stability of the United States. The Board of Governors shall not delegate these responsibilities to any Federal Reserve Bank.

# Regulation of Banking Organizations

The complexity of the current regulatory framework and shortcomings on the part of regulators have been cited as contributing factors in the financial crisis. The Dodd-Frank Act makes numerous key changes in the regulation of banks, thrifts, their parent companies and their affiliates.

The Act does little to rationalize the historical structural “patchwork” of U.S. banking agencies. Different types of institutions will continue to be regulated by multiple and overlapping federal and state agencies. The Act eliminates one banking regulator, but it creates a number of new agencies, bureaus and offices. The Board of Governors of the Federal Reserve System (the “Board of Governors”) emerges with significantly expanded jurisdiction and powers.

The Act will increase the cost of doing business for banking organizations. Many of the costs associated with the Act will be borne by the largest banking organizations, but even the smallest community banks will need to increase their financial and management resources dedicated to compliance and risk management.

Key aspects of many of the Act’s most important provisions are left to be implemented by the banking agencies through rulemaking. A large number of rulemakings will occur over the next two years to give substance to the outline provided by Congress in the Act — a process that is likely to preoccupy the regulators and tax their staffs’ ability to do the day-to-day work of supervision. The rulemaking process will be subject to industry, public and Congressional input.

The Act is more than 2,300 pages, and many of its provisions involve complex, technical and inter-related areas of law. Chairman Frank has already promised a “technical corrections” bill. Even with such corrections, banking organizations and their regulators will face an extended transition period as they identify and deal with ambiguities, inconsistencies and interpretive questions.

We outline below key provisions of the Act related to the regulation of banking organizations, which are principally contained in Titles III and VI.<sup>1</sup>

## Elimination of the Office of Thrift Supervision

There are currently more than 750 federal thrifts and 400 state thrifts. The primary federal regulator for these institutions and their parent companies is the Office of Thrift Supervision (the “OTS”). The Act will eliminate the OTS. It will not, however, eliminate the thrift charter itself, whether for existing or newly chartered institutions.

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<sup>1</sup> See “Consumer Protection Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act,” “The Volcker Rule,” “Derivatives” and “Analysis of the Orderly Liquidation Authority, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act” for the areas of the Act that will affect banking organizations that are not covered in this summary.

**Transfer of OTS Responsibility to Other Agencies.** The Act requires that federal regulation and supervision of thrifts be transferred from the OTS to specified banking agencies on a transfer date within one year of enactment.<sup>2</sup> The Secretary of the Treasury may extend the transfer date up to an additional six months, after consultation with the other banking agencies. The following summary reflects the Act’s division and transfer of the powers of the OTS among the existing banking agencies:<sup>3</sup>

Office of the Comptroller of the Currency (“OCC”)	<ul style="list-style-type: none"> <li>• supervisory authority over federal thrifts</li> <li>• rulemaking authority for federal and state thrifts, except in areas reserved for the Board of Governors</li> </ul>
Federal Deposit Insurance Corporation (“FDIC”)	<ul style="list-style-type: none"> <li>• supervisory authority over state thrifts</li> </ul>
Board of Governors	<ul style="list-style-type: none"> <li>• supervisory and rulemaking authority for savings and loan holding companies</li> <li>• rulemaking authority for federal and state thrifts with respect to affiliate transactions, loans to insiders and anti-tying prohibitions</li> </ul>

The Act requires the OCC to designate a deputy comptroller to supervise and examine federal thrifts.<sup>4</sup> We believe that thrift organizations will be expected to meet the expectations of their new regulators and that the transition from the OTS to another supervisor will be challenging for many institutions. The transition may be particularly difficult for state thrift organizations, which will become regulated in part by four separate banking regulators: the state, the FDIC for examinations, the OCC for rulemaking and the Board of Governors for holding company and certain other regulations.

The Act contains several savings provisions to continue the validity of OTS orders, resolutions, determinations, agreements, regulations, interpretations, guidelines and other supervisory materials.<sup>5</sup>

**Provisions Affecting Thrift Holding Companies.** The Act retains distinctions between thrift holding companies and bank holding companies. However, it takes a number of steps to align the regulation of thrift holding companies with that of bank holding companies. The Board of Governors will become responsible for the supervision of thrift holding companies, and it will have examination and enforcement authority over thrift holding companies similar to its authority over bank holding companies.

The Act directs the Board of Governors to require that any depository institution holding company (including a thrift holding company) serve as a source of financial strength for its subsidiary depository institutions. In addition, the Act authorizes the Board of Governors to promulgate capital requirements for thrift holding companies.<sup>6</sup>

<sup>2</sup> Act § 311.

<sup>3</sup> Act § 312.

<sup>4</sup> Act § 314 (to be codified at 12 U.S.C. § 1).

<sup>5</sup> Act § 316.

<sup>6</sup> Act § 616 (to be codified at 12 U.S.C. § 1844(b)).

A number of thrift holding companies operate otherwise impermissible nonbanking businesses under grandfather authority (*e.g.*, unitary thrift holding companies). The Act preserves this grandfather treatment but authorizes the Board of Governors to direct a grandfathered thrift holding company to house its thrift and other financial activities in an intermediate thrift holding company subject to the full panoply of regulation.<sup>7</sup> The Act specifies the level of regulation that applies to the intermediate thrift holding company in contrast to the parent holding company.

Thrift holding companies that do not rely upon the grandfather authority, and have diverse financial businesses such as securities and insurance firms, have been permitted under current law to conduct “financial” activities that would be permitted for a financial holding company under the BHCA. However, those thrift holding companies have not been required to meet the financial holding company criteria applicable to bank holding companies. The Act requires that a non-grandfathered thrift holding company meet the capital and management criteria for financial holding company status in order to conduct “financial” activities.<sup>8</sup> This change — when coupled with the change in financial holding company criteria discussed below — increases the supervisory leverage of the Board of Governors over those thrift holding companies that rely heavily on financial authority, such as insurance and securities firms.

### **Creation of the Consumer Financial Protection Bureau**

A major component of the Act is the creation of a new Consumer Financial Protection Bureau (the “CFPB”).<sup>9</sup> The CFPB will be a largely autonomous bureau within the Board of Governors. Its director will be appointed by the President and confirmed by the Senate. The CFPB will have a broad mandate to issue regulations, examine compliance and take enforcement action under the federal financial consumer laws. **See “Consumer Protection Provisions.”**

The President’s selection of the first director of the CFPB will be critical in shaping the role of this new agency. He or she will be responsible for issuing and implementing numerous important regulations and establishing the CFPB’s enforcement posture. The director of the CFPB also will serve on the board of directors of the FDIC, replacing the seat previously held by the director of the OTS.<sup>10</sup>

### **Enhanced Supervision and Standards for Large Institutions**

The Act establishes the Financial Stability Oversight Council (the “Council”) to monitor and manage systemic risk. The Act provides the Council with the authority to designate systemically significant non-bank financial companies for prudential supervision. The Act also grants the Board of Governors broad new authority to establish prudential standards for nonbank financial companies and for bank holding companies with assets of \$50 billion or more. **See “Key Measures to Address Systemic Risk.”**

### **More Rigorous Examination and Supervision of Nonbank Affiliates**

Under current law, the nonbank affiliates of banking organizations are generally subject to bank regulatory examination and enforcement. The Act will eliminate certain procedural hurdles to that authority

<sup>7</sup> Act § 626 (to be codified at HOLA § 10A).

<sup>8</sup> Act § 606 (to be codified at 12 U.S.C. § 1467a(c)(2)(H)).

<sup>9</sup> Act Title X.

<sup>10</sup> Act § 336 (to be codified at 12 U.S.C. § 1812(a)(1)(B)).

and, in some cases, mandate that the Board of Governors regularly and rigorously examine the nonbank affiliates of banking organizations.

**Mandatory Examination of Bank-Permissible Activities in Nonbank Affiliates.** The Act mandates that the Board of Governors conduct regular and rigorous examinations of any activities conducted by a nonbank affiliate that would be permissible for a bank subsidiary.<sup>11</sup> These examinations must be conducted in the “same manner, subject to the same standards, and with the same frequency” as if the activity were being conducted in a bank subsidiary. For example, a mortgage banking or commercial finance company that is a sister affiliate of a bank will become subject to bank-like examination by the Board of Governors on a regular basis.

Banking organizations should be prepared for the Board of Governors to hold their nonbank affiliates to the same standards and expectations as their subsidiary banks, such as with respect to risk management, internal controls and compliance.

This new examination requirement does not apply to functionally regulated subsidiaries or to subsidiaries of depository institutions. The Act also includes a number of procedural provisions under which the Board of Governors shall seek to avoid duplication and by which the other federal banking agencies can exercise back-up authority.

**Less Deference to Functional Regulators.** When the Gramm-Leach-Bliley Act of 1999 expanded the ability of banking organizations to affiliate with securities and insurance firms, Congress sought to balance the role of the Board of Governors, as the umbrella regulator of bank holding companies, against the functional jurisdictions of the SEC, CFTC and state insurance regulators. Current law limits the ability of the Board of Governors to examine and take action against the “functionally regulated subsidiaries” (*e.g.*, broker-dealers, investment advisers and insurance companies) of a bank holding company and includes provisions requiring deference to the functional regulator.

The Act eliminates existing restrictions on the Board of Governors’ ability to make regulations, issue guidance or take action against functionally regulated subsidiaries.<sup>12</sup> The Act also reduces the procedural hurdles for the Board of Governors to examine and obtain information from functionally regulated subsidiaries — requiring only that the Board of Governors give notice, consult with the functional regulator, and avoid duplication of examination activities “to the fullest extent possible.” The Act therefore expands the Board of Governors’ power to monitor and enforce “safety and soundness” standards across the entire banking organization, including its functionally regulated subsidiaries.

### **The Volcker Rule: Proprietary Trading and Fund Activities**

The Act contains broad prohibitions on proprietary trading and fund activities by depository institutions and their affiliates.<sup>13</sup> These prohibitions are the so-called “Volcker Rule.” The Volcker Rule generally prohibits depository institutions and their affiliates from sponsoring a hedge fund or private equity fund or investing in such funds. It provides certain carve outs for qualifying fund sponsorship and investment in seed capital, provided all such investments do not exceed certain aggregate limits as a percentage of

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<sup>11</sup>Act § 605 (to be codified at FDIA § 26(b)).

<sup>12</sup>Act § 604 (to be codified at 12 U.S.C. § 1848(a)).

<sup>13</sup>Act § 619 (to be codified at BHCA § 13(a)(1)).

Tier 1 capital. The Volcker Rule also prohibits depository institutions and their affiliates from conducting proprietary trading in securities and other instruments, other than federal, state and municipal securities. The prohibition affects the purchase and sale of a range of securities and other instruments in a trading book that holds “near term” transactions or transactions that involve “short-term price movements.”

See “The Volcker Rule.”

### Derivatives Activities

The Act substantially revamps the regulation of derivatives, including provisions that require banks to reorganize their derivatives business by transferring certain aspects of the business to a nonbank affiliate.<sup>14</sup> See “Derivatives.”

### Capital Regulation

The Act includes provisions related to capital standards affecting banking organizations, securities firms and nonbank financial companies designated by the Council and supervised by the Board of Governors. The overall theme underlying these provisions is to increase the amount of capital to be held by banking organizations and other systemically important firms. However, with the exception of the Collins Amendment described below, the Act largely avoids establishing substantive capital measures — leaving such measures for adoption and implementation by the regulators.

**The Collins Amendment; Status of Trust Preferred Securities.** An amendment offered by Senator Susan Collins (R-ME) and included in the Act has a significant effect on the capital requirements for bank holding companies and nonbank financial companies supervised by the Board of Governors.<sup>15</sup> The Collins Amendment requires that bank holding companies hold the same amount and same type of leverage and risk-based capital that is required of an insured depository institution.

A key consequence of the Collins Amendment would be to exclude trust preferred securities from the regulatory capital of bank holding companies. A large number of banking organizations of all sizes rely on this type of capital at the holding company level. In recognition of this effect, the Collins Amendment includes a number of transition provisions.

- The Collins Amendment will be deemed effective as of May 19, 2010, with respect to securities issued on or after May 19, 2010.
- For institutions with consolidated assets of less than \$15 billion on December 31, 2009, the Collins Amendment will not apply to securities issued before May 19, 2010.
- For institutions with consolidated assets of \$15 billion or more on December 31, 2009, the Collins Amendment will phase in over three years beginning on January 1, 2013.
- Holding companies that were not subject to supervision by the Board of Governors on May 19, 2010, would become subject to the Collins Amendment five years after enactment of the Act.
- The Act exempts from the Collins Amendment small bank holding companies subject to the Board of Governors’ Small Bank Holding Company Policy Statement, which generally covers bank holding companies with less than \$500 million of total consolidated assets.

<sup>14</sup>Act Title VII.

<sup>15</sup>Act § 171.

Another consequence of the Collins Amendment is to create a capital floor based on Basel I capital standards — even for those large banking organizations required to calculate capital under Basel II.

**Studies Regarding Capital.** The Act instructs the GAO (in consultation with the Board of Governors, OCC and FDIC) to conduct a study of hybrid capital instruments as a component of capital for banking organizations and the potential consequences of prohibiting the use of such instruments.<sup>16</sup> The Act also instructs the GAO (in consultation with the Board of Governors, OCC, FDIC and Treasury) to conduct a study of capital requirements applicable to U.S. intermediate holding companies that are bank or thrift holding companies and that are controlled by non-U.S. banking organizations. The Act sets forth a number of factors to be considered in these GAO studies. Within 18 months of enactment of the Act, the GAO must report the results of these studies to Congress and include specific recommendations for legislative or regulatory action regarding the treatment of hybrid capital instruments, including trust preferred securities.

**Source of Strength Obligation.** Regulations and historical practice of the Board of Governors currently require that bank holding companies serve as a “source of strength” for their subsidiary depository institutions. The Act statutorily codifies this requirement and expands it to cover any company that controls an insured depository institution — whether or not that company is a bank holding company under the BHCA.<sup>17</sup> The expanded source of strength obligations would apply to thrift holding companies and the parent companies of nonbank banks, such as industrial banks, credit card banks and trust banks.

The Act also requires that, if a nonbank financial company supervised by the Board of Governors organizes an intermediate holding company to house its financial activities, then the parent company must serve as a source of strength for the intermediate holding company.<sup>18</sup>

**Counter-Cyclical Capital Requirements.** The Act adds the following language to the Board of Governors’ authority to adopt capital regulations: “[T]he Board shall seek to make such requirements countercyclical, so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the company.”<sup>19</sup> The Act does not provide more specificity on this point.

### **Change to Criteria for Financial Holding Company Status**

Under current law, a bank holding company can qualify to become and remain a “financial holding company” permitted to engage in a broad range of nonbank “financial” activities based on the capital status, examination ratings and CRA ratings of its subsidiary depository institutions. The Act requires that the holding company itself also meet the well-capitalized and well-managed requirements.<sup>20</sup> In practice, this change will give more supervisory leverage to the Board of Governors over banking organizations that rely on financial holding company status to conduct financial activities, such as securities underwriting and dealing, merchant banking, and insurance underwriting. As discussed above, this change will affect not only bank holding companies, but also thrift holding companies. This change will become effective on the date when the OTS responsibilities are transferred to the other banking agencies.

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<sup>16</sup>Act § 174.

<sup>17</sup>Act § 616 (to be codified at FDIA § 38A).

<sup>18</sup>Act § 167(b)(3).

<sup>19</sup>Act § 616 (to be codified at 12 U.S.C. § 1844(b)).

<sup>20</sup>Act § 606 (to be codified at 12 U.S.C. § 1843(l)(1)).



## Deposit Insurance and Assessments

**Changes in Deposit Insurance Coverage.** The Act permanently increases the standard maximum federal deposit insurance coverage amount to \$250,000.<sup>21</sup> The Act makes this increase retroactive to January 1, 2008, with respect to insured depository institutions for which the FDIC was appointed receiver or conservator after that date. The effect of this retroactive application is to provide the increased coverage to depositors in a handful of institutions (including IndyMac) that failed between January 1, 2008, and the date on which the Emergency Economic Stabilization Act of 2008 first temporarily increased coverage from \$100,000 to \$250,000.

The Act also extends until January 1, 2013, federal deposit coverage for the full net amount held by depositors in noninterest-bearing transaction accounts.<sup>22</sup> The Act defines “noninterest-bearing transaction accounts” as: accounts maintained at an insured depository institution on which the depositor is permitted to make withdrawals by negotiable or transferable instruments, payment orders of withdrawal, telephone or other electronic media transfers, or similar items for the purpose of making payments on transfers to third parties or others; and deposits or accounts on which the insured depository institution does not reserve the right to require advance notice of an intended withdrawal.

These changes in deposit insurance coverage apply to both insured depository institutions and credit unions.

**Change in Assessment Base.** The FDIC has a set of regulations that provide formulae for determining the amount of an institution’s deposit insurance premiums. Under current law, these formulae create an “assessment base” related to the amount of U.S. deposits held by a particular institution. The Act will change the “assessment base” to be founded generally on the amount of liabilities held by the institution.<sup>23</sup> The FDIC has additional discretion with respect to custodial banks and bankers’ banks. The effect of this provision will be to shift the burden of deposit insurance premiums toward those depository institutions that rely on funding sources other than U.S. deposits. Smaller community banks tend to rely primarily on U.S. deposits; whereas, large money-center banks tend to have a broader base of funding sources.

**Minimum Reserve Ratio Increase for Deposit Insurance Fund.** Current law requires the FDIC annually to designate a reserve ratio for the Deposit Insurance Fund, which may not be less than 1.15% of the estimated amount of total insured deposits. The Act raises the minimum designated reserve ratio to 1.35% and requires the FDIC to take steps to achieve this higher level by September 30, 2020.<sup>24</sup> When setting the assessments necessary to achieve this higher level, the FDIC is required by the Act to “offset” the effect of such assessments on insured depository institutions with total consolidated assets of less than \$10 billion. The result of this offset requirement is to shift the assessment burden to larger banking organizations.

**Measures to Eliminate Pro-Cyclical Assessments.** Current law establishes a ceiling on the designated reserve ratio of the Deposit Insurance Fund and requires the FDIC to pay dividends from the Deposit Insurance Fund if it reaches certain levels. These requirements are seen as being “pro-cyclical” because

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<sup>21</sup>Act § 335 (to be codified at 12 U.S.C. § 1821(a)(1)(E)).

<sup>22</sup>Act § 343 (to be codified at 12 U.S.C. § 1821(a)(1)).

<sup>23</sup>Act § 331 (to be codified at 12 U.S.C. § 1817(b)(2)).

<sup>24</sup>Act § 334 (to be codified at 12 U.S.C. § 1817(b)(3)(B)).

they limit the growth of the Deposit Insurance Fund during positive economic conditions. The Act will eliminate the ceiling on the designated reserve ratio and allow the FDIC to suspend or limit the declaration of dividends.<sup>25</sup>

## Limits on Size

**Limit Based on Combined Liabilities of All Financial Companies.** The Act imposes a new limit on the size of any single banking organization or nonbank financial company designated by the Council.<sup>26</sup> Limiting the overall size of financial firms was proposed by President Obama as a key element of financial reform on the grounds that risk should not be concentrated in a handful of massive financial firms. It is also a nod to the idea that no institution should grow “too big to fail.”

The Act will prohibit a banking organization or nonbank financial company designated by the Council from conducting a merger or acquisition if the total consolidated liabilities of the resulting company would exceed 10% of the aggregate consolidated liabilities of all financial companies (calculated as of the end of the preceding calendar year). The Board of Governors may approve exceptions to this size limit for transactions involving troubled institutions, FDIC assistance or a *de minimis* increase in liabilities.

Within six months of enactment, the Council must complete a study on the extent to which this size limit affects financial stability, moral hazard in the financial system, the efficiency and competitiveness of U.S. financial firms and markets, and the cost and availability of credit and other financial services to households and businesses in the United States. The Council’s study shall make recommendations on modifying the concentration limit. Within nine months after the Council completes its study, the Board of Governors must issue final rules reflecting the Council’s recommendations. It is therefore possible that this new size limit could be established by regulation at a level below 10%.

**Expansion of 10% Nationwide Deposit Cap.** Current law includes a 10% nationwide deposit concentration cap on certain types of interstate mergers and acquisitions involving banks. The Act would expand the nationwide deposit cap to apply to a broader universe of depository institution transactions, including those involving thrifts and industrial banks.<sup>27</sup> The Act provides exceptions for transactions involving troubled institutions.

## Enhanced Lending and Concentration Limits

The Act strengthens a number of existing laws that limit a depository institution’s credit exposure to one borrower, to its affiliates and to its insiders. Many of these changes seek to address credit exposure arising from derivative transactions, repurchase agreements, and securities lending and borrowing transactions.

**Loans to One Borrower.** Current banking law limits a depository institution’s ability to extend credit to one person (or group of related persons) in an amount exceeding certain thresholds. The Act expands the scope of these restrictions to include credit exposure arising from derivative transactions, repurchase agreements, and securities lending and borrowing transactions.<sup>28</sup> The Act includes provisions intended to implement these changes with respect to national banks, federal thrifts and state-chartered depository institutions.<sup>29</sup>

<sup>25</sup>Act §§ 332 & 334 (to be codified at 12 U.S.C. §§ 1817(e)(2) & 1817(b)(3)(B)).

<sup>26</sup>Act § 622 (to be codified at BHCA § 14(b)).

<sup>27</sup>Act § 623 (to be codified at 12 U.S.C. §§ 1828(c), 1843(i) & 1467a(e)(2)).

<sup>28</sup>Act § 610 (to be codified at 12 U.S.C. § 84(b)).

<sup>29</sup>See Act §§ 610 & 611.

**Transactions With Affiliates: Section 23A.** Section 23A of the Federal Reserve Act is a key statutory provision that imposes quantitative limits, qualitative standards and collateral requirements on certain transactions by an insured depository institution with its affiliates. The Act expands the scope of Section 23A. Some of the key changes are outlined below.<sup>30</sup>

- The Act expands the definition of “affiliate” for purposes of Section 23A to include any investment fund advised by the depository institution or its affiliates. In addition, other sections of the Act include outright prohibitions on a depository institution or its affiliates conducting any transaction covered by Section 23A with a fund they advise or sponsor.<sup>31</sup> **See “Private Fund Investment Advisers.”**
- The Act expands the applicability of Section 23A to derivative transactions, repurchase agreements, and securities lending and borrowing transactions that create credit exposure by a depository institution to its affiliates. Among other things, the Act will require that a depository institution’s credit exposure to its affiliates resulting from securities lending and borrowing, repurchase agreements and derivative transactions be secured at all times.
- The Act raises significantly the procedural and substantive hurdles required to obtain an exemption from Section 23A. The Board of Governors will no longer have the authority to grant exemptive orders. Instead, the Act will require that the depository institution’s primary federal regulator approve the exemption with the concurrence of the Board of Governors and the non-objection of the FDIC — in each case, under standards specified in the Act.
- The Act also will eliminate an existing provision that excludes transactions by a depository institution with its “financial subsidiary” from the 10% single affiliate limit of Section 23A.<sup>32</sup>

**Transactions With Insiders.** The Act broadens the existing limitations on transactions by a depository institution with its insiders to include credit exposure arising from derivative transactions, repurchase agreements, and securities lending and borrowing transactions.<sup>33</sup>

The Act prohibits an insured depository institution from purchasing or selling an asset to an executive officer, director, or principal shareholder (or any related interest of such a person) unless the transaction is on market terms and, if the transaction exceeds 10% of the institution’s capital, it is approved in advance by a majority of disinterested directors.<sup>34</sup> The Board of Governors has rulemaking authority with respect to this new provision (after consultation with the OCC and FDIC).

## Nonbank Banks

Under current law, certain types of depository institutions are not treated as “banks” for purposes of the BHCA. These so-called “nonbank banks” include credit card banks, industrial banks and trust banks that meet certain legal requirements. Companies owning nonbank banks are not required to become bank holding companies regulated by the Board of Governors and are therefore not limited in their ability to conduct commercial activities.

<sup>30</sup>Act § 608 (to be codified at 12 U.S.C. § 371c).

<sup>31</sup>Act § 619 (to be codified at BHCA § 13(f)(1)).

<sup>32</sup>Act § 609 (to be codified at 12 U.S.C. § 371c(e)).

<sup>33</sup>Act § 614 (to be codified at 12 U.S.C. § 375b(9)(D)(ii)).

<sup>34</sup>Act § 615 (to be codified at 12 U.S.C. § 1828).

The Act stops short of eliminating the exemptions for nonbank banks, but it constrains the ability of commercial firms to take advantage of them. The Act imposes a three-year moratorium on applications by commercial firms either to obtain deposit insurance for a new nonbank bank and or to acquire control of an existing nonbank bank.<sup>35</sup> The Act also requires the GAO to study the necessity of the nonbank bank exemptions from the BHCA. The GAO must report the results of its study to Congress within 18 months of enactment of the Act.

### **Elective Federal Reserve Supervision for Securities Holding Companies**

The Act creates a new regime through which companies that control an SEC-registered broker-dealer (but not a bank) may elect to become subject to consolidated supervision by the Board of Governors.<sup>36</sup> This regime is intended to allow U.S. securities firms to satisfy the requirements of the European Union and certain other foreign countries that the company be subject to comprehensive supervision on a consolidated basis. This new regime replaces the current “investment bank holding company” system by which securities firms can elect to be supervised on a consolidated basis by the SEC.

Securities holding companies supervised by the Board of Governors will become subject to most provisions of the BHCA but not its limitations on nonbanking activities. The Board of Governors will have the same reporting, examination and rulemaking authority over these securities holding companies as it has over bank holding companies. The Board of Governors must prescribe capital adequacy and risk management standards for supervised securities holding companies consistent with the safety and soundness of the companies and any risks posed to financial stability. In applying these standards, the Board of Governors may differentiate among securities holding companies on an individual basis or by category depending on the specified factors. Furthermore, the Act provides the Board of Governors with enforcement authority over supervised securities holding companies that is similar to its enforcement authority over bank holding companies.

### **Miscellaneous Provisions**

**Financial Stability as a Regulatory Objective.** The Act adds financial stability as an express regulatory objective of the banking laws. For example, the Act identifies “the stability of the financial system of the United States” as a statutory purpose for Board of Governors examination of banking organizations.<sup>37</sup> The Act also adds financial stability as a statutory factor to be considered in the application process, such as for mergers and acquisitions involving banking organizations.

**Fees for Federal Banking Regulators.** The Act grants the OCC, FDIC and Board of Governors broad discretion to establish and collect supervisory and examination fees from their respective supervised institutions.<sup>38</sup> In the case of the Board of Governors, such fees may be assessed only against bank and thrift holding companies with consolidated assets of \$50 billion or more and nonbank financial companies designated by the Council. The fee authority of the OCC and FDIC is not limited by size of the institution. Neither the FDIC nor the Board of Governors currently charge examination or supervision fees.

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<sup>35</sup>Act § 603.

<sup>36</sup>Act § 618.

<sup>37</sup>Act § 604 (to be codified at 12 U.S.C. § 1844(c)(2)).

<sup>38</sup>Act § 318 (to be codified at U.S. Rev. Stat. tit. LXII, ch. 4, § 5240A; 12 U.S.C. §§ 1820(e), 248).

**Expanded Backup Authority for FDIC.** The FDIC has historically had back-up examination and enforcement authority over banking organizations for purposes of safeguarding the Deposit Insurance Fund. The Act strengthens this back-up authority and removes various procedural hurdles for its use. For example, the Act will eliminate an existing requirement that the FDIC obtain agreement of the primary federal regulator before requiring reports from an institution.<sup>39</sup>

The Act also grants the FDIC back-up examination authority over large bank holding companies and non-bank financial companies designated by the Council when deemed necessary for insurance purposes or to implement the FDIC's orderly liquidation authority. See **"Orderly Liquidation Authority."**

**Prohibition on "Excessive Compensation."** The Act requires the federal banking and securities regulators to adopt regulations applicable to "covered financial institutions" (including banking organizations) to prohibit incentive-based compensation arrangements that encourage inappropriate risks by providing "excessive compensation" or which could lead to material financial loss to the covered financial institution.<sup>40</sup> See **"Executive Compensation."** This continued focus on executive compensation follows the Guidance on Sound Incentive Compensation Policies jointly adopted by the federal banking agencies on June 21, 2010.<sup>41</sup>

**Interstate Branching.** Under current law, banks are limited in their ability to establish branches outside their home state. Depending on a particular state's law, banks are often required to "buy" their way into a new state by acquiring an institution or branch in the target state. The Act relaxes these requirements and allows national banks and state banks to establish branches in any state if that state would permit the establishment of the branch by a state bank chartered in that state.<sup>42</sup> The Act also allows a thrift that converts to a bank to retain any branches operated prior to the conversion and to establish additional branches in the states where it operated.<sup>43</sup>

**Interest on Demand Deposits.** The Act repeals the longstanding prohibition on the payment of interest on demand deposit accounts.<sup>44</sup> The repeal will become effective one year after enactment of the Act.

**Charter Conversions by Institutions Subject to Enforcement Action.** The Act prohibits a bank or thrift from consummating a charter conversion if it is subject to an enforcement action with respect to a "significant supervisory matter."<sup>45</sup> This provision is intended to prevent institutions from "forum shopping" for a more lenient regulator. The Act provides an exception to the prohibition if (i) the resulting regulator gives the departing regulator notice of the conversion and a plan to address the significant supervisory matter; (ii) the departing regulator does not object to the plan; (iii) the resulting regulator implements the plan; and (iv) in cases involving final action by a state attorney general, approval of the conversion is conditioned on compliance with the terms of the state attorney general's action.

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<sup>39</sup> Act § 333 (to be codified at 12 U.S.C. § 1817(a)(2)(B)).

<sup>40</sup> Act § 956.

<sup>41</sup> 75 Fed. Reg. 36,395 (June 25, 2010).

<sup>42</sup> Act § 613 (to be codified at 12 U.S.C. § 36(g)(1)(A)).

<sup>43</sup> Act § 341.

<sup>44</sup> Act § 627 (to be codified at 12 U.S.C. §§ 371a, 1464(b)(1)(B) & 1828(g)).

<sup>45</sup> Act § 612.

**Office of Minority and Women Inclusion.** The Act requires that an Office of Minority and Women Inclusion be established within each of the Treasury, Board of Governors, Federal Reserve Banks, FDIC, OCC, CFPB, SEC, Federal Housing Finance Agency and National Credit Union Administration.<sup>46</sup> This Office will be responsible for agency matters relating to diversity in management, employment and business activities. Each Office will have a director that reports to its respective agency administrator. The Act requires that each Office develop standards for equal employment opportunities and the diversity of the agency’s workforce, increased participation of minority and women-owned businesses in agency activities, and assessment of the agency’s diversity policies and practices.

The Act also requires that each agency’s contracting policies include a component giving consideration to an applicant’s diversity. We note that the scope of this contracting provision includes not only personnel and vendor hiring decisions, but also contracts for “all business and activities of an agency, at all levels, including contracts for the issuance or guarantee of any debt, equity, or security, the sale of assets, the management of the assets of the agency, [or] the making of equity investments by the agency.”<sup>47</sup>

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<sup>46</sup>Act § 342.

<sup>47</sup>Act § 342(d).

# The Volcker Rule

The “Volcker Rule”<sup>1</sup> prohibits an insured depository institution and its affiliates from:

- engaging in “proprietary trading”;
- acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and
- sponsoring a hedge fund or a private equity fund.

Nonbank financial companies designated by the Council for supervision by the Board of Governors would not be subject to this prohibition. The Act provides, however, that they could be subject to additional capital requirements for, and additional quantitative limits with respect to, the foregoing activities.

The Volcker Rule would apply to proprietary trading and fund activities by U.S. banking organizations regardless of where the trading or activities are conducted. However, for non-U.S. banking organizations, the Volcker Rule would apply only to proprietary trading and fund activities in the U.S., or such activities outside the U.S., if they involve the offering of securities to any U.S. resident.

While the Volcker Rule has been moderated since its inception, these limitations would have a significant impact on the ability of U.S. banking organizations to provide investment management products and services that are competitive with nonbanking firms generally and with non-U.S. banking organizations in overseas markets. It would also effectively prohibit short-term trading strategies by any U.S. banking organization, regardless of the location of its trading business, if those strategies involve instruments other than those specifically permitted for trading, as described below.

## Proprietary Trading

The Volcker Rule would prohibit any insured depository institution and its affiliates from engaging in “proprietary trading” of debt and equity securities, commodities, derivatives, or other financial instruments. “Proprietary trading”<sup>2</sup> is defined as engaging as a principal for the trading account of a banking organization or supervised nonbank financial company in any transaction to purchase or sell, or otherwise acquire or dispose of:

- any security;
- any derivative;
- any contract of sale of a commodity for future delivery;
- any option on any such security, derivative, or contract; or
- any other security or financial instrument that the appropriate federal banking agencies, the SEC, and the CFTC (the “Regulators”) may determine by rule.

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<sup>1</sup>The Volcker Rule is implemented by Title VI of the Dodd-Frank Act; it is named for former Federal Reserve Chairman Paul Volcker.

<sup>2</sup>Act § 619 (to be codified at 12 U.S.C. § 1851(h)(4)).

The key term “trading account” is defined as any account used for acquiring or taking positions in the proprietary trading of securities and instruments principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the Regulators may determine by rule.<sup>3</sup>

In summary, investments made “for the trading account” would be deemed proprietary trading and therefore prohibited. The “trading account” definition only covers “near-term” transactions or transactions that involve “short-term price movements.” Thus, this definition substantially limits the scope of prohibited proprietary trading. However, the Volcker Rule also provides the Regulators with the authority to determine that other accounts meet the “trading account” definition. The Regulators could use this authority to expand the scope of the prohibition.

The Volcker Rule also specifically permits trading transactions:

- in government securities;<sup>4</sup>
- in connection with underwriting or market-making, to the extent that either does not exceed near term demands of clients, customers, or counterparties;
- on behalf of customers; or
- by an insurance business for the general account of the insurance company.<sup>5</sup>

The Volcker Rule also permits certain risk-mitigating hedging related to an insured depository institution’s holdings. Investments in small business investment companies, the public welfare, and qualified rehabilitation expenditures also would be excluded from the ban. Additionally, offshore proprietary trading conducted by insured depository institutions, that are not U.S.-controlled, is permitted. Finally, additional activities may be permitted to the extent the Regulators determine that they promote and protect the safety and soundness of the banking organization and financial stability of the United States.

### **Fund Sponsorship**

The Volcker Rule prohibits insured depository institutions and their affiliates from “sponsoring” a hedge fund or private equity fund. It would not prohibit banking organizations from providing advice to such funds.

The Volcker Rule defines “hedge fund” and “private equity fund” to include any issuer that is exempt from SEC registration under the Investment Company Act of 1940 (the “1940 Act”) based on Section 3(c)(1) (100 or fewer beneficial owners) or Section 3(c)(7) (qualified purchasers).<sup>6</sup> It also would include any “similar fund” determined by the Regulators. **See “Private Fund Investment Advisers.”**

The Volcker Rule defines “sponsoring” a fund as:

- serving as a general partner, managing partner, or trustee of a fund;

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<sup>3</sup> Act § 619 (to be codified at 12 U.S.C. § 1851(h)(6)).

<sup>4</sup> The government securities exception for proprietary trading is much narrower than the universe of bank-eligible “investment securities” that have been permitted for national banks under the National Bank Act and OCC regulations, for the most part, for the last century.

<sup>5</sup> Act § 619(d)(1)(F).

<sup>6</sup> Act § 619 (to be codified at 12 U.S.C. § 1851(h)(2)).



- selecting or controlling (or having employees, officers, directors, or agents constituting) a majority of the directors, trustees, or management of a fund; or
- sharing the same name of the banking organization or any affiliate or a similar name with the fund.<sup>7</sup>

The sponsorship concept is based on a model that the Board of Governors used to allow banking organizations, prior to the adoption of the Gramm-Leach-Bliley Act, to sponsor and advise funds if they met similar requirements.

In certain circumstances, the Volcker Rule permits a banking organization to organize and offer a hedge fund or private equity fund, including serving as general partner, management member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund. **See also “Private Fund Investment Advisers.”** The banking organization may organize and offer a hedge fund or private equity fund if it:

- provides trust, fiduciary, or investment advisory services and the fund is organized and offered only in connection with such services and only to customers of such services;
- does not have an ownership interest in the fund except for a seed<sup>8</sup> or de minimis investment (subject to certain limitations);
- complies with Section 23A and 23B affiliate transaction limitations;
- does not guarantee, assume, or otherwise insure obligations or performance of the fund;
- does not share the same or similar name as the fund;
- prohibits directors or employees from having an ownership interest in the fund, except for any director or employee who is directly providing investment advisory or other services to the fund; and
- discloses, in writing, to investors that any losses in the fund are borne solely by the investors.<sup>9</sup>

### Fund Ownership Interest

The general prohibition on the ownership of any interest in a fund is subject to an exception for a seed investment in a fund advised by the banking organization or its affiliates that comes within the exception above permitting the sponsorship of certain funds, for the purpose of providing the fund sufficient initial equity for investment to permit the fund to attract unaffiliated investors. If the banking organization makes a seed investment, it must seek unaffiliated investors to reduce or dilute the investment to not more than 3% of total ownership interest of the fund within one year after the date of establishment of the fund (the Board of Governors may extend the period for two years); and be “immaterial” (as defined by rules

<sup>7</sup> Act § 619 (to be codified at 12 U.S.C. § 1851(h)(5)).

<sup>8</sup> A banking organization may make a seed investment only for the purpose of establishing the fund and providing the fund sufficient initial equity for investment to permit the fund to attract unaffiliated investors. Act § 619 (to be codified at 12 U.S.C. § 1851(d)(4)).

<sup>9</sup> Act § 619 (to be codified at 12 U.S.C. § 1851(d)(1)(G)).

to be issued by the Regulators). In addition, the aggregate investment in all the investment interests in such funds may not exceed 3% of the Tier 1 capital of the banking organization. **See “Private Fund Investment Advisers.”**

Foreign banking organizations (outside of the United States) may operate without regard to the Volcker Rule provided no ownership interest in such fund is offered for sale or sold to a U.S. resident. Finally, other sponsorships may be permitted to the extent the Regulators determine that they promote and protect the safety and soundness of the banking organization and financial stability of the United States.

### **Affiliate Transactions Prohibited**

The Volcker Rule flatly prohibits a banking organization (and any of its affiliates) that manages, sponsors, advises, or organizes and offers a fund from entering into a Section 23A covered transaction (loans to the fund and asset purchases from the fund) with such fund. This is considerably broader than the prohibition on sponsorship and effectively prohibits such transactions where the banking organization has nothing more than an advisory role. In addition, the banking organization and such fund are subject to Section 23B’s<sup>10</sup> requirements for arm’s-length terms on all services and transactions with such fund. The Board of Governors may grant a banking organization a Section 23A exception for the purpose of entering into any prime brokerage transactions with a fund in which a fund that the banking organization manages, sponsors or advises has taken an equity, partnership or other ownership interest. This exception permits prime brokerage transactions with funds in which a “fund of funds” has invested. In general, the grant of the exception requires the following conditions to be met:

- The banking organization complies with the Volcker Rule’s exception for sponsoring or making seed or de minimis investments in funds;
- The CEO (or equivalent officer) annually certifies, in writing, that the banking organization does not guarantee, assume, or otherwise insure the obligations or performance of the fund or any other fund in which such fund invests; and
- The Board of Governors determines that such transaction is consistent with the safe and sound operation and condition of the banking entity.<sup>11</sup>

### **Conflicts of Interest Prohibited**

The Volcker Rule provides that no transaction, class of transaction, or activity by a banking organization may be deemed to be permitted under the authority described above to conduct certain permitted proprietary trading or fund sponsorship or investment if it would:

- result in a material conflict of interest between the banking organization and its clients, customers, or counterparties;
- result in material exposure by the banking organization to “high-risk assets” or “high-risk strategies” (as defined by rules to be issued by the Regulators);

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<sup>10</sup>Act § 619 (to be codified at 12 U.S.C. § 1851(f)(1)-(2)).

<sup>11</sup>Act § 619 (to be codified at 12 U.S.C. § 1851(f)(3)).

- pose a threat to the safety and soundness of the banking organization; or
- pose a threat to the financial stability of the United States.

The Regulators are required to impose additional capital requirements and quantitative limitations on permitted activities if they determine that such requirements and limitations are needed to protect the safety and soundness of the banking organizations. The Regulators also are required to issue regulations regarding internal controls and recordkeeping to ensure compliance with the Volcker Rule.

Finally, the Volcker Rule prohibits a banking organization or designated nonbank financial company from engaging in activities that are authorized under another authority if such activities are prohibited by the Volcker Rule. It remains to be seen how the Board of Governors will interpret this limitation on reliance on other authority. In particular, will investments that are not prohibited by the Volcker Rule's proprietary trading prohibition and are separately authorized under provisions such as the merchant bank authority be prohibited solely because the form of the ownership is regarded as a fund? Will the Volcker Rule proprietary trading prohibition be interpreted to prohibit derivative activities permitted by Title VII of the Act?

See "Derivatives."

### **Nonbank Supervised Entities**

The Volcker Rule would not prohibit proprietary trading or fund activities by a designated nonbank financial company. However, it would allow the Board of Governors to impose capital requirements and quantitative limits on the conduct of such activities by those companies. These additional requirements and limitations will not apply to the permitted activities exemptions discussed above. Also, the Regulators are required to adopt regulations imposing additional capital charges or other restrictions for these companies to address the risks to and conflicts of interest of banking entities described in the affiliate transaction limitations.

### **Timeline**

Within six months of enactment of the Act, the Council is required to complete a study of the definitions and restrictions imposed by the Volcker Rule. The study could recommend "modifications" of the definitions or limitations contained in the Volcker Rule. Within nine months after completion of the Council's study, the Regulators are required to issue a joint rulemaking reflecting the recommendations and modifications contained in the study.

The Volcker Rule would become effective upon the earlier of two years after its enactment or 12 months after issuance of the final rules. It is unlikely that the Regulators will issue the final rules earlier than 12 months after the enactment of the Volcker Rule. Therefore, it is expected that the Volcker Rule will become effective two years after its enactment. It is possible that the Regulators will not have effective regulation in place within two years, and the law would become effective without the guidance of such regulations.

Once the Volcker Rule regulations become effective, the Volcker Rule would require banking organizations to divest or discontinue prohibited activities within two years. The regulators could then grant specific one-year extensions for up to three additional years. The divestiture period and extensions probably would be interpreted to allow only for transition and wind down and not to allow for new or expanded activities otherwise prohibited by the Volcker Rule.

The Volcker Rule allows the Board of Governors to grant a banking organization a single extension of up to five years to take or retain its ownership interest in, or provide additional capital to, “illiquid funds.” This authority allows a banking organization to make additional investments in illiquid funds pursuant to contractual obligations after the Volcker Rule is effective. The “up to five year” period for an investment in an illiquid fund could be read to run from the effective date of the Volcker Rule. In the alternative, it could be read to allow a banking organization to have a five-year period in addition to all other periods permitted.

# Private Fund Investment Advisers

Title IV of the Dodd-Frank Act provides for a number of changes to the regulatory regime governing investment advisers and private funds. Among other effects, the Act will require many currently unregistered investment advisers to register with the SEC pursuant to the Investment Advisers Act of 1940, as amended (the “Advisers Act”), by removing a commonly used exemption from registration under the Advisers Act. The Act also will impose increased recordkeeping and reporting obligations on investment advisers to certain private funds. Additionally, the “Volcker Rule” contained in the Act will limit the ability of banking entities and nonbank financial companies supervised by the Board of Governors to sponsor or invest in private funds, including hedge funds and private equity funds.

## Enhanced Registration Requirements for Advisers to Private Funds

Currently, many investment advisers are not registered with the SEC, instead relying on various exemptions to registration granted pursuant to the Advisers Act. One of the more commonly used exemptions to registration is the “private adviser exemption,” which is available to investment advisers with fewer than 15 clients, among other criteria.<sup>1</sup> The Act eliminates the private adviser exemption, which will have the effect of requiring a large number of currently unregistered advisers to register with the SEC.<sup>2</sup>

## Exclusions and Exemptions to Registration Requirements for Advisers to Private Funds

Despite the elimination of the private adviser exemption, the Act provides for several new exemptions to the registration requirements for private fund advisers, which are summarized below.

**Mid-Sized Private Fund Advisers.** The Act requires that the SEC provide an exemption from the registration requirements for investment advisers with less than \$150 million in assets under management.<sup>3</sup> This \$150 million exemption, however, applies only to investment advisers who act solely as advisers to private funds<sup>4</sup> and have assets under management in the United States of less than \$150 million. Nevertheless, the Act requires that investment advisers who take advantage of this exemption maintain such records and provide such annual reports to the SEC as the SEC by rulemaking shall determine are necessary and appropriate in the public interest or for the protection of investors. The Act also grants the SEC the authority to propose registration and examination procedures for investment advisers to “mid-sized private funds,” taking into account the size, governance, investment strategy and level of systemic risk posed by such funds.<sup>5</sup> This authority will allow, but not require, the SEC to carve out full or partial exemptions for categories of mid-sized private funds beyond the exemption levels that are expressly provided for in the Act.

A private fund adviser that utilizes this exemption will need to determine in what states it is required to register as an investment adviser. Such an adviser may in fact be required to register in a number of different states, depending on where it conducts its business.

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<sup>1</sup> The private adviser exemption contained in Section 203(b)(3) of the Advisers Act exempts from registration an investment adviser that (i) had fewer than 15 clients during the preceding 12 months, (ii) does not hold itself out to the public as an investment adviser, and (iii) does not serve as an investment adviser to a registered investment company or a business development company.

<sup>2</sup> Act § 403.

<sup>3</sup> Act § 408.

<sup>4</sup> A private fund is an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, as amended (the “1940 Act”), but for section 3(c)(1) or 3(c)(7) of the 1940 Act.

<sup>5</sup> Act § 408.

**Venture Capital Funds.** The Act exempts venture capital fund advisers from registration under the Advisers Act. To qualify for the exemption, an adviser must act as an investment adviser solely to one or more venture capital funds. Although the Act exempts such advisers from registration, it permits the SEC to subject venture capital fund advisers to reporting and recordkeeping requirements as the SEC determines necessary or appropriate in the public interest or for the protection of investors.<sup>6</sup>

The SEC is charged with defining “venture capital fund” within one year after the passage of the Act.<sup>7</sup> The different registration and reporting requirements applicable to “venture capital funds,” and otherwise to “private funds,” will make the SEC’s chosen definition of great interest to investment advisers.

**Foreign Private Advisers.** The Act exempts from registration any investment adviser that is a “foreign private adviser,” which is defined in the Act as any investment adviser that:

- has no place of business in the United States;
- has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;
- has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than \$25 million, or such higher amount as the SEC may, by rule, deem appropriate; and
- neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to any registered investment company or any business development company.<sup>8</sup>

Unless the SEC, by rulemaking, significantly increases the \$25 million threshold described above, the Act’s exemption for this purpose is fairly narrow, and will limit the ability of non-U.S. advisers to raise significant funds in the United States without first registering as investment advisers.

**Family Offices, Small Business Investment Companies, Commodity Trading Advisers and the Intra-State Exemption.** The Act exempts family offices from the definition of investment adviser and directs the SEC to promulgate rules pertaining to the exemption.<sup>9</sup> Further, the Act exempts from registration any investment adviser that is registered with the CFTC as a commodity trading adviser (so long as the business of the adviser does not become predominantly the provision of securities-related advice) or solely advises small business investment companies.<sup>10</sup>

The Act also narrows but does not eliminate the “intra-state exemption.” The current intra-state exemption in the Advisers Act exempts from registration any investment adviser all of whose clients are residents of the state within which such investment adviser maintains its principal office. The Act narrows this exemption by excluding investment advisers to any “private fund” (as defined in the Act).<sup>11</sup>

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<sup>6</sup>Act § 407.

<sup>7</sup>*Id.*

<sup>8</sup>Act § 403.

<sup>9</sup>Act § 409.

<sup>10</sup>Act § 403.

<sup>11</sup>Act § 403.

### Increased Recordkeeping and Reporting Requirements for Advisers to Private Funds

The Act empowers the SEC to create broad recordkeeping and reporting requirements for registered investment advisers to “private funds.”<sup>12</sup> The records that must be maintained by such an investment adviser, made available for SEC inspection, and possibly subject to future SEC filing requirements, include:

- the amount of assets under management and use of leverage, including off-balance-sheet leverage;
- counterparty credit risk exposure;
- trading and investment positions;
- valuation policies and practices of the fund;
- types of assets held;
- side arrangements or side letters;
- trading practices; and
- such other information as the SEC, in consultation with the Council, determines is necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.<sup>13</sup>

Under the Act, the recordkeeping requirements listed above are generally applicable to registered investment advisers to private funds. However, the SEC may establish different reporting standards for different classes of fund advisers, based on the size or type of private fund being advised.<sup>14</sup> Additionally, as described above, venture capital fund advisers and mid-size fund advisers may be subject to different recordkeeping and reporting requirements to be determined by the SEC.

**Confidentiality.** The Act requires that the SEC share reports and documents filed with it with the Council. Furthermore, the Act provides that neither the SEC nor the Council may be compelled to disclose information received from private funds, and such information is exempt from disclosure pursuant to the Freedom of Information Act (“FOIA”). However, the confidentiality requirement of the Act does not authorize the SEC to withhold information from Congress, or prevent the SEC from complying with a relevant request from any other federal department, agency, or self-regulatory organization or an order of a U.S. court in an action brought by the federal government or the SEC. Any other such recipient is also bound by similar confidentiality provisions and is granted an exemption from the FOIA.<sup>15</sup> The Act also protects from public disclosure any “proprietary information” of the investment adviser received by the

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<sup>12</sup>Act § 402 defines the term “private fund” as any issuer that would be an investment company under the 1940 Act, but for Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. Section 3(c)(1) of the 1940 Act generally provides an exemption from registration for an issuer (i) whose securities are owned by not more than 100 persons and (ii) who does not engage or propose to engage in a public offering of securities. Section 3(c)(7) of the 1940 Act generally provides an exemption from registration for an issuer (i) all of whose security holders are “qualified purchasers” (as defined in the 1940 Act) and (ii) who does not engage or propose to engage in a public offering of securities.

<sup>13</sup>Act § 404.

<sup>14</sup>*Id.*

<sup>15</sup>*Id.*

SEC to the same extent as facts the SEC ascertains during an examination.<sup>16</sup> Finally, the SEC will provide an annual report to Congress detailing how the SEC has used this information to monitor the market for the protection of investors and the integrity of the markets.<sup>17</sup>

**Advisory Client Disclosures.** Prior to the passage of the Act, Section 210(c) of the Advisers Act prevented the SEC from requiring an investment adviser to disclose the identity, investments or affairs of its clients, except as may be necessary or appropriate in a particular enforcement proceeding or investigation under the Advisers Act. The Act creates a new exception to this provision, allowing such disclosure “for purposes of assessment of potential systemic risk.”<sup>18</sup>

**Possible Effects of the Enhanced Reporting Obligations.** Notwithstanding the confidentiality provisions of the Act, the new recordkeeping and reporting requirements may give the SEC and other government agencies access to highly detailed and confidential information regarding a private fund’s positions, trading strategies, side letters and advisory clients. This heightens the risk of accidental disclosure of confidential information.

### **Asset Threshold for SEC Registration**

An investment adviser may register with the SEC if it has assets under management of at least \$25 million. However, as part of the Act’s increased reliance on state regulators instead of the SEC for the regulation of mid-sized investment advisers, the Act requires that investment advisers register with state regulators (and not the SEC) if the investment adviser would be subject to examination by the state regulators and the investment adviser has between \$25 million and \$100 million in assets under management.<sup>19</sup> An investment adviser that meets these two criteria may still register with the SEC if the investment adviser (a) serves as investment adviser to a registered investment company, (b) serves as investment adviser to a business development company, or (c) would otherwise be required to register in 15 or more separate states.<sup>20</sup>

Coupled with the elimination of the “private adviser exemption” described above, the “higher assets under management” threshold will delegate regulation of many mid-sized investment advisers to the various states. As a result, advisers that are not permitted to register with the SEC may be subject to varied and potentially contradictory state “Blue Sky” laws governing investment adviser registration, while allowing the SEC to focus on the regulation of larger investment advisers.

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<sup>16</sup>*Id.* “Proprietary information” is defined in the Act to include sensitive, non-public information regarding (i) the investment or trading strategies of the investment adviser, (ii) analytical or research methodologies, (iii) trading data, (iv) computer hardware or software containing intellectual property and (v) any additional information that the SEC determines to be proprietary.

<sup>17</sup>Act § 404.

<sup>18</sup>Act § 405.

<sup>19</sup>Act § 410.

<sup>20</sup>*Id.*



## Transition Period

The Act provides for a one-year transition period from the date of enactment before the provisions of the relevant legislation become effective, except as otherwise provided.<sup>21</sup> During that period, the SEC will promulgate rules and regulations regarding the various new standards coming into place. Investment advisers to private funds may, at the adviser's discretion, register with the SEC during the one-year transition period subject to the SEC's rules.<sup>22</sup>

## Enhanced Role of the Federal Reserve

The Federal Reserve's role will be greatly expanded under the Act. The following discussion summarizes certain areas in which the Federal Reserve's new powers and duties may affect investment advisers.

**Systemic Risk Regulation.** Under the Act, the Federal Reserve will have the ability to extend its regulatory powers to cover financial institutions that potentially pose a threat to the financial stability of the United States. This may come to include private funds under the newly defined term "nonbank financial company." The Act defines a "nonbank financial company" generally as a company predominantly engaged in activities that are financial in nature.<sup>23</sup> The Council is granted the authority to determine which nonbank financial companies potentially pose a threat, and has the ability to subject such a company to regulation by the Federal Reserve, including regulation of capital amounts, leverage and liquidity.<sup>24</sup> Non-U.S. financial companies are generally included in the definition of "nonbank financial companies" to the extent of their U.S. activities.

It is possible that the enhanced regulatory powers of the Federal Reserve pursuant to the Act could be used to regulate large private funds, especially highly-leveraged hedge funds. See "Key Measures to Address Systemic Risk."

## Limitation of Bank Ownership or Sponsorship of Private Funds — The "Volcker Rule"

Along with the Federal Reserve's expanded powers summarized above, the Act includes the so-called "Volcker Rule," which limits the activities of banking entities<sup>25</sup> as well as nonbank financial companies supervised by the Board of Governors pursuant to the powers granted under the Act.<sup>26</sup> The following section focuses on the Volcker Rule's applicability to private fund investment advisers. For a general discussion of the Volcker Rule, see "The Volcker Rule."

Under the Volcker Rule, banking entities and nonbank financial companies supervised by the Board of Governors are limited in their ability to sponsor or invest in a hedge fund or a private equity fund. The terms "hedge fund" and "private equity fund" are defined for purposes of this section in the same manner as the term "private fund" is defined in the Act (*i.e.*, any fund that would be an investment company

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<sup>21</sup>Act § 419.

<sup>22</sup>*Id.*

<sup>23</sup>Act § 102(a)(4).

<sup>24</sup>Act § 113(a).

<sup>25</sup>Act § 619 (to be codified at 12 U.S.C. § 1851(h)(1)) defines "banking entity" to include insured depository institutions, any company that controls an insured depository institution or is treated as a bank holding company, and affiliates and subsidiaries of any such entities (including private fund managers and broker-dealer subsidiaries).

<sup>26</sup>Act § 619 (to be codified at 12 U.S.C. § 1851).

but for Sections 3(c)(1) or 3(c)(7) of the 1940 Act); however, the appropriate federal agencies, including the SEC, may expand this definition by rule.<sup>27</sup> In contrast to the term “private fund” for purposes of Title IV, the definition under the Volcker Rule does not include any carve-outs for venture capital funds.

The Volcker Rule generally bans banking entities from sponsorship of or investment in a private fund unless an exception is available.<sup>28</sup> “Sponsoring” is defined for these purposes as: serving as a managing member, general partner or trustee of a fund; in any manner selecting or controlling a majority of the directors, trustees or management of a fund; or sharing with the fund the same name or a variation of the same name for corporate, marketing, promotional or other purposes.<sup>29</sup> While nonbank financial companies supervised by the Board of Governors are not subject to an outright ban like banking entities, they will be subject to additional capital requirements and quantitative limits if they do not comply with the same exceptions as banking entities regarding the sponsorship of or investment in a private fund as described below.

**Sponsorship of Private Funds.** A banking entity is permitted to sponsor a private fund if it complies with each of the following criteria:

- (i) the banking entity provides bona fide trust, fiduciary or investment advisory services;
- (ii) the fund is organized and offered only in connection with the services described in the foregoing paragraph (i) and only to persons that are customers of such services of the banking entity;
- (iii) the banking entity does not acquire or retain an equity interest in the private fund except for a de minimis interest (as described below);
- (iv) the banking entity does not enter into “covered transactions” as defined in Section 23A of the Federal Reserve Act with the private fund, and the banking entity acts in accordance with Section 23B of the Federal Reserve Act as if such entity was a member bank and such private fund was an affiliate;
- (v) the banking entity does not, directly or indirectly, guarantee the obligations or performance of the private fund;
- (vi) the banking entity does not share the same name (or a variation thereof) with the private fund;
- (vii) no director or employee of the banking entity takes or retains an equity interest in the private fund, except for any such person engaged in providing investment advisory or other services to the private fund; and
- (viii) the banking entity discloses to prospective and actual investors in the private fund, in writing, that any losses in the private fund will be borne solely by investors in the fund and not by the banking entity.<sup>30</sup>

Meeting the criteria listed above will add certain compliance costs to the operations of a typical private fund. In particular, the limitation on bank ownership except for a de minimis interest will reduce, but not

<sup>27</sup>Act § 619 (to be codified at 12 U.S.C. § 1851(h)(2)).

<sup>28</sup>Act § 619 (to be codified at 12 U.S.C. § 1851(a)(1)).

<sup>29</sup>Act § 619 (to be codified at 12 U.S.C. § 1851(h)(5)).

<sup>30</sup>Act § 619 (to be codified at 12 U.S.C. § 1851(d)(1)(G)).

remove, the ability of banks to invest their own capital side-by-side with third-party investors. Additionally, the de minimis investment limitation may require some private funds to alter their carried interest payment provisions, as carried interest left invested in a fund may, over time, exceed the de minimis investment limit. The de minimis investment limitations are discussed in more detail below.

Similarly, the name restriction described in paragraph (vi) above, the equity interest restriction described in paragraph (vii) above, and the written disclosure requirement described in paragraph (viii) above may require certain changes to existing or contemplated private funds, while the Section 23A and 23B restrictions described in paragraph (iv) above may limit a private fund's ability to enter into certain transactions. See "The Volcker Rule."

Finally, banking entities will need answers, through SEC guidance or rulemaking, to significant questions regarding the requirement for bona fide investment advisory services described in paragraphs (i) and (ii) above. Banking entities must be sure to meet those requirements, as well as the requirements described in paragraph (v) above regarding the absence of guarantees of private fund obligations or performance, once the appropriate standards are determined by final regulations.

**De Minimis Investments in Private Funds.** A banking entity may make investments in a private fund it organizes or offers if the investment does not exceed 3% of the total ownership interests of such private fund and the aggregate of all of the investments made by the banking entity in such private funds does not exceed 3% of the banking entity's Tier 1 capital.<sup>31</sup> Additionally, banking entities are allowed to exceed the 3% fund ownership limit when providing seed capital to a private fund, provided that the banking entity seek unaffiliated investors and reduce its holdings to meet the 3% total ownership test within one year after the date of the establishment of the fund, whether by redemption, sale, or dilution (with up to a two-year extension at the discretion of the Board of Governors).<sup>32</sup> The "3% of Tier 1 capital" test also may be reduced by a forthcoming rule to ensure that the total investment is "immaterial" to the banking entity.<sup>33</sup>

This "3 and 3" rule is a more favorable standard than the early proposals of the Volcker Rule, which called for significantly more stringent prohibitions on the ability of banking entities to invest in private funds. While the Volcker Rule will limit the ability of banking entities to invest side-by-side with third-party investors, it will not prohibit banking entities from sponsoring and managing hedge funds and private equity funds going forward.

**Timing.** It may take as long as seven years before the provisions of the Volcker Rule come into effect. This time estimate is reached as follows: The effective date of the Volcker Rule is the earlier of 12 months from the date of the issuance of final rules or two years after the enactment of the Act. Given the complexity of the legislation and the number of different regulatory agencies involved in the process, we expect it will take at least one year for final rules to be issued, so we estimate this effective date to be two years after the enactment of the Act. Following effectiveness, banking entities have two years to come into compliance with the provisions of the Volcker Rule. The Board of Governors may extend this period further by up to three one-year extensions, leading to a total of up to seven years from the enactment of the Act. For illiquid funds, extensions of the effective date of up to five years are available from the Board of Governors on a case-by-case basis.<sup>34</sup>

<sup>31</sup>Act § 619 (to be codified at 12 U.S.C. § 1851(d)(4)(B)(ii)).

<sup>32</sup>Act § 619 (to be codified at 12 U.S.C. §§ 1851(d)(4)(B)(i), 1851(d)(4)(B)(ii)(I) & 1851(d)(4)(C)).

<sup>33</sup>Act § 619 (to be codified at 12 U.S.C. § 1851(d)(4)(B)(ii)(II)).

<sup>34</sup>Act § 619 (to be codified at 12 U.S.C. §§ 1851(c)(1) – (3)). For additional detail regarding timing, see "The Volcker Rule."

### Adjustment of Accredited Investor Standard

Immediately upon passage of the Act, the accredited investor standard for natural persons will be revised such that the net worth threshold of \$1 million will exclude the value of the investor's primary residence.<sup>35</sup> The exclusion of the primary residence marks a change from the current net worth threshold. The SEC may review the other provisions of the natural person accredited investor definition (such as the net income test) immediately upon passage of the Act, and may adjust or modify such provisions immediately for the protection of investors, in the public interest and in light of the economy. After the four-year period from the enactment of the Act, and every four years thereafter, the SEC is tasked with reviewing the accredited investor standard and, if appropriate, adjusting such standard for the protection of investors, in the public interest and in light of the economy.<sup>36</sup>

The changes to the accredited investor definition contained in the Act are expected to have a limited impact on Section 3(c)(7) funds, since investors in such funds also must meet the generally higher qualified purchaser standard under the 1940 Act. Furthermore, the changes to the accredited investor standard apply to *all* private placements under Regulation D, not just offerings made by private funds. As such, the impact of the new rules will be felt well beyond the private fund sphere.

### Custody of Client Assets and Accounts

The Act adds to the Advisers Act a specific requirement that registered investment advisers who have custody of client assets must take such steps to safeguard client assets as the SEC may prescribe, including, without limitation, having such assets verified by an independent public accountant.<sup>37</sup> Further, the Act directs the Comptroller General of the United States to conduct a study of the compliance costs associated with the custody rules and submit a report on the results of the study to Congress within three years of the enactment of the Act.<sup>38</sup>

### Adjustment of the Qualified Client Standard for Inflation

Generally, investment advisers required to be registered may only charge a carried interest or performance fee or allocation to investors who meet the qualified client standard. The Act requires the SEC to adjust for inflation any dollar-amount tests used to determine the qualified client standard. The first such adjustment must occur within one year of the enactment of the Act, and subsequent adjustments will occur every five years thereafter. Any such adjustment will be rounded to the nearest multiple of \$100,000.<sup>39</sup> Like the change to the accredited investor standard, this increase is expected to have a limited impact on Section 3(c)(7) funds since investors in such funds must meet the generally higher qualified purchaser standard.

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<sup>35</sup>Act § 413(a).

<sup>36</sup>Act § 413(b).

<sup>37</sup>Act § 411.

<sup>38</sup>Act § 412.

<sup>39</sup>Act § 418 (to be codified at 15 U.S.C. § 80b-5(e)).

# Insurance

The Dodd-Frank Act provides for the creation of the Financial Stability and Oversight Council, the stated purposes of which are to identify risks to the financial stability of the U.S., promote market discipline and respond to emerging risks in the U.S. financial system. The Council, with at least a two-thirds vote (including the Council's Chairperson), can require a U.S. or foreign nonbank financial company to be regulated by the Federal Reserve if its financial distress or its nature, size, scale, concentration, interconnectedness or mix of activities would pose a threat to the country's financial stability.<sup>1</sup>

The Act provides that a "nonbank financial company" is a company that predominantly engages in financial activities.<sup>2</sup> As a result, an insurance company, as well as any other company engaged in financial services, could become subject to prudential regulation (including capital requirements, leverage limits, liquidity requirements and examinations) by the Federal Reserve. The Act does not limit such Federal Reserve oversight to companies of any minimum size or type of business, but instead permits the Council to take into consideration a variety of factors in determining whether to subject a nonbank financial company to regulation, including:

- the degree of its leverage;
- the extent and types of its off-balance sheet exposures and transactions with other significant nonbank financial companies;
- the degree to which it already is regulated by a primary financial regulatory agency;
- the amount and nature of its assets and liabilities, including its reliance on short-term funding; and
- other risk-related factors that the Council deems appropriate.<sup>3</sup> See "Key Measures to Address Systemic Risk."

Unlike the current state-based insurance regulatory framework, which focuses on licensed insurance companies and their transactions with other members of their holding company system, upon designation by the Council as a "nonbank financial company," the Act provides for substantive federal regulation of the entire insurance holding company system, subject to certain limited exceptions.

The insurance legislation portion of the Act, Title V, forms within Treasury a Federal Insurance Office ("Office"), with limited powers, headed by a career position Director appointed by the Treasury Secretary. In order to assist in the coordination of insurance aspects of financial market reform and oversight, the Director will serve on the Council in an advisory capacity. Title V also includes provisions to streamline state-based regulation of nonadmitted insurers, most surplus lines insurance and reinsurance.

In our view, Title V should not have a meaningful impact on insurance M&A or capital markets transactions, or fundamentally alter the practicalities (and in some cases, difficulties) inherent in the current state-based insurance regulatory framework, except possibly with respect to the limited number of insurance holding company systems that may become subject to Federal Reserve oversight as non-

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<sup>1</sup> Act §§ 113(a) & (b).

<sup>2</sup> Act § 102(a)(4)(C).

<sup>3</sup> Act §§ 113(a)(2) & (b)(2).

bank financial companies. See “[Regulation of Banking Organizations](#).” Although Title V does not provide for an optional federal charter, there is likely to be considerable concern on the part of state insurance regulators and the National Association of Insurance Commissioners (“NAIC”) over the potential in the near term for the Office’s substantive powers and resources to be broadened, which could follow from the findings and recommendations of the numerous studies and reports to be undertaken pursuant to Title V, as discussed below.

### Office of Federal Insurance

**Authority.** The authority of the Office will extend broadly to all lines of insurance except health insurance, long-term care insurance that is not included with life or annuity insurance components and crop insurance.<sup>4</sup>

**Powers.** The Office will be charged with monitoring all aspects of the insurance industry. Its mandate requires it to:

- identify issues in the regulation of insurers that could precipitate a systemic crisis in the insurance industry or the broader U.S. financial system;
- monitor the extent to which traditionally underserved communities and constituencies have access to affordable insurance products;
- recommend to the Council that it designate an insurer, including its affiliates, as being subject to regulation as a nonbank financial company;
- assist in administering the Terrorism Insurance Program;
- coordinate and develop federal policy on international insurance matters, including assisting the Treasury Secretary in negotiating international insurance agreements;
- determine whether state insurance regulations are preempted by international agreements;
- consult with state insurance regulators regarding insurance matters of national and international importance; and
- advise the Treasury Secretary on major domestic and international insurance policy issues.<sup>5</sup>

The Office will be empowered to gather data and information regarding the insurance industry and insurers, enter into information-sharing agreements, analyze and disseminate data and information, and issue reports.<sup>6</sup> Prior to collecting any data or information from an insurer or any of its affiliates, the Office will be required to coordinate with other regulators and any publicly available sources to determine if the information to be collected is otherwise available from another regulator or publicly available source.<sup>7</sup> Title V provides that the submission of any non-publicly available information to the Office under its information-gathering powers will not constitute a waiver of any privilege arising under federal or state law to which the information is otherwise subject.<sup>8</sup>

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<sup>4</sup> Act § 502 (to be codified at 31 U.S.C. § 313(d)).

<sup>5</sup> Act § 502 (to be codified at 31 U.S.C. § 313(c)).

<sup>6</sup> Act § 502 (to be codified at 31 U.S.C. § 313(e)(1)).

<sup>7</sup> Act § 502 (to be codified at 31 U.S.C. § 313(e)(4)).

<sup>8</sup> Act § 502 (to be codified at 31 U.S.C. § 313(e)(5)).

The Office's information-gathering powers are subject to a minimum-size threshold to be established; and include the authority to issue subpoenas to collect data and information from an insurer and its affiliates upon a written finding by the Director that such data or information is required and after prior coordination with other regulators.<sup>9</sup> Title V contains a savings provision specifying that it will not be construed to affect development and coordination of U.S. trade policy.<sup>10</sup>

**Primacy of State-Based Regulation.** The Act provides that state insurance regulators will remain the primary regulatory authority over insurance, and expressly withholds from the Office and Treasury general supervisory or regulatory authority over the business of insurance.<sup>11</sup>

**Limited Federal Preemption.** The Office will have the power to preempt a state insurance measure to the extent that the Director determines that such measure results in less favorable treatment of a non-U.S. insurer, domiciled in a foreign jurisdiction that is subjected to an international insurance agreement, than a U.S. insurer domiciled, licensed or otherwise admitted in the relevant state and is inconsistent with an international insurance agreement on prudential measures.<sup>12</sup> Prior to making a preemption determination, the Office must notify and consult with the relevant state regulator and the U.S. Trade Representative regarding any potential inconsistency or preemption, publish in the Federal Register notice of the issue regarding the potential inconsistency or preemption, provide interested parties a reasonable opportunity to submit written comments to the Office and consider any comments received.<sup>13</sup>

Any state insurance measure preemption determination by the Director will be limited to the subject matter contained within the applicable international insurance agreement and must achieve a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under state insurance or reinsurance regulation.<sup>14</sup>

Notwithstanding its preemptive authority, the Office will not be permitted to preempt any state insurance measure that governs an insurer's rates, premiums, underwriting, or sales practices; any state coverage requirements for insurance; the application of state antitrust laws to the business of insurance; or any state insurance measure governing the capital or solvency of an insurer, except to the extent that such state insurance measure results in less favorable treatment of a non-U.S. insurer than a U.S. insurer.<sup>15</sup>

**Annual Reports.** Title V requires the Director, beginning September 30, 2011, and on or before September 30th of each calendar year thereafter, to submit to the President and certain Congressional committees a report on any actions taken by the Office regarding preemption of inconsistent state insurance measures and a report on the insurance industry and other information as determined by the Director or as requested by the Congressional committees.<sup>16</sup>

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<sup>9</sup>Act § 502 (to be codified at 31 U.S.C. §§ 313(e)(2) & (6)).

<sup>10</sup>Act § 502 (to be codified at 31 U.S.C. § 313(m)).

<sup>11</sup>Act § 502 (to be codified at 31 U.S.C. § 313(k)).

<sup>12</sup>Act § 502 (to be codified at 31 U.S.C. § 313(f)(1)).

<sup>13</sup>Act § 502 (to be codified at 31 U.S.C. § 313(f)(2)).

<sup>14</sup>*Id.*

<sup>15</sup>Act § 502 (to be codified at 31 U.S.C. § 313(j)).

<sup>16</sup>Act § 502 (to be codified at 31 U.S.C. § 313(n)).

**Other Reports.** Not later than September 30, 2012, Title V requires the Director to prepare a report describing the breadth and scope of the global reinsurance market and the important role such market plays in supporting the U.S. insurance market.<sup>17</sup> Not later than January 1, 2013, Title V requires the Director to prepare a report, to be updated not later than January 1, 2015, describing the impact of federal preemption of regulation of credit for reinsurance and reinsurance agreements on the ability of state regulators to access reinsurance information for regulated companies in their jurisdictions.<sup>18</sup>

Not later than 18 months after enactment of the Act, Title V requires the Director to prepare a study, together with a related report submitted to Congress, on methods to modernize and improve the U.S. insurance regulatory system.<sup>19</sup> This study and report are to consider:

- systemic risk regulation with respect to insurance;
- capital standards and the relationship between capital allocation and liabilities;
- consumer protection for insurance products and practices, including gaps in state-based regulation;
- the extent of national uniformity of state insurance regulation;
- regulation of insurance holding company systems on a consolidated basis;
- international coordination of insurance regulation;
- the costs and benefits of potential federal regulation of insurance;
- the feasibility of regulating specified lines of insurance solely at the federal level;
- the ability of federal regulation to minimize regulatory arbitrage;
- the impact that developments in the international regulation of insurance might have on potential federal regulation of insurance;
- the ability of federal regulation to provide robust consumer protection; and
- the potential consequences of subjecting insurance companies to a federal resolution authority.

In addition, this study and report are to include recommendations to carry out or effectuate the report's findings.<sup>20</sup>

### **State-Based Insurance Reform**

**Background.** The Nonadmitted and Reinsurance Reform Act of 2010, included as part of Title V, will generally take effect on the one-year anniversary of the Act. Its provisions are designed to promote uniformity of regulation in the market for nonadmitted insurance and reinsurance among the states.

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<sup>17</sup>Act § 502 (to be codified at 31 U.S.C. § 313(o)(1)).

<sup>18</sup>Act § 502 (to be codified at 31 U.S.C. § 313(o)(2)).

<sup>19</sup>Act § 502 (to be codified at 31 U.S.C. § 313(p)(1)).

<sup>20</sup>Act § 502 (to be codified at 31 U.S.C. § 313(p)(4)).



**Nonadmitted Insurance.** The nonadmitted insurance legislation limits state regulatory authority with respect to nonadmitted insurance exclusively to the home state of the insured, other than with respect to certain workers' compensation insurance lines. In addition, it includes the following provisions:

- Only the home state of an insured may require any premium tax payment for nonadmitted insurance where risks are located in more than one state. The Act states the intent of Congress that each state enter into nationwide uniform arrangements for the reporting, payment, collection and allocation of such premium tax payments.<sup>21</sup>
- To facilitate the payment of premium taxes among the states, an insured's home state may require surplus lines brokers and insureds who have independently procured insurance, or an authorized agent, to file annual tax allocation reports with the insured's home state, detailing the portion of the nonadmitted insurance policy premium attributable to risks located in each state.<sup>22</sup>
- No state other than an insured's home state may require a surplus lines broker to be licensed in order to sell nonadmitted insurance to such insured.<sup>23</sup>
- Following the second-year anniversary of the Act, a state may not collect any fees relating to licensing of a surplus lines broker in such state unless such state then has in effect regulations that provide for participation by such state in the NAIC insurance producer database or equivalent uniform national database, for the licensing and renewal of surplus lines brokers.<sup>24</sup>
- No state may impose eligibility requirements on nonadmitted insurers domiciled in a U.S. jurisdiction except in conformity with the criteria set forth in the NAIC Non-admitted Insurance Model Act or unless the state has adopted nationwide uniform eligibility standards.<sup>25</sup>
- No state may prohibit a surplus lines broker from doing nonadmitted insurance business with a nonadmitted insurer domiciled outside the U.S. that is included on the Quarterly Listing of Alien Insurers published by the NAIC.<sup>26</sup>
- Subject to certain disclosure and written request requirements being met, a surplus lines broker seeking to procure or place nonadmitted insurance in a state for certain sophisticated, commercial purchasers would not be required to satisfy any state requirement to complete a due diligence search to determine whether coverage can be obtained from an admitted insurer. An "exempt commercial purchaser" is any entity that employs a qualified risk manager to negotiate insurance coverage, has paid aggregate commercial property and casualty insurance premiums in excess of \$100,000 in the immediately preceding 12-month period, and meets one of the following criteria for commercial businesses: net worth; annual revenues; or number of employees.<sup>27</sup>
- The Comptroller General is required to conduct a study in consultation with the NAIC and submit a report on the effect of this legislation on the nonadmitted insurance market.<sup>28</sup>

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<sup>21</sup>Act §§ 521(a) & (b).

<sup>22</sup>Act § 521(c).

<sup>23</sup>Act § 522(b).

<sup>24</sup>Act § 523.

<sup>25</sup>Act § 524(1).

<sup>26</sup>Act § 524(2).

<sup>27</sup>Act § 527(5).

<sup>28</sup>Act § 526.

**Reinsurance.** The reinsurance legislation provides that no other state may deny credit for reinsurance if the ceding insurer's state of domicile recognizes such credit.<sup>29</sup> This legislation also reserves the sole responsibility for regulating the financial solvency of a reinsurer to its state of domicile and prohibits a state from requiring a reinsurer to provide any additional financial information other than that which it is required to file with its domiciliary state. In regard to the above, the domiciliary state of the reinsurer must be NAIC-accredited or have financial solvency requirements substantially similar to those necessary for NAIC accreditation.<sup>30</sup>

In addition, this legislation provides that laws and other actions of a state other than the domiciliary state of a ceding insurer (except with respect to taxes and assessments on insurance companies or income) are preempted to the extent that they: restrict a ceding or assuming insurer from resolving disputes pursuant to contractual arbitration provisions that are not in conflict with federal arbitration regulations; mandate that the laws of a certain state govern the reinsurance agreement or disputes thereunder; enforce a reinsurance agreement on terms that differ from those in the reinsurance agreement; or apply the laws of such state to reinsurance agreements of ceding insurers not domiciled in such state.<sup>31</sup>

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<sup>29</sup>Act § 531(a).

<sup>30</sup>Act § 532(a).

<sup>31</sup>Act § 531(b).

# Supervision of Payment, Clearing and Settlement

The Dodd-Frank Act provides for the supervision of systemically important financial market utilities and payment, clearing and settlement activities conducted by financial institutions. The Board of Governors is given a greater role in supervision of risk management standards for these financial market utilities and has been authorized to promote uniform standards to effect this supervision.

The Act defines a “financial market utility” as “a person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person.”<sup>1</sup> This definition excludes several types of entities. A “payment, clearing or settlement activity” is defined as “any activity carried out by one or more financial institutions to facilitate completion of financial transactions.”<sup>2</sup>

## Designation of Systemic Importance

By vote of no fewer than two-thirds of its members (including an affirmative vote by the Chairperson), the Financial Stability Oversight Council (“Council”) must determine that a financial market utility or payment, clearing or settlement activity is, or is likely to become, systemically important. This determination will take into consideration a number of guidelines provided in the Act, such as:

- aggregate monetary value of transactions processed or carried out;
- aggregate exposure to counterparties;
- relationships, interdependencies or other interactions with other financial market utilities or payment, clearing or settlement activities; and
- effect failure or disruption of the utility or activity would have on critical markets, financial institutions, or the broader financial system.<sup>3</sup>

In addition to the authority to designate a financial market utility or payment, clearing or settlement activity as systemically important, the Council may also rescind such a designation by a vote of no fewer than two-thirds of its members (including an affirmative vote by the Chairperson). Once the designation of systemic importance is rescinded, the utility or institution conducting the activity is no longer subject to Title VIII of the Act.<sup>4</sup> A financial market utility that has been determined to be systemically important has been defined in the Act as a “designated financial market utility.”<sup>5</sup> See “Key Measures to Address Systemic Risk.”

The Council is required to consult with the relevant federal agency with primary jurisdiction over the designated financial market utility (the “Supervisory Agency”) and with the Board of Governors prior to either making a determination of systemic importance or rescinding such determination.<sup>6,7</sup> The financial market utility or financial institution conducting the activity shall be provided with advance notice by the

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<sup>1</sup> Act § 803(6).

<sup>2</sup> Act § 803(7).

<sup>3</sup> Act § 804(a)(2).

<sup>4</sup> Act § 804(b).

<sup>5</sup> Act § 803(4).

<sup>6</sup> Act § 803(a)(8).

<sup>7</sup> Act § 804(c).

Council, published in the Federal Register, and shall be given the opportunity to refute the designation of systemic importance or the rescission of that designation.<sup>8</sup> These requirements may be waived or modified by the Council if it determines that the waiver or modification is necessary to either prevent or mitigate an immediate threat to the financial system. Notice of the waiver or modification, if effected, and of final determination on designation must be provided by the Council. This notice or final determination will be published in the Federal Register.<sup>9</sup>

### **Board of Governors Prescription of Risk Management Standards**

The Act provides that the Federal Reserve shall prescribe risk management standards in consultation with the Council and the Supervisory Agencies. In prescribing these standards, the Federal Reserve will take into consideration international standards and existing prudential requirements.<sup>10</sup> These risk management standards are to:

- promote robust risk management;
- promote safety and soundness;
- reduce systemic risks; and
- support stability of the broader financial system.<sup>11</sup>

The standards may address a variety of areas, including:

- risk management policies and procedures;
- margin and collateral requirements;
- participant or counterparty default policies and procedures;
- ability to complete timely clearing and settlement of financial transactions;
- capital and financial resource requirements for designated financial market utilities; and
- other areas that are necessary to achieve the objectives listed above.<sup>12</sup>

The Act provides for the CFTC and the SEC to prescribe regulations, in consultation with the Council and the Board of Governors, that contain risk management standards for those designated clearing entities and financial institutions engaged in designated activities for which each of the CFTC and the SEC is the Supervisory Agency or appropriate financial regulator. These standards may govern the operations related to payment, clearing, and settlement activities of designated clearing entities and conduct of designated activities by such financial institutions.<sup>13</sup> The Board of Governors is given the authority to determine that the existing prudential requirements of the CFTC and the SEC are insuffi-

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<sup>8</sup> *Id.*

<sup>9</sup> Act § 804(d).

<sup>10</sup> Act § 805(a).

<sup>11</sup> Act § 805(b).

<sup>12</sup> Act § 805(c).

<sup>13</sup> Act § 805(a)(2)(A).

cient to prevent or mitigate risks to the financial stability of the United States.<sup>14</sup> The CFTC and the SEC are provided the opportunity to object to the Board of Governor’s determination or to submit an explanation to the Board of Governors and the Council describing remediating actions.<sup>15</sup> The Council shall require the CFTC or the SEC to prescribe risk management standards as the Council may determine are necessary in order to address requirements that are determined to be insufficient. The Act does not permit the Council or the Board to take any action or exercise any authority granted to the CFTC or the SEC under section 3C(a) of the Securities Exchange Act of 1934.

### **Designated Financial Market Utilities — Payment System Access and Examination**

The Act provides authority for the Board of Governors to establish and maintain an account for a designated financial market utility and also to provide the services listed in section 11A(b) of the Federal Reserve Act and to provide deposit accounts in “unusual or exigent circumstances.” The Board also may authorize a Federal Reserve bank to provide discount and borrowing privileges to designated financial market utilities in unusual or exigent circumstances. Extension of these privileges requires the affirmative vote of a majority of the Board of Governors.<sup>16</sup> These privileges are available to all designated financial market utilities, not just those that are banks or bank holding companies.<sup>17</sup>

Designated financial market utilities are subject to annual examination by the Supervisory Agency. The Supervisory Agency shall consult with the Board of Governors.

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<sup>14</sup>Act § 805(a)(2)(B).

<sup>15</sup>Act § 805(a)(2)(D).

<sup>16</sup>Act § 806(a).

<sup>17</sup>Act § 806(b).



# Derivatives

(This is a summary of this topic. For more in-depth information, see [“Regulation of Over-the-Counter Derivatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”](#))

Title VII of the Dodd-Frank Act, referred to herein as the “Derivatives Title,” imposes a regulatory regime on over-the-counter (“OTC”) derivatives and the market for such derivatives. The primary goals of the legislation and related rulemaking are to increase the transparency and efficiency of the OTC derivatives market and reduce the potential for counterparty and systemic risk. The main mechanisms for achieving this are:

- to require that as many product types as possible be centrally cleared and traded on exchanges or comparable trading facilities;
- to subject swap dealers and major market participants to capital and margin requirements; and
- to require the public reporting of transaction and pricing data on both cleared and uncleared swaps.

Many market participants could be affected by increased costs and increased regulatory oversight and reporting. The impact on some thinly capitalized, leveraged investment funds and structured finance vehicles could be significant and may make certain structures unfeasible. In addition, the language of the Act is ambiguous as to whether new margin requirements may apply retroactively to existing swap transactions.

With limited exceptions, the provisions of the Derivatives Title become effective on the later of 360 days following enactment and, to the extent a provision requires rulemaking, not less than 60 days after publication of the final rule. Many key concepts, processes and issues under the Derivatives Title have been left to the relevant regulators, primarily the CFTC and the SEC, to define and address. The rulemaking generally is required to be completed within 360 days following enactment.

## Division of Regulatory Authority<sup>1</sup>

The Act divides the regulation of the OTC derivatives market between “swaps” regulated by the CFTC and “security-based swaps” regulated by the SEC.<sup>2</sup> “Swap” is broadly defined to include most types of OTC derivatives, subject to a carve-out for “security-based swaps” and certain other specified exceptions. “Security-based swap” is defined as a swap that is based on, among other things, a narrow-based security index or a single security or loan, including in each case any interest therein or the value thereof. The definition of “swap” excludes (and consequently “security-based swap” excludes), among other categories, options on securities, or groups or indices of securities, that are subject to the Securities Act and the Exchange Act.

## Expanded Application of Securities Laws<sup>3</sup>

The Act repeals the provisions enacted under the Gramm-Leach-Bliley Act and the Commodity Futures Modernization Act of 2000 that prohibited the SEC from regulating security-based swaps beyond the

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<sup>1</sup> Act § 712.

<sup>2</sup> Except where otherwise indicated, the term “swap” refers to both swaps and security-based swaps, and “swap dealer” refers to both swap dealers and security-based swap dealers.

<sup>3</sup> Act §§ 761 (to be codified at 15 U.S.C. 78c(a)), 762 , 763 (to be codified at 15 U.S.C. 78a *et seq.*), 766 (to be codified at 15 U.S.C. 78a *et seq.*) & 768 (to be codified at 15 U.S.C. 77b(a)).

anti-fraud and anti-manipulation provisions of the Securities Act and the Exchange Act, and the insider trading provisions of the Exchange Act, and adds regulation of security-based swaps under the Securities Act and the Exchange Act.

### **Mandatory Clearing and Exchange Trading Requirements<sup>4</sup>**

Subject to limited exemptions, the Act requires swaps to be cleared if they are of a type that the CFTC or SEC, as applicable, determines must be cleared and are accepted for clearing by a “derivatives clearing organization” (a “DCO”) (in the case of a swap) or a clearing agency (in the case of a security-based swap). Swaps subject to the clearing requirement also must be traded on a board of trade designated as a contract market or a swap execution facility (in the case of a swap) or on a security-based swap execution facility or a national securities exchange (in the case of a security-based swap), unless no relevant facility will make the particular swap available to trade.

A swap will be exempt from the clearing and exchange trading requirements if one of the counterparties to the swap is an end user that is hedging its own commercial risk. The end user can elect to require the swap to be cleared and traded on an exchange or execution facility even if the exemption is available.

The end user exemption applies only to a swap counterparty that “(i) is not a financial entity; (ii) is using swaps to hedge or mitigate financial risk; and (iii) notifies the CFTC or SEC, in a manner set forth by the CFTC or SEC, how it generally meets its financial obligations associated with entering into non-cleared swap.”<sup>5</sup>

“Financial entity” means any of the following:

- a swap dealer or a Major Participant (as defined below);
- a commodity pool as defined in the CEA;
- a “private fund,” defined to mean a fund that would be required to register as an investment company but for the exemption provided by Sections 3(c)(1) or 3(c)(7) of the 1940 Act;<sup>6</sup>
- an ERISA plan; or
- a person predominantly engaged in activities that are in the business of banking or financial in nature.<sup>7</sup>

For purposes of the clearing exemption for end users of swaps, the term “financial entity” expressly excludes captive finance companies that meet specified criteria.<sup>8</sup>

Swaps entered into prior to enactment (or post-enactment but prior to the effective date of the clearing requirement) will not be subject to the clearing or exchange trading requirements but will be subject to reporting and recordkeeping requirements.

<sup>4</sup> Sections 723 (to be codified at 7 U.S.C. 2) & 763 (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>5</sup> Act §§ 723(a)(3) (to be codified at 7 U.S.C. 2) & 763(a) (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>6</sup> Given this definition, most CDOs and many other types of SPEs and investment funds will be financial entities for purposes of the Derivatives Title.

<sup>7</sup> “Financial in nature” is as defined in Section 4(k) of the BHCA.

<sup>8</sup> No parallel exclusion is made for purposes of the clearing exemption in respect of security-based swaps, presumably reflecting an assumption that the hedging instruments typical of the activities of a captive finance company would include interest rate and currency hedges.



### Definitions for Major Swap Participant/Major Security-Based Swap Participant<sup>9</sup>

The Act uses the term “Major Swap Participant” to refer to a participant in swaps regulated by the CFTC and “Major Security-Based Swap Participant” to refer to a participant in security-based swaps regulated by the SEC. The term “Major Participant” is used herein to refer to both (and a particular entity may fall within both categories for purposes of the Derivatives Title). Major Participants are subject to registration, capital, margin and other compliance requirements under the Act.

A Major Participant is any entity that is not a swap dealer that satisfies any one of the following alternative conditions:

- It maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC or SEC, excluding positions held for hedging or mitigating commercial risk (or hedging or mitigating any risk directly associated with the operation of an ERISA plan);
- Its outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- It is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency, and it maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC or SEC.

The definitions of Major Swap Participant and Major Security-Based Swap Participant are identical in substance, except that only the definition of Major Swap Participant expressly excludes captive finance companies that meet the captive finance company standard described above in connection with the end user exemption.

The key term, “substantial position,” as well as “highly leveraged” and other threshold requirements used for purposes of determining if an entity is a Major Participant, are not defined and are to be addressed in the rulemaking process.

### Mandatory Registration, Capital and Margin Requirements<sup>10</sup>

The Act requires swap dealers and Major Participants to register with the CFTC or SEC not later than one year after enactment, and to satisfy capital and margin requirements to be established by the applicable regulatory authority. The CFTC or SEC, as applicable, will set capital and margin requirements for nonbank swap dealers and Major Participants. The appropriate federal banking regulator will set the capital and margin requirements for banks that are required to register as swap dealers or Major Participants. The margin requirements to be set by the applicable regulatory authority for swap dealers and Major Participants apply only to uncleared swaps; the DCO or clearing agency (as applicable) will set the margin requirements applicable to cleared swaps.

<sup>9</sup>Act §§ 721 (to be codified at 7 U.S.C. 1a) & 761 (to be codified at 15 U.S.C. 78c(a)).

<sup>10</sup>Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

### Public Reporting of Swap Data<sup>11</sup>

Among other swap data to be reported pursuant to the Act, the CFTC or SEC, as applicable, is to promulgate rules and regulations for “real-time public reporting” of swap transaction and pricing data in such form and such times as the applicable regulator determines appropriate. “Real-time public reporting” means the reporting of data relating to a swap transaction as soon as is technologically practicable after execution.

### Segregation of Swap Collateral<sup>12</sup>

Any person that holds margin for DCO-cleared swaps for customers is required to register with the CFTC as a futures commission merchant (“FCM”). Any person that holds margin for clearing agency-cleared swaps for customers is required to be registered with the SEC as a broker-dealer or security-based swap dealer. The FCM, the broker-dealer or the security-based swap dealer, as applicable, is required to segregate such funds or other property held. The use and investment of segregated funds will be subject to such rules as the CFTC or SEC may promulgate.

Uncleared swaps are not subject to the above statutory requirements. However, with respect to uncleared swaps entered into with a swap dealer or a Major Participant, the counterparty is entitled to require the swap dealer or Major Participant to maintain property posted as initial margin in a segregated account. This option of the counterparty does not apply to variation margin.

### The Volcker Rule<sup>13</sup>

The Volcker Rule’s prohibition against “proprietary trading” by insured depository institutions and their affiliates could have far-reaching consequences for the conduct of derivatives activities by banking organizations. [See “The Volcker Rule.”](#)

### The Lincoln Provision (Swaps “Push-Out” by Banks)<sup>14</sup>

The Act also includes a controversial provision that prohibits “federal assistance” to any “swaps entity.” Federal assistance is defined for this purpose as including advances from any Federal Reserve credit facility or discount window (subject to an exception for a program with broad-based eligibility under the emergency lending powers), or FDIC insurance or guarantees. “Swaps entity” is defined as any swap dealer or Major Participant that is registered under the CEA or the Exchange Act, other than a Major Participant that is an insured depository institution. Therefore, an insured depository institution will be a “swaps entity” for purposes of this provision only if it is a swap dealer.

This provision effectively requires any bank or other entity with access to Federal Reserve credit or FDIC assistance, and whose derivatives activities constitute acting as a swap dealer, to cease (after a transition period) engaging in swap activities other than those specifically permitted. The specifically permitted swap activities include interest rate and currency swaps, cleared credit derivatives on investment grade securities, and hedging activities directly related to the insured depository institution’s activities.

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<sup>11</sup>Act §§ 727 (to be codified at 7 U.S.C. 2(a)) & 763(i) (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>12</sup>Act §§ 724 (to be codified at 7 U.S.C. 6d) & 763 (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>13</sup>Act § 619 (to be codified at 12 U.S.C. 1841 *et seq.*).

<sup>14</sup>Act § 716.

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Nonpermitted swap activities may be conducted in a separately capitalized nonbank affiliate. The effective date of this provision is deferred until two years after the effective date of the Derivatives Title (which is approximately three years after enactment of the Act) and a transition period of up to two years, with a potential, discretionary extension of one additional year, follows that deferred effective date.

### **Extraterritorial Application<sup>15</sup>**

The Derivatives Title does not include any express exemptions for non-U.S. entities from the requirements applicable to swap dealers or Major Participants. Many non-U.S. entities will be subject to regulation as swap dealers because they conduct substantial activities of that type in the U.S. However, the extent to which the Derivatives Title would affect their activities outside the U.S. remains to be clarified during the rulemaking process, and presumably will include coordination with relevant foreign regulatory authorities.

The Derivatives Title also leaves open issues with respect to non-U.S. entities that on the basis of their swap positions may be categorized as Major Participants. For example, it is uncertain whether such entities would be excluded by regulation from the Major Participant category if they enter into swaps only outside the U.S. and only with non-U.S. entities. The intended scope of the definition of “Major Participant,” and in particular the extent to which it may apply to entities outside the U.S., may not be known with certainty until the rulemaking process has been concluded (if then).

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<sup>15</sup>Act §§ 722 (to be codified at 7 U.S.C. 2(a)(1)) & 772(b) (to be codified at 15 U.S.C. 78 dd).



# Swap Clearinghouses and Markets

An objective of Title VII of the Dodd-Frank Act is to create a structure and incentives to expand pre- and post-execution transparency for swaps and security-based swaps<sup>1</sup> and contain the consequences of the failure of a party with a massive swaps position. The Act mandates regulated, centralized clearing and trading environments for swap agreements or, where clearing is unavailable, imposes effective collateralization and capital requirements to protect counterparties and to discourage over-leveraging.

## What Must Be Cleared?

All swaps not subject to enumerated exceptions must be submitted for clearing to a registered derivatives clearing organization or a derivatives clearing organization exempt from registration under the Act.<sup>2</sup> The enumerated exceptions to the clearing requirement are limited. A swap is exempt from the clearing requirement if one of the counterparties is not a financial entity and is using the swap to hedge or mitigate its commercial risk, and that party notifies the CFTC how it generally meets the financial obligations associated with entering into a non-cleared swap. The CFTC is to set forth the manner of notification that will be required.<sup>3</sup>

“Financial Entity” is broadly defined in this context and includes a swap dealer, major swap participant, private fund as defined by section 202(a) of the Advisers Act, an employee benefit plan under section 3 of ERISA, and a person predominantly engaged in banking or financial activities.<sup>4</sup> Some leeway in this definition remains, however, because the CFTC is given discretion to determine whether small banks, savings associations, farm credit system institutions and credit unions are exempt. Additionally, the definition of “financial entity” does not include any entity the primary business of which is providing financing and which uses derivatives to hedge commercial risks related to interest-rate and foreign currency exposure, if 90% or more of the exposures arise from financing that facilitates the purchase or lease of products, 90% or more of which is manufactured by the parent company or another subsidiary.<sup>5</sup>

An affiliate of a person that qualifies for the exemption may avail itself of the exemption if it is acting as an agent of the person or another affiliate so long as it is not a swap dealer, a major swap participant, an issuer that would be defined as an investment company, a commodity pool, or a bank holding company with over \$50 billion in consolidated assets. Additionally, the Act provides a transition period for the benefit of affiliates that are predominantly engaged in providing financing for the purchase or lease of merchandise or manufactured goods. Such affiliates are exempt from the clearing requirements as well as the margin requirements of the Act with regard to swaps entered to mitigate the risk of financing activities for at least two years.<sup>6</sup>

Notably, these exceptions may be narrowed, at least to some extent, by the CFTC. That is, the CFTC may prescribe and interpret rules it determines to be necessary to “prevent abuse of the exceptions.”<sup>7</sup>

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<sup>1</sup> For the definitions of “swap” and “security-based swap,” see [“Regulation of Over-the-Counter Derivatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”](#)

<sup>2</sup> Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(1)).

<sup>3</sup> Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(A)).

<sup>4</sup> Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(C)).

<sup>5</sup> *Id.*

<sup>6</sup> Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(D)).

<sup>7</sup> Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(F)).

No further guidance as to what constitutes an “abuse” is given, leaving the CFTC with considerable discretion. Additionally, obvious efforts to structure swaps to avoid clearing may be precluded. The SEC and CFTC are specifically granted the power to prescribe rules determined to be necessary to “prevent evasion” of the mandatory clearing requirement.<sup>8</sup> No further guidance as to the exercise of this power is given by the Act; however, the CFTC is specifically tasked with adopting rules to further define “swap,” “swap dealer,” “major swap participant,” and “eligible contract participant” in order to include transactions or entities that have been structured to evade these provisions.<sup>9</sup> Additionally, a designated clearing organization, swap dealer, or major swap participant that knowingly or recklessly evades or participates in or facilitates an evasion of the clearing requirement is liable for a money penalty in twice the amount otherwise available for such a violation.<sup>10</sup>

Also, if the CFTC finds that a particular swap that otherwise would be subject to the mandatory clearing requirement is not listed by a derivatives clearing organization, it may investigate such a situation, issue a public report within 30 days, and take whatever actions it determines to be necessary and in the public interest, including requiring the retention of adequate margin or capital by parties to the swap (but not including requiring a reluctant clearinghouse to clear the contract). More specifically, the CFTC is not authorized to require a derivatives clearing organization to list a swap for clearing if such an action would threaten its financial integrity.<sup>11</sup> This protection, however, appears to be minimal and may only allow derivatives clearing organizations to refuse required clearing in the most dire circumstances and, in any case, will require a derivatives clearing organization to perform a defensive analysis in order to fend off an unwanted swap.

Regardless, the Act provides some incentive to dealers to structure swaps as clearable. Most notably, the Act provides a roadblock for publicly traded corporations to participate in uncleared swaps. If a publicly traded corporation wishes to avail itself of an exemption from the clearing requirement or even wishes not to trade a cleared swap on a board of trade, designated contract market, or swap execution facility, it must first receive approval from the appropriate committee of its board or governing body.<sup>12</sup> This could result in large delays before such an entity could enter into a swap, or at least would require the entity to plan ahead to receive timely audit committee approval. However, although it is not entirely clear, the language of the Act (“only if an appropriate committee of the issuer’s board or governing body has reviewed and approved its decision to enter into swaps that are subject to such exemptions”)<sup>13</sup> may permit the appropriate body to issue an effective blanket approval to enter into uncleared swaps, or at least certain large categories of uncleared swaps.

Swaps not subject to the clearing requirement are still subject to additional regulation imposed by the Act. All swaps, cleared or uncleared, must be reported to a swap data repository, a registered entity that collects and maintains records with respect to transactions or positions in, or terms and conditions of, swaps.<sup>14</sup> Additionally, in what appears to be a somewhat overlapping provision, the Act provides that swaps that are not accepted for clearing by any derivatives clearing organization must be reported

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<sup>8</sup> *Id.*

<sup>9</sup> Act § 721(c).

<sup>10</sup> Act § 741(a).

<sup>11</sup> Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(4)(C)).

<sup>12</sup> Act § 723(b) (to be codified at 7 U.S.C. 2(j)).

<sup>13</sup> *Id.*

<sup>14</sup> Act § 727 (to be codified at 7 U.S.C. 2(a)(13)(G)).

to a swap data repository, or if no repository will accept the swap, to the CFTC itself.<sup>15</sup> These reporting requirements are to some extent retroactive, because the Act provides that swaps entered into before the enactment of the clearing subsection must be reported to a swap data repository or the CFTC within 180 days of the effective date of the subsection.<sup>16</sup> Additionally, in what again may be an overlapping provision, the Act provides that pre-enactment swaps, the terms of which have not expired as of enactment, must be reported to a registered swap data repository or the CFTC within 30 days of the issuance of a final rule by the CFTC regarding reporting of pre-enactment swaps or within any other time period determined by the CFTC.<sup>17</sup> All foreign exchange swaps must be reported regardless of whether the Treasury Secretary determines that they should not be regulated as swaps.<sup>18</sup> Additionally, if an individual or entity fails to clear a swap or report the swap to a swap data repository in accordance with the rules, it must maintain records regarding the swaps it holds in a manner prescribed by the CFTC and provide reports upon request of the CFTC.<sup>19</sup>

The Act provides guidance as to which party to a swap, under certain circumstances, has the right to choose where the swap will be cleared: the party to a swap other than a swap dealer or major swap participant may select the clearinghouse. Specifically, in a swap subject to the clearing requirement entered into by a swap dealer or major swap participant with a counterparty that is not a swap dealer or major swap participant, the counterparty that is not a swap dealer or major swap participant has the right to select a derivatives clearing organization at which to clear a swap.<sup>20</sup> In the case of a swap that is not subject to the clearing requirement entered into by a swap dealer or major swap participant and a counterparty that is not a swap dealer or major swap participant, the counterparty may first elect to require the swap to be cleared and, if it makes such an election, has the right to select the derivatives clearing organization at which the swap will be cleared.<sup>21</sup> The Act does not explicitly prohibit dealers from refusing to deal unless their choices of clearing agency are respected.

Although many provisions of the Act appear to be retroactive, the clearing requirement is not. **See “Derivatives.”** According to the terms of the Act, any swap that was entered into prior to enactment is not subject to the mandatory clearing requirement, although such swaps must be reported to a swap data repository within 180 days after the effective date of the clearing requirement. Similarly, swaps entered into after enactment but before application of the clearing requirement are not required to be cleared, but must be reported to a swap data repository either 90 days after the effective date or such other time as specified by the CFTC.<sup>22</sup> In addition, persons may petition to avoid the mandatory clearing requirement for a year after enactment of the Act. Specifically, no later than 60 days after enactment, a person may submit a petition to the CFTC requesting to remain subject to Section 2(h) of the Commodity Exchange Act, thereby avoiding the new mandatory clearing provisions for up to a year.<sup>23</sup> No guidance is given regarding how the CFTC will decide to deny or approve such petitions, but the CFTC is required to consider petitions in a “prompt” manner.<sup>24</sup>

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<sup>15</sup>Act § 729.

<sup>16</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(5)).

<sup>17</sup>Act § 729.

<sup>18</sup>Act § 721(a)(21) (to be codified at 7 U.S.C. 1a(47)(E)(iii)).

<sup>19</sup>Act § 729.

<sup>20</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(E)(i)).

<sup>21</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(E)(ii)).

<sup>22</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(6)).

<sup>23</sup>Act § 723(c).

<sup>24</sup>Act § 723(c)(2)(A).

## Role of the Regulator in Determinations Related to Clearing

According to the Act, the CFTC occupies a gate-keeping role in determining which swaps must be cleared. The CFTC may review swaps by two alternative means. First, and perhaps of greatest concern, it may review a swap or group, category, type or class of swaps to determine whether it should be required to be cleared on its own initiative.<sup>25</sup> The CFTC must consider several broad factors in making its decision:

- the existence of significant outstanding notional exposures, trading liquidity and adequate pricing data;
- the availability of rule framework, capacity, operational expertise and resources and credit infrastructure to clear the contract;
- the effect on mitigation of systematic risk; and
- the effect on competition; and the existence of reasonable legal certainty in the event of the insolvency of the derivatives clearing organization or its members.

Regardless of these factors, it remains difficult to predict what swaps will be subject to the requirement.<sup>26</sup>

Alternatively, a derivatives clearing organization is required to submit any group, category, type or class of swaps that it plans to accept for clearing to the CFTC.<sup>27</sup> Any swap, group, category, type or class of swaps listed for clearing as of the enactment of Section 723 is, however, deemed already submitted. Thereafter, the CFTC has 90 days, unless the submitting entity agrees to an extension, to make a determination as to whether the clearing requirement should apply. In making its determination, the CFTC is to consider whether clearing the swap at issue is consistent with the core principles for derivatives clearing organizations prescribed by the Act as well as the considerations described above.<sup>28</sup>

After making its initial determination on a swap submitted by a derivatives clearing organization, the CFTC on its own initiative or at the request of a counterparty may stay the clearing requirement until it completes a review of the terms of the swap and the clearing arrangement. Unless the derivatives clearing organization that clears the swap agrees to an extension, the CFTC must determine within 90 days after issuing the stay whether the swap must be cleared.<sup>29</sup>

As a corollary, if a swap is subject to the clearing requirement, it also is required to be executed on a regulated platform. That is, it must be traded on a designated contract market or a registered swap execution facility.<sup>30</sup> The only exception to this requirement is if no designated contract market or swap execution facility makes the swap available for trade.<sup>31</sup> Additionally, the Act makes it unlawful for any person other than an eligible contract participant to enter into a swap that is not on or subject to the rules of a board of trade or designated contract market.<sup>32</sup>

<sup>25</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(2)(A)).

<sup>26</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(2)(A)).

<sup>27</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(2)(B)).

<sup>28</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(2)(D)).

<sup>29</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(3)(A-C)).

<sup>30</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(8)(A)).

<sup>31</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(8)(B)).

<sup>32</sup>Act § 723(a)(2) (to be codified at 7 U.S.C. 2(e)).



## Swap Execution Facility

The Act creates a new regulated trading platform called a swap execution facility. A swap execution facility is defined as “a facility trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that facilitates the execution of security-based swaps between persons and is not a designated contract market.”<sup>33</sup> This definition is broad and encompasses a large number of previously unregulated entities. Uncertainty remains as to exactly what can be traded on a swap execution facility, and the Act allows the CFTC and SEC to promulgate rules defining the universe of swaps that may be traded on a swap execution facility.<sup>34</sup>

The deletion of one word from the Act has created significant uncertainty regarding the conduct of trading on a swap execution facility. The Act had originally required that a swap execution facility be a “trading facility.” The word “trading” was omitted from the final version of the Act. Eliminating “trading” and requiring only that a swap execution facility be a “facility” could have important consequences. The Commodity Exchange Act definition provides that a “trading facility” does *not* include:

a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm.<sup>35</sup>

This language, defining what isn’t a “trading facility” has been interpreted to mean that any “trading facility” must have an automated matching and execution algorithm. Therefore, striking the word “trading” from “trading facility” frees the operator of the facility from the automated matching requirement. The swap execution facility remains subject to the requirement that it be: “a facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the facility or system . . . .” Critics of this amendment have suggested that it permits swap dealers to operate private trading systems, but the use of the plural “participants” may preclude that reading. The question is whether the language requires that there be at least two market makers and two potential customers for each trade.

## Regulation of Clearinghouses

As a corollary to the clearing requirement, the Act requires open access to derivatives clearing organizations. The open access provision requires that a derivative clearing organization’s rules prescribe non-discriminatory clearing. The goal of the drafters was to preclude the tight vertical relationship between exchanges and their clearinghouses, which is a common feature of futures markets. The Act requires a clearinghouse to accept transactions without regard to the platform on which they were executed.<sup>36</sup> It is likely however, that the contracts must be equivalent to contracts already being cleared by that clearinghouse. Effectively, if contracts traded on separate platforms are identical, they become fungible if cleared at the same clearinghouse.

<sup>33</sup>Act § 721(a)(21) (to be codified at 7 U.S.C. 1a(50)).

<sup>34</sup>Act § 733.

<sup>35</sup>7 U.S.C. 1a(34).

<sup>36</sup>Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(1)(B)).

The Act prescribes a shared scheme of regulation; the CFTC and the SEC share the power to regulate derivatives clearing organizations, designated contract markets, and swap execution facilities based on the type of swap at issue. Pursuant to the Act, the CFTC and the SEC both issue rules and regulations related to the Act, but they must consult and coordinate with each other to assure that the regulations prescribed by each are consistent. Importantly, however, although the CFTC and SEC must treat functionally or economically similar products and entities in a similar manner, they need not treat them in an identical manner.<sup>37</sup>

The CFTC has been given authority to regulate swaps and the SEC has been given authority to regulate securities-based swaps. Specifically, the CFTC may not issue a rule or regulation related to securities-based swaps or related to dealers, major participants, repositories, associated persons of dealers or major participants, eligible contract participants, or swap execution facilities with respect to securities-based swaps, and the SEC may not regulate the same as to swaps.<sup>38</sup> In a similar vein, absent certain issues reserved for prudential regulators, the CFTC has sole enforcement authority as to the portions of the Act dealing with swaps and related entities, and the SEC has “primary” enforcement authority regarding the portions of the Act dealing with securities-based swaps and related entities.<sup>39</sup> The CFTC and SEC, after consultation with the Board of Governors, are to jointly prescribe regulations regarding mixed swaps.<sup>40</sup>

The CFTC and SEC, in consultation with the Board of Governors, are also to jointly further define various terms relevant to the Act including “swap,” “swap dealer,” “major swap participant” and “eligible contract participant” as well as other rules regarding such definitions as they determine are necessary and appropriate in the public interest and for the protection of investors.<sup>41</sup> Additionally, they are to jointly prescribe various rules governing recordkeeping related to swaps.<sup>42</sup> If the CFTC and SEC fail to jointly prescribe such rules in a timely manner, the Financial Stability Oversight Council may step in to resolve disputes at the request of either party.<sup>43</sup> Additionally, where joint regulations are required, any interpretation of provisions of the Act issued by a CFTC are effective only if issued jointly after consultation with the Board of Governors.<sup>44</sup> This portion of the Act clearly contemplates a slow and contentious rulemaking process.

The rules applying to swaps entities and security-based swaps entities provided in the Act — that is, clearing rules, core principles, and related provisions — are virtually identical. However, as discussed above, based upon the type of swap at issue, an entity or swap is subject to the rules promulgated pursuant to the Act by either the CFTC or the SEC or both. As such, an entity that deals in both swaps and securities-based swaps will face regulation by both the CFTC and the SEC, and the regulations prescribed by those commissions may differ, despite the fact that the entities at issue may be serving the same purpose regarding swaps and securities-based swaps.

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<sup>37</sup>Act § 712(a). See “Derivatives.”

<sup>38</sup>Act § 712(b).

<sup>39</sup>Act § 741.

<sup>40</sup>Act § 712(a)(8).

<sup>41</sup>Act § 712(d)(1).

<sup>42</sup>Act § 712(d)(2).

<sup>43</sup>Act § 712(d)(3).

<sup>44</sup>Act § 712(d)(4).

# Securitization

## Risk Retention Requirement

Under the Dodd-Frank Act, a securitizer<sup>1</sup> must retain no less than 5% of the credit risk in assets it sells into a securitization.<sup>2</sup> The retention threshold may be decreased below 5% if the quality of the underwriting standards employed by the originator<sup>3</sup> of the assets would indicate that those assets have less credit risk. Further, the risk retention requirement does not apply to “qualified residential mortgages”<sup>4</sup> if these are the only assets in the pool collateralizing the asset-backed securities<sup>5</sup> (“ABS”), but the issuer must certify that it has evaluated the effectiveness of its internal controls to ensure that all the assets backing the ABS are, in fact, qualified residential mortgages. ABS backed by tranches of other ABS are not eligible for the qualified mortgage exemption, even if the underlying ABS is backed exclusively by qualified residential mortgages.

The Act requires the SEC and the federal banking agencies<sup>6</sup> to promulgate regulations specifying the allowable forms and minimum duration of risk retention.<sup>7</sup> For commercial mortgages, the regulations must set forth the type of risk retention that would be acceptable, including:

- the retention of a specified amount or percentage of the total credit risk of the commercial mortgage;
- the retention of the first-loss position by a third-party purchaser that negotiates for this position, holds adequate financial resources to back losses, performs due diligence on all the commercial mortgages before the issuance of the securities and otherwise meets standards analogous to those required for a securitizer;

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<sup>1</sup> “Securitizer” is defined in the Act as (i) an issuer of an asset-backed security or (ii) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. Act § 941(b) (to be codified at Exchange Act § 15G(a)(3)).

<sup>2</sup> Act § 941(b) (to be codified at Exchange Act § 15G(c)(1)(B)).

<sup>3</sup> “Originator” is defined in the Act as a person who (i) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security and (ii) sells an asset directly or indirectly to a securitizer. Act § 941(b) (to be codified at Exchange Act § 15G(a)(3)).

<sup>4</sup> This term is to be defined jointly by the federal banking agencies, the SEC, the Secretary of Housing and Urban Development and the Director of the Federal Housing Finance Agency, taking into consideration factors that have historically resulted in a lower default risk. Such definition, however, cannot be less restrictive than the definition of “qualified mortgage” as defined under Section 129C(c)(2) of the Truth in Lending Act, as amended by Title XIV of the Act, which essentially means a mortgage (a) that is fully amortizing and does not have any unconventional attributes, such as interest-only payments, principal increases and balloon payments, (b) for which the basis of the borrower’s qualification is verified and documented, (c) that complies with the debt-to-income ratio or other affordability regulations set by the Board of Governors and (d) for which the total points and fees payable do not exceed 3% of the loan amount.

<sup>5</sup> “Asset-backed security” is defined in the Act as a “fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset.” The definition includes “(i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the SEC, by rule, determines to be an asset-backed security for purposes of this section.” The term does not include “a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.” Act § 940(a) (to be codified at 15 U.S.C. § 78c(A)(77)).

<sup>6</sup> The term “federal banking agencies” under the Act means the Office of the Comptroller of the Currency, the Board of Governors and the FDIC. Act § 941(b) (to be codified at Exchange Act § 15G(a)(1)).

<sup>7</sup> Act § 941(b) (to be codified at Exchange Act § 15G(c)(1)(C)).

- the existence of adequate underwriting standards and controls (as determined by the federal banking agencies and the SEC); and
- provision of adequate representations and warranties and related enforcement mechanisms.

Separately, the federal banking agencies and the SEC must establish risk retention standards with respect to collateralized debt obligations, securities collateralized by collateralized debt obligations and similar instruments collateralized by other ABS.<sup>8</sup> The Act also requires regulations to establish underwriting standards for different asset classes, including residential mortgages, commercial mortgages, commercial loans and auto loans.

Under the Act, the federal banking agencies and the SEC must allocate the risk retention obligations between a securitizer and an originator by reducing the percentage of the retained risk required to be held by the securitizer by the percentage required to be held by the originator.<sup>9</sup> The following factors will also bear on the risk retention allocation:

- whether the assets transferred into a securitization reflect a lower credit risk;
- whether the form or volume of the securitization transaction creates incentives for imprudent origination; and
- the possible impact of risk allocation on consumer credit (which is not to include credit risk transfer to a third party).<sup>10</sup>

The Act prohibits hedging or transferring the retained credit risk, but provides for exemptions or adjustments to the retention requirement and the hedging prohibition.<sup>11</sup> These exemptions are to be jointly issued by the federal banking agencies and the SEC. The exemptions must ensure high underwriting standards and also promote sound risk management practices, improve credit access for businesses or consumers, or otherwise serve the public interest and protect investors. In addition, certain financial assets of institutions subject to the supervision of the Farm Credit Administration (including the Federal Agricultural Mortgage Corporation) and certain financial instruments insured or guaranteed by the United States or an agency of the United States (including the Federal Housing Administration) will not be subject to the risk retention requirements.

The regulations described above are required to be promulgated under the Act and will become effective one year after final rules are published for securities backed by residential mortgages and two years after final rules are published for securities backed by all other classes of assets.<sup>12</sup> It is unclear whether and how the proposed requirements will apply to outstanding ABS transactions. Additionally, the Chairman of the Council is required to conduct a study on the macroeconomic effects of the risk retention requirements with a particular focus on the cause and prevention of real estate price bubbles, and issue a report to Congress within 180 days after the Act is enacted.<sup>13</sup>

On April 7, 2010, the SEC issued a release under the Securities Act (the “ABS Release”) in which it proposed amendments to the rules applicable to ABS issuers.<sup>14</sup> In the ABS Release, the SEC proposed

<sup>8</sup> Act § 941(b) (to be codified at Exchange Act § 15G(c)(1)(F)).

<sup>9</sup> Act § 941(b) (to be codified at Exchange Act § 15G(d)(1)).

<sup>10</sup> Act § 941(b) (to be codified at Exchange Act § 15G(d)(2)).

<sup>11</sup> See Act § 941(b) (to be codified at Exchange Act § 15G(e)).

<sup>12</sup> Act § 941(b) (to be codified at Exchange Act § 15G(i)).

<sup>13</sup> Act § 946(b).

<sup>14</sup> Securities Act Release No. 91177 (the “ABS Release”), published in the Federal Register on May 3, 2010.

risk retention requirements that are different from those contained in the Act. The SEC proposals apply to “sponsors” of securitizations, which are the same entities as securitizers but do not include “issuers of ABS.” Sponsors must retain an interest in the issued ABS rather than in the underlying assets. They must retain a 5% “vertical slice” of each ABS transaction, consisting of 5% of each tranche of securities issued. The SEC did not provide for reductions in the required risk retention due to better underwriting standards, enforceable repurchase obligations or risk retention by originators. The SEC will need to revise its proposed risk retention rules to cover the underlying assets rather than the issued ABS and to take into account the variables identified in the Act which may be considered in reducing the risk retention burden for assets and asset classes that are of a better credit quality and/or for originators with superior underwriting standards and asset repurchase track records.

As a separate matter, the “Garrett amendment” to Title I of the Act, as originally approved by the House of Representatives, would have established an oversight program for the covered bond market as an alternative to the traditional ABS market.<sup>15</sup> Specifically, the Garrett amendment legislation included standards with respect to eligible assets, asset classes and over-collateralization and set procedures upon the occurrence of a default or insolvency with respect to the covered bond issuer. Although not part of the Act, the proposed framework for covered bonds will continue to be the subject of discussion for potential legislation in the future, as it has seemingly gained sufficient support among members of the Senate and of the House.

### **Disclosure, Due Diligence and Reporting Requirements**

The Act requires each issuer of ABS, at a minimum, to disclose asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence, including the identity of brokers or originators of the assets, compensation of such brokers or originators, and the amount of risk retained by the originator or securitizer.<sup>16</sup> A securitizer also must disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so investors can identify asset originators with clear underwriting deficiencies. The Act also requires rating agencies to include in their rating reports for each ABS a description of the representations, warranties and enforcement mechanisms for the ABS being rated and how the ABS transaction differs from similar securities.<sup>17</sup>

In the ABS Release, the SEC also proposed extensive asset-level data requirements. The SEC proposed 28 unique data items or “points” that would be applicable for most ABS transactions, as well as additional data points for specific data classes — for example, an additional 137 data points for residential mortgage-backed securities. In addition, ABS issuers would be required to update these data points, as well as prepare additional data points relating to asset performance, in their ongoing periodic reports relating to each of the scheduled distribution dates for their ABS issuances. For credit card securitizations, the SEC identified 14,256 distinct categories of various asset characteristics relating to, *e.g.*, obligor credit scores, state of residence, and delinquency. For each of these “grouped account” categories, issuers must provide aggregate calculations of credit limit, account balance, number of accounts, and the weighted average annual percentage rate, with and without the deduction of servicing fees. The final asset-level disclosure requirements applicable to ABS will likely consist of an amalgam of the proposals in the ABS Release and those contained in the Act.

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<sup>15</sup> The Garrett amendment was ultimately excluded from the Act.

<sup>16</sup> Act § 942(b) (to be codified at 15 U.S.C. § 77g(c)(2)(B)).

<sup>17</sup> Act § 943.

While asset-level disclosure requirements are intended to enhance investors' due diligence review, the Act further requires the SEC to issue rules requiring issuers of ABS to conduct their own review of the underlying assets and to disclose the nature of such review.

Finally, the Act excludes ABS from the automatic reporting suspension provision of the Exchange Act that permits issuers to suspend their reporting obligations after one year if their securities are held by fewer than 300 holders.<sup>18</sup> Accordingly, publicly registered ABS issuers would be required to continue making periodic disclosures as long as their ABS remained outstanding, even if fewer than 300 security holders held such ABS. Nevertheless, the SEC may continue to provide for the suspension or termination of any ABS issuer's reporting requirements by rule or regulation, as it deems necessary and appropriate in the public interest or to protect investors. In the ABS Release, the SEC eliminated automatic reporting suspension for ABS issuers using the shelf registration process, but not for other public issuers.

Despite the potentially lengthy implementation period for the provisions of the Act, securitizers may wish to begin generating, assembling and disclosing the extensive asset level data required by the ABS Release and by the provisions of the Act as part of their efforts to implement "best practices" in their securitization business and to create the necessary facilities and processes that will allow them to comply with the new asset-level disclosure rules, once they have been implemented.

### **Credit Rating Agency Regulation; Removal of Statutory References to Credit Ratings**

The Act also amends the Exchange Act by directing the SEC to conduct a two-year study on the credit rating process for structured finance products,<sup>19</sup> the related conflicts of interest issues and the feasibility of establishing a system in which a self-regulatory organization assigns Nationally Rated Statistical Ratings Organizations ("NRSROs") to determine the ratings of structured finance products.<sup>20</sup> Upon completion of the study and submission of its findings to the Senate and House committees, the SEC will have the authority to establish a mechanism for assigning NRSROs to determine the initial credit ratings of structured finance products in a manner that would prevent issuers from "shopping" among NRSROs. In doing so, the SEC must give thorough consideration to the so-called "Franken amendments," under which an issuer desiring an initial credit rating for a structured finance product must submit a request to the Credit Rating Agency Board (a self-regulatory organization to be established), which will select an NRSRO from a pool of qualified NRSROs based on a selection method intended to reduce the conflicts of interest inherent to the issuer-paid structure.<sup>21</sup> Separately, the Act requires the SEC to establish the Office of Credit Ratings to administer SEC rules governing NRSRO rating practices, promotion of ratings accuracy and conflict of interest matters.<sup>22</sup> Each NRSRO will be subject to an annual examination by the Office of Credit Ratings.

To enhance transparency for users of credit ratings, the SEC will require NRSROs to provide extensive disclosure with respect to its ratings, including the main assumptions and principles used in constructing

<sup>18</sup> Exchange Act § 15(d).

<sup>19</sup> As used here, "structured finance product" means an asset-backed security as defined under the Act and any structured product based on an asset-backed security, as determined by the Commission, by rule.

<sup>20</sup> See "**Credit Rating Agencies.**"

<sup>21</sup> Act § 939D. The Act further provides that the rating assignment system set forth in the "Franken Amendments" must be implemented unless the SEC determines that an alternative system would better serve the public interest and the protection of investors. Act § 939F(d).

<sup>22</sup> Act § 932(a) (to be codified at 15 U.S.C. § 78o-7(p)).

procedures and methodologies for the ratings, information on the uncertainty of the ratings, whether and to what extent third-party due diligence services have been used by the NRSRO, and an overall assessment of the quality of information available and considered in producing the particular ratings, in relation to the quality of information available to the NRSRO in similar issuances.<sup>23</sup> In addition, an NRSRO will be required to consider information about an issuer that it obtains from a source other than the issuer or underwriter and that it finds credible and potentially significant to a rating decision. Another important amendment with respect to information disclosure is the elimination of the exemption for rating agencies under Regulation FD, which must occur within 90 days of enactment. It is unclear if the intent of this amendment is to cause issuers to disclose any material nonpublic information provided to rating agencies for purposes of their rating decisions without any exception, or if the issuer still can withhold such information to the extent the rating agencies “expressly agree to maintain the disclosed information in confidence” for purposes of the exemption provided under Rule 100(b)(2)(ii) of Regulation FD. **See “Credit Rating Agencies.”**

In terms of rating agency liabilities, the Act enables investors to bring private actions against a credit rating agency if there is a “strong inference” that the agency “knowingly or recklessly” failed to conduct a reasonable investigation of the factual elements related to the rated security that the credit rating agency relied on when evaluating credit risks or failed to obtain verification of such elements from a competent independent source. In the context of rated ABS transactions, this could mean that ABS issuers and other transaction parties will need to consider the engagement of third parties that are independent from the ABS issuers or underwriters to conduct a review of the assets underlying the ABS for purposes of the rating agency’s verification of the facts underlying the ratings. In addition, the Act eliminates the exemption afforded under Rule 436(g) of the Securities Act to NRSROs with respect to expert liability for purposes of Section 11 of the Securities Act. It is unclear, however, how the elimination of the expert exemption will impact rating agencies, particularly with respect to Item 1120 of Regulation AB under the Securities Act, which requires the disclosure of the identity of each rating agency and the required minimum ratings in prospectuses to the extent an ABS issuance is conditioned upon the assignment of a rating.

To reduce dependency on credit ratings, the Act also amends certain statutes, including the Federal Deposit Insurance Act, the Exchange Act, and the 1940 Act, to remove references to specific ratings requirements and to insert instead standards of credit worthiness to be established by the FDIC, the SEC or the other applicable authority under the relevant statute. The SEC’s stated goal in the ABS Release was to minimize investor reliance on credit ratings, so the foregoing requirements of the Act will create an additional set of rules with which ABS issuers will need to acquaint themselves.

Other changes relating to the regulation of credit rating agencies include the prohibition of NRSRO compliance officers from participating in the ratings, methodologies or sales functions; the SEC’s authority to deregister an NRSRO for repeatedly issuing inaccurate ratings; testing and other qualification requirements for NRSRO analysts; and a requirement that at least half of the board of directors of an NRSRO (but not fewer than two of the board members) be independent directors.<sup>24</sup>

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<sup>23</sup>Act § 932(a) (to be codified at 15 U.S.C. § 78o-7(s)(3)(A)).

<sup>24</sup>See Act § 932(a) (to be codified at 15 U.S.C. § 78o-7).





# Credit Rating Agencies

The Dodd-Frank Act includes reforms that address credit rating agencies and the credit ratings they provide. The Act seeks to impose corporate governance guidelines, reduce conflicts of interest, and improve the rating process through enhanced controls and greater transparency. Furthermore, the Act will greatly expand the SEC's oversight and enforcement powers and seeks to make it easier for investors to bring civil lawsuits against rating agencies. In addition, the reforms seek to reduce reliance on ratings as a litmus test for credit quality in favor of broader standards that encompass multiple factors and credit criteria.

## Corporate Governance and Conflict of Interests

The Act requires rating agencies to:

- establish internal controls to monitor adherence to credit rating policies and procedures;<sup>1</sup>
- submit annual compliance reports to the SEC;<sup>2</sup>
- maintain an independent board of directors, or in the case of a rating agency that is subsidiary, an independent committee of the parent's board of directors, which is tasked with certain responsibilities related to the rating agency subsidiary;<sup>3</sup>
- take steps to prevent sales and marketing considerations from influencing ratings;<sup>4</sup>
- apply qualification standards to credit analysts;<sup>5</sup> and
- establish procedures to evaluate possible conflicts of interest related to former employees and provide public reports to the SEC regarding former employees in certain circumstances.<sup>6</sup>

The Act also includes a provision encouraging the SEC to adopt rules designed to reduce conflicts of interest by placing restrictions on the ability of rating agencies to provide services other than credit ratings.<sup>7</sup>

A newly created office of the SEC will administer standards relating to rating agencies and conduct periodic compliance examinations.<sup>8</sup> In addition, the SEC will be permitted to suspend or revoke a rating agency's registration for a particular class of securities for failure to satisfy certain requirements.<sup>9</sup>

## Modifications to the Credit Rating Process

The Act imposes new rules relating to credit rating procedures and methodologies.<sup>10</sup> To increase transparency in the ratings process, rating agencies will be required to use a standardized form to

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<sup>1</sup> Act § 932(a) (to be codified at 15 U.S.C. § 78o-7(c)(3)).

<sup>2</sup> *Id.*

<sup>3</sup> Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(t)(2)).

<sup>4</sup> Act § 932(a) (to be codified at 15 U.S.C. § 78o-7(h)(3)).

<sup>5</sup> Act § 936.

<sup>6</sup> Act § 932(a)(4) (to be codified at 15 U.S.C. § 78o-7(h)(4)).

<sup>7</sup> Act § 939H.

<sup>8</sup> Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(p)).

<sup>9</sup> Act § 932(a)(3) (to be codified at 15 U.S.C. § 78o-7(d)(2)).

<sup>10</sup> Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(r)).

publicly disclose their rating methodology, a description of issuer data considered in the rating process and any additional information that the SEC may require.<sup>11</sup> It remains unclear how detailed the SEC will require these descriptions to be and if the SEC will require any additional disclosure. In addition, issuers and underwriters of asset-backed securities will be required to publicly disclose the findings of any third-party diligence reports they obtain, and the thoroughness of the review performed in producing such reports must be publicly disclosed and certified by the provider of the diligence service.<sup>12</sup> See “Securitization.”

To facilitate comparisons among rating agencies, each agency will be required to periodically disclose information demonstrating, in hindsight, the degree of accuracy of its prior credit ratings.<sup>13</sup>

To broaden the scope of information considered in determining credit ratings, rating agencies will be required to consider credible and significant information from sources other than the issuer.<sup>14</sup> In addition, whistle blower provisions will require rating agencies to refer information received from a third party about material violations of law by an issuer to appropriate regulatory authorities.<sup>15</sup>

The Act also requires the SEC to study issues related to the credit rating process for structured finance products.<sup>16</sup> To address so-called “rating-shopping” by issuers and underwriters of such products, the SEC will be authorized to establish a mechanism to change how the initial rating agency is selected.<sup>17</sup> See “Securitization.”

### Increased Potential Liability

**Securities Act.** Prior to the effectiveness of the Act, Rule 436(g) exempts rating agencies from liability under Section 11 of the Securities Act.<sup>18</sup> The Act rescinds this exemption, thus exposing rating agencies to expert liability if they consent to the inclusion of a credit rating in a registration statement.<sup>19</sup> In order to defend against a Section 11 claim, a rating agency would be required to show that it had reasonable grounds to believe, and did in fact believe, that the included credit rating was accurate.

The implications of this reform could have profound effects on the securities offering process for rated securities, particularly structured finance products for which ratings have traditionally played a central role. It remains unclear how rating agencies will react to this change; however, rating agencies have successfully challenged claims on constitutional grounds in the past, arguing that ratings are protected by the First Amendment.<sup>20</sup> In 2009, the SEC proposed rescinding Rule 436(g). In the proposing release, the SEC acknowledged that rating agencies previously had indicated that they would refuse to consent to the inclusion of a credit rating in an issuer’s registration statement.<sup>21</sup> It also is possible that rating agencies

<sup>11</sup>Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(s)).

<sup>12</sup>Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(s)(4)).

<sup>13</sup>Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(q)).

<sup>14</sup>Act § 935 (to be codified at 15 U.S.C. § 78o-7(v)).

<sup>15</sup>Act § 934 (to be codified at 15 U.S.C. § 78o-7(u)).

<sup>16</sup>Act § 939F(b).

<sup>17</sup>Act § 939F(d)(1).

<sup>18</sup>Rating agencies which are not “nationally recognized statistical rating organizations” were not covered by the Rule 436(g) exemption from liability under Section 11 of the Securities Act. As a result of this reform, all rating agencies will be treated the same for the purposes of such liability.

<sup>19</sup>Act § 939G.

<sup>20</sup>See *Compuware Corp. v. Moody’s Inv. Servs., Inc.*, 499 F.3d 520 (6th Cir. 2007).

<sup>21</sup>See Concept Release on Possible Recession of Rule 436(g) Under the Securities Act of 1933 (SEC Release No. 33-9071). In a companion release, the SEC also proposed requiring issuers to include credit ratings and related information in registration statements when credit ratings are used in connection with the offering (SEC Release 33-9070).

would seek to refuse to permit the inclusion of credit ratings in private offering documents.<sup>22</sup> To the extent that rating agencies follow such an approach, adjustments in the marketing of securities may be required, especially with regard to securities in which investors were historically reliant on ratings to assess credit quality.

**Exchange Act.** The Act confirms the availability of civil remedies against rating agencies by specifically making the enforcement and penalty provisions of the Exchange Act applicable to rating agencies in the same manner the provisions currently apply to registered public accountants and securities analysts.<sup>23</sup> The Act also excludes credit ratings from the protection of the safe harbor provisions for forward-looking statements of the Private Securities Litigation Reform Act of 1995.<sup>24</sup>

The Act alters the pleading standards that were implemented by the Private Securities Litigation Reform Act of 1995 as applied to actions for money damages against rating agencies.<sup>25</sup> Under the standards in place prior to the enactment of the Act, to survive a motion to dismiss a claim based on Rule 10b-5, a plaintiff had to allege facts giving rise to a “strong inference” that the defendant knowingly or recklessly made a material misstatement or omission.<sup>26</sup> In the context of credit ratings, courts required plaintiffs to plead that the rating agency did not genuinely believe its opinions regarding credit quality or that the opinions lacked basis in fact.<sup>27</sup> Plaintiffs were often unable to satisfy this pleading burden in actions against rating agencies. Under the Act, a pleading against a rating agency would satisfy the state-of-mind requirement if it alleges facts with particularity giving rise to a strong inference that the rating agency knowingly or recklessly “failed to conduct a reasonable investigation” of the factual elements relied upon in evaluating the credit risk of the rated security. The determination of what constitutes a “reasonable investigation” will be based on a court’s consideration of the particular facts and circumstances.

It should be noted that the reforms do not purport to modify the elements of a Rule 10b-5 claim that plaintiffs must ultimately satisfy after the pleading stage, nor do they purport to impair the First Amendment defenses traditionally employed by rating agencies, particularly in the case of unsolicited ratings.

In addition, the Act replaces references to “furnish” with references to “file” in certain provisions of the Exchange Act that govern a rating agency’s application for registration and related amendments.<sup>28</sup> These applications contain information about the rating agency and its business, including its credit ratings performance, procedures and methodologies, and conflicts of interest. By requiring the rating agencies to file (as opposed to merely furnish) certain materials, this reform effectively subjects rating agencies to Section 18 of the Exchange Act, which provides a civil remedy for misleading statements made in applications and other documents filed with the SEC under the Exchange Act.

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<sup>22</sup>The SEC has proposed mandating the inclusion of ratings information in 144A offerings with Exxon Capital exchange rights (SEC Release 33-9070).

<sup>23</sup>Act § 933(a) (to be codified at 15 U.S.C. § 78o-7(m)(1)).

<sup>24</sup>*Id.*

<sup>25</sup>Act § 933(b)(2) (to be codified at 15 U.S.C. § 78u-4(b)(2)(B)).

<sup>26</sup>15 U.S.C. § 78u-4(b)(2).

<sup>27</sup>See *In re IBM Corp. Sec. Litig.*, 163 F.3d 102 (2d Cir. 1998) (discussing securities law liability related to opinions).

<sup>28</sup>Act § 932(a) (to be codified at 15 U.S.C. § 78o-7); possibly due to an error in the Act, references to “furnish” are not changed to “file” in 15 U.S.C. § 78o-7(a)(1)(A), which is related to initial applications by rating agencies.

### **Sole Reliance on Credit Ratings**

Prior to the effectiveness of the Act, institutional investors, including banks, insurers and money market funds were permitted to rely solely on credit ratings when making certain investment decisions. The Act seeks to compel such investors to conduct an independent investigation into the multiple factors that influence the risk profile of a security and thereby diminish their reliance on credit ratings. The Act seeks to achieve this objective by replacing references to credit ratings in certain federal laws with a requirement that such investors consider the creditworthiness of a security, thus encouraging these investors to consider factors beyond the security's credit rating.<sup>29</sup>

In addition, every federal agency will be required to study any regulation it has issued that requires the assessment of creditworthiness or the use of credit ratings and replace such references to credit ratings with references to broader standards of creditworthiness where the agency determines such changes are appropriate.<sup>30</sup>

### **Elimination of Automatic Regulation FD Exemption**

Regulation FD was adopted to prevent selective disclosure to those who would reasonably be expected to trade securities on the basis of the information or provide others with advice about securities trading.<sup>31</sup> The Act removes an existing blanket exemption from Regulation FD for information provided to rating agencies;<sup>32</sup> the impact of the removal of this exemption is unclear. Under Regulation FD, material nonpublic information made available by or on behalf of an issuer to certain defined parties, including brokers, dealers, investment advisers, institutional investment managers, investment companies, certain persons associated with the foregoing and holders of the issuer's securities (each a "Covered Recipient"), also must be made available to the public.<sup>33</sup>

Following the effectiveness of the Act, if a rating agency were deemed to be a Covered Recipient, then Regulation FD could apply to information that rating agency receives from the issuer. In addition, a Regulation FD obligation may be triggered if a rating agency were deemed to be acting as an agent of the issuer and further deemed to have disclosed nonpublic issuer information to a Covered Recipient on the issuer's behalf.<sup>34</sup> However, the public disclosure of the information would not be required in either of these circumstances if another exemption to Regulation FD applies.

Notably, the Act does not modify the exemption that permits nonpublic information to be shared with a person who agrees to maintain the information in confidence.<sup>35</sup> An open question is whether such contractual protections will be effective in light of the Act's increased disclosure requirements related to credit ratings and the credit rating process or, in the case of certain structured finance products, where disclosure of nonpublic information to other rating agencies is required by Rule 17g-5(a)(3). In light of the removal of the blanket Regulation FD exemption, issuers and underwriters seeking to avoid a Regulation FD disclosure requirement will need to carefully evaluate whether an exemption from Regulation FD applies prior to furnishing sensitive information to a rating agency.

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<sup>29</sup>Act § 939.

<sup>30</sup>Act § 939A.

<sup>31</sup>Selective Disclosure and Insider Trading (SEC Release 33-7881) (Modified August 21, 2009).

<sup>32</sup>Act § 939B.

<sup>33</sup>17 C.F.R. § 243.100(b).

<sup>34</sup>See 17 C.F.R. § 243.101(c).

<sup>35</sup>17 C.F.R. § 243.100(b)(2)(ii).

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### **Additional Studies of Credit Rating Process**

The Act requires the SEC and the Comptroller General of the United States to undertake studies related to rating agencies and the credit rating process to facilitate future rulemaking. The SEC is required to conduct studies on conflicts of interest and standardizing credit rating terminology and the market stress conditions under which credit ratings are evaluated.<sup>36</sup> The Comptroller General is required to conduct studies on alternative means for compensating rating agencies and the creation of an independent professional organization for credit rating analysts.<sup>37</sup>

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The Act requires rating agencies to implement significant changes in their business practices. Heightened corporate governance standards, new policies and procedures related to the credit rating process, and the potential for fines, penalties and increased private litigation are intended to increase the transparency and integrity of the rating process. However, at least in the near term, these reforms can be expected to increase the amount of time and the volume of information required to obtain credit ratings, possibly increasing the amount time needed to bring a securities offering to market. In addition, the reforms will most likely result in higher fees charged by rating agencies to compensate them for incremental administrative, compliance and operating costs and increased exposure to third-party claims.

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<sup>36</sup>Act §§ 939(h) & 939C.

<sup>37</sup>Act §§ 939D & 939E.

the 1990s, the number of people with a mental health problem has increased in the UK (Mental Health Act 1983, 1990).

There is a growing awareness of the need to improve the lives of people with mental health problems. The Department of Health (1999) has set out a vision of a new mental health system, which will be based on the following principles:

- (i) People with mental health problems should be treated as individuals, with their own needs and wishes.
- (ii) People with mental health problems should be given the opportunity to participate in decisions about their care and treatment.
- (iii) People with mental health problems should be given the opportunity to live in their own homes and communities.

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# Investor Protection and SEC Enforcement

(This is a summary of this topic. For more in-depth information, see “[Investor Protection and SEC Enforcement: New Authority and Directed Studies Increase Risks and Costs for Firms.](#)”)

Various provisions of the Dodd-Frank Act are intended to enhance investor protection by strengthening the SEC’s enforcement program and adding to its regulatory authority. On several difficult questions, the Act deferred decision but mandated further study and regulation, suggesting that the Act may be only the opening salvo in a sustained period of regulatory change. Given the significance of some of those questions, it will be vital for affected firms to participate effectively in that regulatory debate to assure the outcomes are workable and reasonable. Overall, while many of the immediate changes are incremental, in the aggregate they represent a renewed commitment to the SEC as regulator of the securities market, and are likely to increase the volume and pace of enforcement activity and add to firms’ compliance and litigation risks and costs.

## Aggressively Expanded SEC Whistleblower Bounty Program

In what may prove to be the provision that has the biggest immediate impact on the SEC’s enforcement program, the Act provides the SEC with new authority to pay large cash bounties to persons who provide original information that leads to a successful SEC enforcement action. The SEC is required to award such persons between 10% and 30% of monetary sanctions over \$1 million assessed by the SEC, the DOJ or other regulatory agencies in related enforcement actions. Bounty decisions are subject to limited review in appropriate federal courts of appeal.<sup>1</sup>

The provisions for minimum and maximum awards and judicial review are modeled on a similar whistleblower program of the Internal Revenue Service, which was established in 2006. Experience with the IRS whistleblower program suggests that the proposed SEC bounty program will result in numerous actionable tips.

The whistleblower bounty program dovetails with recent SEC efforts to encourage company insiders and other individuals to cooperate with enforcement investigations. The impact of this sustained effort to increase the flow of enforcement tips from potentially knowledgeable insiders is likely to lead to more investigative activity. Also, it underscores the importance of robust compliance and self-evaluative programs for all entities that are subject to SEC regulation. As a practical matter, it complicates already-difficult judgments by companies regarding whether and when to self-report information to the government. Additionally, whistleblowing by current company employees raises thorny issues for the government regarding the receipt and use of potentially tainted information.

## Enhanced Remedial Authority

The Act grants the SEC many items that have been on the agency’s wish list, including new statutory enforcement authority and provisions that reverse the effect of judicial rulings that had narrowed its authority. Those provisions include the following:

**Penalty Authority in Cease-and-Desist Proceedings.** The Act provides the SEC with new authority to impose monetary penalties in administrative cease-and-desist proceedings against “any person” for violations of the securities laws.<sup>2</sup> This remedy, long sought by the SEC, was previously available administratively only against registered persons.

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<sup>1</sup> Act § 922(a).

<sup>2</sup> Act § 929P(a).

**Restores Collateral Bar Authority.** The Act also restores the SEC’s ability to impose industry-wide “collateral bars,” which prohibit securities professionals found to have violated any aspect of the securities laws from associating with any regulated entity — including broker-dealers, investment advisers, municipal securities dealers, municipal advisers, transfer agents, and statistical rating organizations.<sup>3</sup> The SEC had routinely imposed collateral bars in settled cases until its authority to obtain that remedy was foreclosed by a 1999 judicial decision.

**Clarifies Authority Over Formerly Associated Persons.** The Act provides that the SEC may bring enforcement actions against persons who were associated with regulated entities at the time of alleged wrongdoing, regardless of their current status.<sup>4</sup> That provision clarifies the SEC’s authority in light of at least one administrative decision to the contrary.

**Limits the Impact of the Supreme Court’s *Morrison* Decision on SEC and DOJ Enforcement Efforts in International Fraud Cases.** The Act codifies the ability of the SEC to reach transnational fraud in a way that effectively nullifies the effect of a recent U.S. Supreme Court decision in the context of SEC enforcement actions. In *Morrison v. National Australia Bank*,<sup>5</sup> the Supreme Court held that Section 10(b) of the Exchange Act does not reach manipulative or deceptive conduct that is not related to the purchase or sale of securities in the United States, or securities that are listed on a national exchange. The Act restores the “conduct” and “effects” tests for jurisdiction over transnational securities fraud — tests that the Supreme Court rejected in *Morrison* — in SEC enforcement actions.<sup>6</sup> For now, the Act does not disturb *Morrison* in the context of private securities lawsuits, but the Act does require the SEC to study the possibility of restoring the conduct and effects tests in private actions to enforce the antifraud provisions of the Exchange Act.<sup>7</sup>

**Provides Joint and Several Liability for Control Persons.** The Act clarifies that the SEC may impose joint and several liability against control persons under Section 20(a) of the Exchange Act, resolving a circuit split.<sup>8</sup>

**Clarifies and Extends SEC Authority Against Aiders and Abettors of Violations.** The Act clarifies and expands the SEC’s authority to bring enforcement actions in federal district court against persons who aid and abet violations of the securities laws. The authority to obtain injunctions and civil monetary penalties against aiders and abettors, previously expressly provided in the Exchange Act following the Supreme Court’s 1994 decision in *Central Bank of Denver v. First Interstate Bank of Denver*,<sup>9</sup> is now extended to the Securities Act of 1933, the Investment Advisers Act of 1940, and the Investment Company Act of 1940.<sup>10</sup> Additionally, the Act clarifies that persons may be held liable for aiding and abetting liability if they behave “recklessly,” reversing the effect of judicial decisions holding that only “knowing” conduct constitutes an aiding or abetting violation.<sup>11</sup>

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<sup>3</sup> Act § 925.

<sup>4</sup> Act § 929F.

<sup>5</sup> *Morrison v. Nat’l Australia Bank*, \_\_\_ U.S. \_\_\_, 2010 WL 2518523, at \*14 (June 24, 2010).

<sup>6</sup> Act § 929P(b).

<sup>7</sup> Act § 929Y.

<sup>8</sup> Act § 929P(c).

<sup>9</sup> *Central Bank of Denver v. First International Bank of Denver*, 511 U.S. 164 (1994).

<sup>10</sup> Act §§ 929M & 929N.

<sup>11</sup> Act §§ 929M, 929N & 929O.



**Central Bank and Stoneridge Investment Partners Left Intact as to Private Claims.** For now, the Act does not disturb the holdings of *Central Bank* and *Stoneridge Investment Partners LLC v. Scientific-Atlanta*,<sup>12</sup> cases that restricted securities lawsuits against secondary actors, in the context of private lawsuits. The Act requires the Government Accountability Office (“GAO”) to conduct a study and report to Congress “on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws,” however, raising the possibility that Congress could yet revive these types of claims.<sup>13</sup>

**Nationwide Service of Process of SEC Subpoenas.** The Act provides the SEC with new authority to serve subpoenas anywhere in the United States in the context of federal court enforcement actions.<sup>14</sup> The Act suspends a rule of civil procedure that limits federal courts’ ability to compel documents or testimony from witnesses outside of a certain geographic area.

**Expanded “Bad Boy” Disability.** The Act requires the SEC to adopt rules disqualifying persons who are subject to certain final orders by state securities regulators or state or federal banking regulators, or who have been convicted of a felony or misdemeanor relating to securities or false filings with the SEC, from participating in exempt offerings of securities under Regulation D.<sup>15</sup> Thus, under the Act, enforcement actions by state and federal officials will collaterally limit violators’ ability to raise capital through private placements.

**Clawback of Executive Compensation.** Through a corporate governance reform, the Act seeks to impose a regime of no-fault clawback of executive compensation in the event of a restatement.<sup>16</sup> This provision goes well beyond somewhat similar compensation clawback provisions of Section 304 of the Sarbanes-Oxley Act of 2002. See “Executive Compensation.”

### Budgetary and Management Reforms for the SEC

Although the Act does not provide the SEC with the “self funding” mechanism that the agency requested, it does allocate additional resources to the SEC and institutes a “match funding” program where the SEC will be removed from the competition among all federal programs for general revenues by having its budget funded through filing fees, which will be adjusted to recover the amounts appropriated by Congress.<sup>17</sup> This additional budgetary flexibility may result in additional resources for the agency, particularly in periods of fiscal austerity. To the extent that it does result in additional resources, it will increase the number and complexity of enforcement cases the SEC can bring.

The Act also imposes a variety of management changes and requires additional managerial review, all apparently intended to address concerns of regulatory “capture” of the agency. It also imposes deadlines requiring the SEC to conclude investigations within 180 days of providing a Wells Notice to any person.<sup>18</sup> This period of time may be extended, but only if a senior official in the Enforcement Division approves and informs the Chair of the SEC.<sup>19</sup> The Act imposes similar time limits on compliance examinations. This provision of the Act responds to criticism that the SEC has been slow to close inactive investigations.

<sup>12</sup> *Stoneridge Inv. Partners v. First Interstate Bank of Denver*, 511 U.S. 164 (2008).

<sup>13</sup> Act § 929Z.

<sup>14</sup> Act § 929E.

<sup>15</sup> Act § 926.

<sup>16</sup> Act § 954.

<sup>17</sup> Act §§ 991.

<sup>18</sup> Act § 929U.

<sup>19</sup> *Id.*

### Fiduciary Duty Study and Rulemaking Authority

The Act requires the SEC to study existing standards of care applicable to broker-dealers and investment advisers that provide personalized investment advice to retail customers.<sup>20</sup> The Act also gives the SEC authority to promulgate rules imposing a uniform “fiduciary duty” applicable to the provision of personalized investment advice to retail and other customers by broker-dealers and investment advisers.<sup>21</sup> The SEC is not required to promulgate rules imposing a uniform fiduciary duty for brokers and advisers, but it is likely to do so.

Although the Act gives the SEC authority to impose a uniform standard of care for broker-dealers and investment advisers, it is fair to say that the avoidance of a legislatively created duty marks a victory for the brokerage industry. As originally proposed by Senate Banking Committee Chairman Christopher Dodd, the Act would have eliminated any distinction between broker-dealers, which are not currently subject to a fiduciary duty when they provide incidental investment advice, and investment advisers, which are subject to a fiduciary duty. The House bill would have imposed a statutory fiduciary duty on broker-dealers. Given the existence of widespread support for the outright imposition of a fiduciary duty, the measured study-and-rulemaking approach contained in the Act may have been the best possible outcome for broker-dealers.

In conducting the study mandated by the Act, the SEC will need to examine difficult questions relating to the “harmonization” of duties owed to clients by broker-dealers and investment advisers. The Act, however, resolves some of these difficult questions for the SEC. Under the rulemaking authority provided in the Act, broker-dealers’ receipt of commissions or other standard forms of compensation cannot be deemed to violate the applicable standard of care. Similarly, broker-dealers will not violate any duty if they sell only proprietary or a limited range of products. Broker-dealers will not be subject to continuing duties of care or loyalty after providing personalized investment advice to customers. Finally, customers of broker-dealers and investment advisers will be able to consent to material conflicts of interest if they are adequately disclosed.<sup>22</sup>

### Other Studies and Rulemaking

The Act provides the SEC with new rulemaking authority and mandates that the SEC or the GAO conduct various studies. The result of the rulemaking and studies may well be increased disclosure and regulatory burdens for firms, as well as increased litigation and compliance risks.

**Point-of-Sale Disclosures.** The Act provides the SEC with authority to require specific disclosures prior to the purchase of investment products or services by retail customers.<sup>23</sup> The SEC has previously proposed, but never adopted, required point of sale disclosures in connection with the sale of certain investment products.<sup>24</sup> An unresolved issue from those proposals was whether broker-dealers could

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<sup>20</sup> Act § 913(b).

<sup>21</sup> Act § 913(g).

<sup>22</sup> *Id.*

<sup>23</sup> Act § 919.

<sup>24</sup> See Confirmation Requirements and Point of Sale Disclosure Requirements, Securities Act Release No. 8358; Exchange Act Release No. 49,148, Investment Company Act Release No. 26,341, 69 Fed. Reg. 6438 (proposed Jan. 29, 2004); Point of Sale Disclosure Requirements and Confirmation Requirements, Securities Act Release No. 8544, Exchange Act Release No. 51,274, Investment Company Act Release No. 26,778, 70 Fed. Reg. 10521 (proposed Feb. 28, 2005).

satisfy point-of-sale disclosure requirements through Internet communications. The proposed rules also would have imposed significant burdens on broker-dealers, such as a requirement that broker-dealers provide individualized disclosures regarding costs and fees based on individuals' anticipated investment amounts. The Act increases the likelihood that the SEC will finalize point-of-sale disclosure rules.

**Access to Registration Information.** The Act also requires the SEC to study ways to improve investors' access to information that broker-dealers and investment advisers must provide when they register with the SEC.<sup>25</sup> Following the study, the SEC must implement any resulting recommendations.<sup>26</sup> Currently, the public may access some registration information for broker-dealers on FINRA's BrokerCheck website, and for investment advisers on the SEC's Investment Adviser Public Disclosure website. The proposed study and rulemaking increase the likelihood that both broker-dealers and investment advisers will be required to disclose more information.

**Mutual Fund Advertisements.** The Act requires the GAO to study mutual fund marketing.<sup>27</sup> The study will focus on, among other things, the use of past performance data in mutual fund advertisements. The GAO must make recommendations to improve mutual fund ads in a report to the Senate Banking and House Financial Services Committees.<sup>28</sup> Although mutual fund advertising is already subject to a panoply of regulation, the study may presage greater restrictions, or even an outright ban on the use of performance data.

**Analyst Conflicts of Interest.** The Act requires the GAO to study potential conflicts of interest between investment banks and their in-house research analysts.<sup>29</sup> Among other things, the Act requires the GAO to consider whether to codify undertakings imposed on 12 investment banks in connection with a 2003 global settlement of enforcement actions by the SEC and New York Attorney General Eliot Spitzer. That settlement imposed significant obligations and limitations on the settling firms, certain of which have been addressed subsequently by regulation, and others of which, in light of experience, have proven to be less useful. The settlement resulted in a regulatory regime that is bifurcated between firms that are subject to the settlement and firms that are not. The study required by the Act may provide an opportunity for thoughtful reconsideration of the existing regulatory regime and elimination of unnecessary settlement provisions. On the other hand, the study also could result in recommendations that burdensome settlement provisions be codified in law or regulation.

**Investment Adviser Examinations.** The Act requires the SEC to study "the need for enhanced examination and enforcement resources for investment advisers," to report to the Senate Banking and House Financial Services Committees within six months, and to use the study as a basis for revising applicable SEC rules.<sup>30</sup> The mandated study addresses a perception that investment advisers face less frequent and rigorous oversight than broker-dealers. The study could result in increased oversight and, more importantly, the designation of a self-regulatory organization ("SRO") for investment advisers. **See "Private Fund Investment Advisers."**

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<sup>25</sup> Act § 919B(a).

<sup>26</sup> Act § 919B(b).

<sup>27</sup> Act § 918(a).

<sup>28</sup> Act § 918(b).

<sup>29</sup> Act § 919A.

<sup>30</sup> Act § 914.

### Short Sale and Anti-Manipulation Reforms

The Act regulates short selling in three important ways. First, the SEC must promulgate rules mandating that institutional investment managers disclose information relating to short positions.<sup>31</sup> Second, the Act prohibits “manipulative” short sales.<sup>32</sup> Third, the Act requires registered broker-dealers to notify customers that they may choose not to allow their securities to be lent in connection with short sales, and if a broker-dealer does lend a customer’s securities to effect a short sale, it must notify the customer that it may receive compensation.<sup>33</sup> The Act also expands the applicability of certain anti-manipulation and short sale provisions under the Exchange Act.<sup>34</sup>

### Authority to Restrict or Prohibit Mandatory Arbitration

The Act permits the SEC to restrict or prohibit mandatory arbitration clauses in contracts between broker-dealers or investment advisers and their customers.<sup>35</sup> Mandatory arbitration has been the norm in the securities industry since *Shearson/American Express v. McMahon*,<sup>36</sup> a 1987 Supreme Court decision in which the Court enforced an arbitration clause in a contract between a broker and its customer. Since *Shearson*, some observers have asserted that securities arbitration — most of which takes place in forums sponsored by the FINRA — is biased in favor of the securities industry. Others have argued that evidence does not support this conclusion, and that mandatory arbitration benefits investors by providing an inexpensive and reliable forum for adjudicating claims. The Act tasks the SEC with resolving this long-running debate. If the SEC prohibits mandatory arbitration or permits investors to choose between arbitration and litigation, litigation costs and risks will increase.

### Recordkeeping, Confidentiality, and Access to Foreign Accounting Firms’ Work Papers

Four provisions of the Act likely will permit the SEC to collect information that it otherwise would not have obtained, potentially enhancing the SEC’s regulatory oversight and enforcement capabilities. First, the Act expands recordkeeping and examination requirements for persons with custody over assets belonging to a registered investment company or the client of an investment adviser.<sup>37</sup> Second, the Act provides that the SEC shall not be compelled to disclose certain records and information provided by regulated entities pursuant to a Freedom of Information Act request.<sup>38</sup> Third, the Act permits the SEC to share privileged information with other federal, state, and foreign regulatory and law enforcement agencies, the Public Company Accounting Oversight Board (“PCAOB”), and SROs without waiving applicable privileges, and conversely provides that those entities will not be deemed to have waived applicable privileges by sharing information with the SEC.<sup>39</sup> Fourth, the Act provides the SEC and the PCAOB with new authority to compel production of certain work papers from foreign accounting firms and foreign affiliates of domestic accounting firms.<sup>40</sup>

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<sup>31</sup> Act § 929X(a).

<sup>32</sup> Act § 929X(b).

<sup>33</sup> Act § 929X(c).

<sup>34</sup> See Act § 929L.

<sup>35</sup> Act § 921.

<sup>36</sup> See *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987)

<sup>37</sup> Act § 929Q.

<sup>38</sup> Act § 929I.

<sup>39</sup> Act § 929K.

<sup>40</sup> Act § 929J.

## New Entities Within SEC

The Act creates three new entities within the SEC. These entities appear designed to institutionalize a retail investor focus in agency decision making, as a means to counteract perceived “agency capture” at the SEC. These new entities may become effective advocates for regulatory change that will be burdensome to affected firms.

**Office of the Investor Advocate.** The Act creates an Office of the Investor Advocate. The Investor Advocate will be appointed by and report directly to the Chairman of the SEC. The Investor Advocate will assist retail investors in resolving significant problems with the SEC or SROs, identify areas in which retail investors would benefit from regulatory changes, identify problems experienced by retail investors, and analyze the impact of proposed rules and regulations. To fulfill his or her statutory function, the Investor Advocate will have access to confidential SEC and SRO documents.<sup>41</sup>

**Investor Advisory Committee.** The Act creates an Investor Advisory Committee consisting of the Investor Advocate, a representative of the state securities regulators, a representative of the interests of senior citizens, and 10 to 20 SEC-appointed members representing individual and institutional investors. The Committee will advise and consult with the SEC regarding regulatory priorities and other issues relating to securities regulation. The SEC will be required to respond to findings and recommendations by both the Investor Advocate and the Investor Advisory Committee.<sup>42</sup>

**Ombudsman.** The Act creates an Ombudsman, who will be appointed by and report to the Investor Advocate. The Ombudsman will liaise between retail investors and the SEC to assist retail investors who experience problems with the SEC or with an SRO. The Ombudsman also will review procedures for presenting compliance questions to the Investor Advocate and establish safeguards to protect the confidentiality of investors submitting these types of questions.<sup>43</sup>

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<sup>41</sup> Act § 915.

<sup>42</sup> Act § 911.

<sup>43</sup> Act § 919D.

the 1990s, the number of people in the Netherlands who are in need of social security has increased. In 1990, 1.5 million people were in need of social security, while in 1998, 2.2 million people were in need of social security.

As a result of the increase in the number of people in need of social security, the amount of social security payments has increased. In 1990, the amount of social security payments was 10.5 billion guilders, while in 1998, the amount of social security payments was 15.5 billion guilders. The amount of social security payments is expected to increase further in the future.

The increase in the number of people in need of social security and the amount of social security payments is a result of the demographic changes in the Netherlands.

The demographic changes in the Netherlands are the result of the increase in life expectancy and the decrease in the birth rate. The increase in life expectancy is a result of the decrease in mortality and the increase in the number of years lived in good health. The decrease in the birth rate is a result of the decrease in the number of children born to women.

The demographic changes in the Netherlands are a result of the changes in the social and economic environment. The changes in the social and economic environment are the result of the changes in the values and attitudes of the Dutch population.

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# Corporate Governance

Together with the say-on-pay and other executive compensation provisions of the Dodd-Frank Act,<sup>1</sup> the corporate governance provisions would continue the shift away from the board-centric model of corporate governance — which has been the accepted U.S. model — toward a more shareholder-centric model. The Act would authorize the SEC to adopt a “proxy access” system that is likely to heighten the pressure on boards to focus on the short term and increase the number of director election contests.<sup>2</sup> An important change from earlier versions of the Act, however, is that it does not mandate a majority voting standard for uncontested director elections.

The Act authorizes the SEC to adopt proxy access — a system in which shareholders may include their own nominees for election to the board of directors in a company’s proxy statement and proxy card.<sup>3</sup> The SEC’s proposed rules on the subject have been pending for over a year and advocates for and against proxy access remain deeply divided. The SEC is expected to finalize its proxy access rules promptly after the Act is enacted.

The proxy access provisions of the Act will accelerate the trend towards annual director elections becoming more contested. The Act also will provide activist investors with increased leverage to pressure companies to take short-term-focused actions rather than allow boards to focus on the long term. Moreover, the prospect of regular director election contests may deter qualified directors from continuing to serve on boards of public companies.

One likely outcome is that public companies will need to increase and enhance their engagement with shareholders — which, at many institutional investors, will involve both the personnel responsible for investment decisions and the personnel responsible for proxy voting decisions. Because many institutional investors effectively outsource the proxy voting decision making — either literally or by following the voting recommendations of proxy advisory firms — this need for further engagement will present challenges for some public companies.

Another likely outcome is the increased influence of proxy advisory firms. Although additional SEC regulation of proxy advisory firms may be coming, the timing and substance of such regulation is uncertain and cannot change the underlying reality that many institutional investors do not have the internal capacity to make voting decisions with respect to all of the public companies in their portfolios. As such, they will turn to proxy advisory firms for advice, and the voting policies of those firms — even if flawed by imposing one-size-fits-all models of corporate governance for all companies — will be ignored by companies at great (and increasing) peril.

Nevertheless, engagement of companies with their shareholders will continue to emerge as a necessary element of the public company landscape — with companies and boards compelled to explain why they took actions that may have proven unpopular with investors and to justify why incumbent directors should continue in their roles as fiduciaries on behalf of shareholders.

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<sup>1</sup> See “[Executive Compensation](#).”

<sup>2</sup> Act § 971.

<sup>3</sup> In addition, the Act would require annual proxy disclosure of the reasons why the company has the same person or different persons serving as the chairman of the board and the chief executive officer. Act § 972. The SEC already has adopted rules requiring essentially this disclosure.





# Executive Compensation

The Dodd-Frank Act requires enhanced disclosure of executive compensation matters; imposes certain substantive requirements on public companies, such as requirements for nonbinding shareholder votes on executive compensation programs (“say-on-pay”); mandates the independence of compensation committee members; requires “clawbacks” of certain incentive compensation; and prohibits any incentive compensation arrangement by bank holding companies and certain other financial institutions that “encourages inappropriate risks.” As discussed in more detail below, these executive compensation provisions will compel public companies to adopt new approaches to both the disclosure and substance of their compensation practices.<sup>1</sup>

## Enhanced Disclosure Requirements May Affect Compensation Behavior

The Act contains a number of provisions that require additional executive compensation-related disclosures by public companies. Consistent with prior enhancements to executive compensation disclosure rules (such as the SEC’s recent series of changes to the executive compensation disclosure required in proxy statements),<sup>2</sup> these rules appear to be designed as much to influence behavior as they are to elicit information.

**Relationship Between Compensation and Performance.** The Act requires disclosure of the relationship between executive compensation and financial performance.<sup>3</sup> The Act directs the SEC to promulgate rules requiring issuers to describe the relationship between executive compensation actually paid and company financial performance, taking into account any change in the value of its shares and dividends and other distributions. While the details of the disclosure await SEC rulemaking, the Act encourages the SEC to require this disclosure to be represented in a graph. In light of the existing (and comprehensive) executive compensation disclosure rules and the public availability of financial performance information, it appears that this disclosure is intended, at least in part, to encourage issuers to moderate the amount of compensation provided to executives, especially in circumstances where increases in compensation have not been matched by the issuer’s financial performance. This represents something of a revival of the company stock performance graph required in proxy compensation disclosure prior to the 2006 revision of the proxy compensation disclosure rules.

**Relationship of CEO Compensation to Employee Compensation.** The Act directs the SEC to require issuers to disclose:

- the annual total compensation of the issuer’s CEO;
- the median annual total compensation of all of the issuer’s other employees; and
- the ratio of the median employee compensation to the compensation of the CEO.<sup>4</sup>

In the past, labor groups have pointed to the growing disparity between CEO compensation and that of rank-and-file employees as evidence of the unfairness of the executive compensation practices of certain

<sup>1</sup> See “Corporate Governance” for a discussion of additional substantive and disclosure requirements applicable to public companies under the Act.

<sup>2</sup> See SEC Release Nos. 33-9089 & 34-61175, available at <http://www.sec.gov/rules/final/2009/33-9089.pdf> (last accessed July 3, 2010).

<sup>3</sup> Act § 953(a) (to be codified at 15 U.S.C. 78n(i)).

<sup>4</sup> Act § 953(b)(1) (to be codified at 17 C.F.R. § 229.402 (2010)).

issuers. The inclusion of this disclosure requirement in the Act may indicate Congressional sympathy for this position, and also may have been intended to moderate executive compensation. The disclosure requirement does not address the relationship between CEO compensation and that of other executive officers, although that relationship (rather than the relationship between CEO and rank-and-file pay) has been viewed as important by many compensation professionals. For purposes of this requirement, “total compensation” is determined in the same manner as it is determined for executive officers under the existing executive compensation disclosure rules. Unless the SEC provides by regulation a more practical methodology, issuers will need to consider how to compile the compensation data on all employees necessary to fulfill this disclosure requirement.

**Hedging.** The Act requires issuers to include in their proxy disclosure a discussion of any hedging in which the issuer’s employees or directors may engage with respect to the issuer’s equity securities.<sup>5</sup> Prior to the Act, SEC disclosure rules suggested that it might be appropriate to include such a discussion relating to the company’s executive officers in the company’s compensation discussion and analysis. This new requirement makes the disclosure mandatory and expands the class of covered persons. Its inclusion in the Act may reflect a legislative view that existing practices with respect to hedging requirements are insufficient and need to be enhanced. In any event, issuers who cite stock ownership requirements as a factor that mitigates the risk incentivized by their compensation programs may wish to reconsider the strength of that argument if anti-hedging policies are not in place.

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

The Act requires that, at a company’s first annual or other shareholder meeting (for which executive compensation disclosure is required by the proxy rules to be included in the proxy statement) occurring after the six-month anniversary of the Act becoming law, shareholders will be given two separate votes.<sup>6</sup> The first is a non-binding vote to approve the compensation of executive officers as disclosed in the proxy statement. The second is a vote on whether future non-binding shareholder votes on executive compensation should take place every one, two or three years. The Act will require companies to hold a shareholder vote on the frequency of say-on-pay votes — *i.e.*, whether say-on-pay votes should occur every one, two or three years — at least once every six years.

The Act also requires that, for any shareholder meeting occurring after the six-month anniversary of the Act becoming law at which shareholders are being asked to approve an acquisition, merger, consolidation or sale or other disposition of all or substantially all of the assets of a company, the company is required to:

- include proxy disclosure in a “clear and simple form,” in accordance with rules to be adopted by the SEC, describing any agreements or understandings that the company or the other party to the transaction has with any of the company’s named executive officers concerning any type of compensation that is based on, or otherwise relates to, the transaction and the aggregate total of all such compensation that may be paid or become payable to the named executive officers; and
- provide shareholders with a separate non-binding vote to approve those merger-related compensation agreements or understandings, unless those agreements or understandings previously have been the subject of an annual meeting say-on-pay vote.<sup>7</sup>

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<sup>5</sup> Act § 955 (to be codified at 15 U.S.C. 78n(j)).

<sup>6</sup> Act § 951 (to be codified at 15 U.S.C. 78n).

<sup>7</sup> *Id.*

Finally, the Act also requires that institutional investment managers that file Form 13F (*i.e.*, investment managers exercising investment discretion over \$100 million or more of U.S. public company equity and certain other securities) disclose at least annually how they voted on say-on-pay votes (including merger-related say-on-pay votes) with respect to the companies in which they hold shares. It remains to be seen whether this additional disclosure will have any impact on the voting decisions of these institutional investment managers.

These requirements represent the culmination of a long-standing executive compensation initiative. Such shareholder votes have been advocated by commentators for some time and are currently required by law for TARP recipients. A number of public corporations voluntarily included say-on-pay proposals in their annual proxies prior to the enactment of the Act. These shareholder votes have been viewed as something of a blunt instrument. Because the vote is on the issuer's executive compensation practices generally, it may be difficult to identify with precision what aspects of a program account for shareholder approval or disapproval of it. For example, the recent disapproval by Motorola's shareholders of its compensation practices (pursuant to a vote voluntarily included in Motorola's 2010 proxy) has been variously attributed to the magnitude of such executive compensation and to the lack of changes to that program following a prior vote where approval was attained only by a small margin.

Issuers also can anticipate that, although the required vote will be non-binding as a legal matter, a disapproval may still have substantive consequences. Institutional shareholders and shareholder advocates may well choose to use a company's perceived non-responsiveness to a disapproval as a factor in determining their votes on other matters, such as approval of equity compensation plans or on the election of compensation committee members or board members generally. The combination of these factors may drive issuers to, at a minimum, eliminate the "low hanging fruit" when it comes to executive compensation practices, such as tax gross-ups and executive perquisites.

### Other Themes of Executive Compensation Provisions

**Compensation Committee Independence.** The Act directs national securities exchanges to require compensation committee members to be "independent" of the issuer.<sup>8</sup> In determining the definition of "independence," national securities exchanges are directed to consider:

- the source of compensation of a director, including any consulting, advisory or other compensatory fee paid by the company to the director; and
- whether the director is affiliated with the company, a subsidiary of the company or an affiliate of any subsidiary.

Since the definition of independence is not specified in the Act, the practical effect of this requirement is uncertain. Many (and probably most) publicly traded companies already have compensation committees composed of directors who are independent, based on rules already in place for the purposes of Internal Revenue Code Section 162(m) and Exchange Act Section 16.

**Independence of Committee Advisers.** A related provision requires compensation committees, prior to retaining compensation consultants, lawyers or other advisers, to take into account factors which may affect the independence of such advisers, such as: whether the proposed adviser provides other

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<sup>8</sup> Act § 952 (to be codified at 15 U.S.C. 78 *et seq.*).

services to the issuer; the amount of fees received in respect of such services; the policies and procedures of the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest; any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee; and any stock of the company owned by the compensation consultant, legal counsel or other adviser.<sup>9</sup> This focus on potential conflicts of interest of compensation committee advisers follows closely on the SEC's most recent revision of the executive compensation disclosure rules, which now require disclosure of scenarios that may be viewed as resulting in conflicts of interest for compensation consultants retained by compensation committees. Although it is unclear from the text of the bill, it is likely that compensation committees will be required to gather information regarding potential conflicts even from long-time advisers in order to comply with the rule.

**Clawbacks.** The Act further requires the SEC to direct national securities exchanges to prohibit the listing of equity security of issuers that do not adopt "clawback" policies to recoup incentive compensation payments made to current or certain former executive officers based on erroneous data, if the issuer is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws.<sup>10</sup> The amount that must be recouped would be the excess over the amount that would have been paid had the data been presented correctly. This concept of a clawback (which was first contained in the Sarbanes-Oxley Act of 2002<sup>11</sup>) has been popular with commentators and already has been adopted by many public companies; for such issuers, the impact may be limited to conforming their policies to the final version of this rule, which is broader in several respects than the clawback provision in Sarbanes-Oxley.

### **Prohibition on Certain Compensation Practices at Covered Financial Institutions**

The Act requires the "appropriate Federal regulators" of bank holding companies and other "covered financial institutions" to prohibit any incentive-based compensation arrangement that the regulators determine (i) encourages inappropriate risks by covered financial institutions by providing "excessive compensation" to any executive officer, employee, director or principal shareholder of a covered financial institution, or (ii) could lead to material financial loss to the covered financial institution.<sup>12</sup> "Covered financial institutions" includes bank holding companies, registered broker-dealers, insured credit unions, investment advisers and any other financial institution that the appropriate federal regulators jointly determine should be treated as a covered financial institution. "Appropriate federal regulators" are the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC and the Federal Housing Finance Agency. The prohibition on compensation plans which could lead to material financial losses appears similar to the TARP prohibition on compensation programs that encourages senior executives to take unnecessary and excessive risks that threaten the value of the financial institution. It remains to be seen, however, whether the required prohibition on arrangements that provide excessive compensation will, in the rule ultimately promulgated by the regulators, effectively give rise to a cap on compensation.

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<sup>9</sup> *Id.*

<sup>10</sup> Act § 954 (to be codified at 15 U.S.C. 78 *et seq.*).

<sup>11</sup> Sarbanes-Oxley Act § 304 (codified at 15 U.S.C. 7243 (2006)).

<sup>12</sup> Act § 956 (to be codified at 12 U.S.C. 1844).

### **Elimination of Broker Discretionary Vote**

The Act also contains provisions which will prohibit broker discretionary voting with respect to the election of directors and executive compensation matters, and permits the SEC to prohibit such discretionary voting in respect of “any other significant matter” as the SEC may determine.<sup>13</sup>

\* \* \*

Many of the compensation-related rules in the Act do not contain sufficient detail to permit a full appreciation of their impact at this stage. For example, the prohibition on excessive compensation at covered financial institutions, the pay-versus-performance disclosure, and the clawback requirements are all formulated as directions to the SEC or other federal regulators to engage in rulemaking. The substance and true import of these provisions will only become apparent once these rules have been issued.

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<sup>13</sup> Act § 957 (to be codified at 15 U.S.C. 78f(b)).

the 1990s, the number of people with a mental health problem has increased in the UK (Mental Health Act 1983, 1990).

There is a growing awareness of the need to improve the lives of people with mental health problems. The UK Government has set out a strategy for mental health care (Department of Health 1999). The strategy is based on the following principles:

- (i) People with mental health problems should be treated as individuals.
- (ii) People with mental health problems should be given the opportunity to participate in decisions about their care.
- (iii) People with mental health problems should be given the opportunity to live in their own homes.

The strategy also states that people with mental health problems should be given the opportunity to live in their own homes.

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# Consumer Protection Provisions

(This is a summary of this topic. For more in-depth information, see “[Consumer Protection Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act.](#)”)

The Dodd-Frank Act brings sweeping changes to the current system of regulating consumer financial products and services. Title X of the Act, the Consumer Financial Protection Act of 2010, creates a new regulator, the Bureau of Consumer Financial Protection, with broad rulemaking and enforcement authority and the mandate to prevent “abusive” financial practices; enhances the ability of states to oversee federally chartered institutions; and imposes a number of enhanced data collection and reporting requirements. Title XIV of the Act, the Mortgage Reform and Anti-Predatory Lending Act, prohibits or restricts many previously common mortgage lending practices, limits a lender’s ability to compensate loan officers and brokers, and imposes new mandatory underwriting standards. These changes are likely to have significant short- and long-term effects on the consumer financial services industry.

## Key Provisions of Titles X and XIV

**Bureau of Consumer Financial Protection.** The Act creates the Bureau within the Federal Reserve dedicated to monitoring and enforcing federal consumer financial protection laws. The Bureau will be headed by a director appointed by the President to a five-year term, subject to Senate confirmation. The Bureau will have separate offices for Fair Lending and Equal Opportunity, Financial Education and Service Member Affairs, as well as separate units for Research, Community Affairs and Complaints. Although housed in the Federal Reserve, the Act has provisions aimed at guaranteeing its operational independence from the Board of Governors.<sup>1</sup>

The Act provides the Bureau with significant power and responsibility.

- The Act transfers rule-making, investigation and enforcement authority with respect to a number of enumerated federal consumer financial protection statutes to the Bureau.<sup>2</sup>
- The Bureau will exercise supervision, examination and enforcement authority over all insured depository institutions with assets in excess of \$10 billion, all non-depository institutions that broker, originate or service mortgage loans, and any “larger participant” in the market for other consumer financial services.<sup>3</sup>
- The Bureau shall appear semiannually before the relevant Senate and House committees and shall file reports concurrent with these appearances that detail its activities and findings.<sup>4</sup>
- The Act exempts some individuals and institutions from the Bureau’s authority, including attorneys, accountants, real estate brokers, tax preparers, insurance companies and merchants not significantly engaged in the consumer financial services business.<sup>5</sup> Most auto-related consumer finance activities undertaken by auto dealers are also exempted.<sup>6</sup>

<sup>1</sup> See Act §§ 1011 & 1012.

<sup>2</sup> Act §§ 1002(12) & 1022.

<sup>3</sup> Act §§ 1024-1026.

<sup>4</sup> Act § 1016.

<sup>5</sup> Act § 1027.

<sup>6</sup> Act § 1029.

**State law and authority.** The Act enhances the role of states in the regulation of federally chartered institutions and clarifies federal preemption of state laws. The Act authorizes states to bring actions against all institutions, including federally chartered banks, to enforce regulations issued under the Act.<sup>7</sup> Furthermore, state consumer financial protection laws will be preempted against federally chartered banks only under certain enumerated circumstances. The Act also eliminates preemption for subsidiaries of federally chartered banks, and thus supersedes current regulations from the Office of the Comptroller of the Currency and recent Supreme Court precedent.

**Ban on abusive acts and practices.** The Act gives the Bureau authority to prevent covered institutions from engaging in unfair, deceptive or abusive acts or practices in the provision of consumer financial products and services.<sup>8</sup>

**Enhanced data reporting for fair lending enforcement.** The Act significantly increases data gathering requirements on mortgage loans under the Home Mortgage Disclosure Act.<sup>9</sup> Among other things, the Act requires lenders to collect and report borrower credit scores, collateral value, origination channel, pricing and fee data, and borrower age.

**National underwriting standards and prohibited loan terms and practices.** The Act mandates that lenders shall verify a mortgage borrower's ability to repay the loan, and requires the lender to consider certain factors, such as credit score, income and debt-to-income ratio, in making that decision.<sup>10</sup> A violation of the "ability to repay" standard (and certain other provisions) may be raised as a foreclosure defense by a borrower against a creditor or assignee without regard to any statute of limitations. The Act bans the payment of yield spread premiums or other originator compensation that is based on the interest rate or other terms of the loans.<sup>11</sup> The Act bans certain loan provisions, including prepayment penalties on certain types of loans.<sup>12</sup> The Act also bans mandatory arbitration provisions on all mortgage loans and mandates further study to determine whether to expand such a ban to all consumer products.<sup>13</sup> Finally, the Act amends the Truth in Lending Act ("TILA") to authorize the Board of Governors to ban "abusive or unfair lending practices that promote disparities among consumers of equal creditworthiness but of different race, ethnicity, gender, or age."<sup>14</sup>

**Qualified mortgage safe harbor.** The Act creates a safe harbor from certain of its provisions for "qualified mortgages," which it defines as mortgage loans meeting several criteria, including "points and fees" as defined by the Act being less than 3% of the loan amount.<sup>15</sup> Among other things, a creditor or assignee may presume that a qualified mortgage has met the "reasonable ability to repay" requirements in the Act.

**Reduced high-cost loan threshold.** The Act reduces the pricing threshold for a loan to qualify as a "high cost" loan subject to the restrictions in the Home Ownership and Equity Protection Act, and expands the definition of "points of fees" for calculating that threshold.<sup>16</sup>

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<sup>7</sup> Act § 1042(a).

<sup>8</sup> Act § 1031.

<sup>9</sup> Act § 1094.

<sup>10</sup> Act § 1411.

<sup>11</sup> Act § 1403.

<sup>12</sup> Act § 1414.

<sup>13</sup> Act §§ 1028 & 1414.

<sup>14</sup> Act § 1403.

<sup>15</sup> Act § 1412.

<sup>16</sup> Act § 1431.



**Enhanced disclosures and consumer counseling.** The Act directs the Bureau to propose a new joint RESPA/TILA disclosure statement and requires new TILA disclosures on monthly mortgage statements and mandates that notice be given regarding mortgage features such as negative amortization and prior to an initial ARM rate reset.<sup>17</sup> The Act establishes an office within HUD aimed solely at developing and funding consumer counseling programs, and requires the HUD Secretary to certify and make publicly available software programs for consumers to use in evaluating mortgage proposals.<sup>18</sup>

**New servicing mandates and enhanced modification transparency.** The Act amends TILA and the Real Estate Settlement Procedures Act (“RESPA”) to set forth circumstances in which creditors must establish escrow accounts for payment of insurance and taxes on certain mortgage loans, as well as defining when servicers may obtain force-placed hazard insurance for borrowers.<sup>19</sup> Servicers also are prohibited from charging certain fees, are required to be responsive to borrowers in certain circumstances, and must credit borrowers’ accounts in a timely manner for payments received.<sup>20</sup> Also, the Act has several provisions designed to enhance transparency in the Administration’s Home Affordable Modification Program, by providing additional information to borrowers whose applications seeking modification are denied and by requiring that certain information regarding eligibility criteria and calculations and servicer performance be posted online.<sup>21</sup>

### Implications of the Act

The Act changes many of the “rules of the road” that govern the relationship between providers and purchasers of consumer financial products while also installing a new traffic cop to enforce the rules and write new ones. The creation of a new and powerful federal bureaucracy with no mandate other than consumer financial protection will have an immediate and long-lasting impact on financial institutions, which can expect increased compliance and enforcement costs.

The law reflects a public policy shift from a “disclosure” regime towards a more paternalistic, rules-based regime. Several once-common practices, such as yield-spread premiums, mandatory arbitration provisions, prepayment penalties and stated income loan applications are either prohibited or effectively banned by the Act.

In the short term, there is little doubt that the Act will lead to less credit and less diversity of credit products. At the same time, the prohibition of “abusive” acts or practices, without a clear definition as to what constitutes an abusive act or practice, will lead to uncertainty and potential litigation. Greater mandatory loan-level data reporting, the creation of an “Office of Fair Lending and Equal Opportunity,” and the release of mandated fair lending studies will affect fair lending statistical screening practices, and robust internal statistical monitoring by regulators will take on enhanced importance. Also, the expanded role of state authority in the regulation of the financial services industry is likely to lead to more enforcement actions and increases the opportunity for inconsistent interpretations of federal standards.

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<sup>17</sup>Act §§ 1032, 1414, 1418 & 1420.

<sup>18</sup>Act §§ 1442 & 1443.

<sup>19</sup>Act §§ 1461(a) & 1463(a).

<sup>20</sup>Act §§ 1463(a) & 1464(a).

<sup>21</sup>Act § 1482(a)-(c).

While there are several short-term implications for the industry, the full impact of the Act will not be evident for years, as enforcement and supervision authorities are transferred to the Bureau, new regulations are crafted by the Bureau to flesh out the broad and sometimes vague mandates of the Act, and consumers and financial services providers respond, directly or indirectly, to the various mandates and public policy choices reflected in this landmark legislation.

# Payment Card Transactions

Section 1075 of the Dodd-Frank Act amends the Electronic Funds Transfer Act to:

- require that the amount of any interchange transaction fee for a debit transaction be “reasonable and proportional” to the cost incurred by the issuer with respect to the transaction, and directs the Board of Governors to prescribe regulations within nine months of the enactment of the legislation to establish standards for assessing whether such fees are “reasonable and proportional” to the cost incurred by the issuer;
- eliminate exclusive arrangements between issuers and networks for electronic debit transactions; and
- limit restrictions on merchant discounting and minimum or maximum dollar-amount thresholds as a condition for acceptance of credit cards.

This summary provides an overview of the key provisions of Section 1075 of the Act.

## **Interchange Fees for Electronic Debit Transactions and Board of Governors Regulations**

Section 1075 requires that any interchange fees that an issuer or payment card network receives or charges for an electronic debit transaction be “reasonable and proportional” to the actual costs incurred by the issuer. The Board of Governors is directed to enact final rules, within nine months of enactment of the legislation, to establish the standards for assessing whether an interchange fee is “reasonable and proportional.”<sup>1</sup>

The Act directs that, in connection with its duty to issue rules to establish the standard for assessing whether an interchange fee is “reasonable and proportional,” with the sole exception of certain fraud prevention costs, the Board of Governors may not consider any costs that are not specific or incremental to the authorization, clearance and settlement of electronic debit transactions when establishing rules. Accordingly, the legislation establishes incremental, or marginal, costs as the key cost reference point for the Board’s development of the “reasonable and proportional” interchange fee standard. In addition, the Act authorizes the Board of Governors to require that issuers and payment card networks provide it with such information as may be necessary to carry out its “reasonable and proportional” fee-standard rulemaking responsibilities, and requires that the Board of Governors publish summary information biannually concerning costs and interchange transaction fees for debit transactions.

There are several exemptions to the Act’s “reasonable and proportional” price regulation provision. Specifically, small issuers, which are defined as issuers that, together with their affiliates, have assets of less than \$10 billion, are exempted from the price regulation provisions. Similarly, the interchange fee price regulation provision of the Act also does not apply to government-administered payment programs and reloadable prepaid cards.

## **Limitations on Exclusivity Arrangements**

The Act also directs the Board of Governors to issue regulations, within one year of enactment of the legislation, to require that all debit transactions be processed by at least two independent networks. Currently, payment networks and issuers may contract that debit transactions be enabled exclusively

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<sup>1</sup>See Act § 1075(a).

on a single network; the regulations that the Act directs the Board of Governors to issue will prohibit such exclusive arrangements. In addition, those regulations will prohibit issuers and payment networks from inhibiting the merchant's ability to direct the routing of debit transactions over any network enabled to process the transaction.

### **Limitations on Discounting Prohibitions**

The Act also provides that payment card networks may not, directly or indirectly (including through any licensed member of the network), limit a merchant's ability to provide discounts, or other in-kind incentives, for payments by use of cash, checks, debit cards or credit cards. However, in the case of a discount or in-kind incentive for use of a debit or credit card, the differentiation may *not* be on the basis of the issuer or payment network. Payment card networks, therefore, may enact rules that would prohibit inter-network and intra-brand discounting, *i.e.*, rules that would prohibit merchants from offering discounts as a means to incentivize use of a payment card offered by one network or issuer over the use of a card offered by another network or issuer.

In sum, the Act's limitations on discounting prohibitions do not significantly alter the "anti-discrimination" or "no-discounting" rules that currently are common features of some payment card networks.

### **Minimums and Maximums**

The Act also limits the ability of any payment card network or issuer to prohibit a merchant from conditioning acceptance of credit cards on a minimum, or maximum, transaction value. Specifically, the Act allows merchants to set a *minimum* dollar value (not to exceed \$10) as a condition for acceptance of credit cards, and federal agencies and institutions of higher education may set a *maximum* dollar value for acceptance of credit cards. Such minimums and maximums, however, may not differentiate between issuers or payment card networks.

# Analysis of the Orderly Liquidation Authority, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Title II of the Dodd-Frank Act, titled “Orderly Liquidation Authority,” creates an entirely new insolvency regime for large, interconnected financial companies, including broker-dealers, whose failure poses a significant risk to the financial stability of the United States.<sup>1</sup> Title II provides for federal receivership proceedings of qualifying financial companies, with the FDIC serving as receiver. Any receivership under Title II is subject to exceptionally broad input and control by the FDIC and numerous other government authorities, including the Board of Governors, the Secretary, Congress and the President. The purpose of Title II is to improve financial stability, mitigate risk, end “too big to fail,” and protect taxpayers by “ending bailouts.”<sup>2</sup> It is modeled in part on those provisions of the Federal Deposit Insurance Act (the “FDIA”) regarding insolvencies of federal banks and savings and loans.<sup>3</sup> It also imports numerous provisions from the United States Bankruptcy Code (the “Bankruptcy Code”)<sup>4</sup> and gives significant authority to the government, similar to that afforded to the government in connection with thrift insolvencies and the special conservatorships governing Freddie Mac and Fannie Mae.<sup>5</sup>

This article offers an overview and analysis of Title II and describes the types of entities that may be placed into federal receivership as well as the process for doing so. It also sets forth the basic attributes of the receivership process, including a mechanism by which the FDIC can create a “bridge financial company” — similar to the process by which the FDIC can create a “bridge bank” under the FDIA — to succeed to selected assets and liabilities of the entity in receivership and that can continue operating as a restructured, going concern for the benefit of stakeholders, pending transfer to a private acquirer. Title II contains new and highly particularized provisions governing financial responsibility for a receivership, including who may — and may not — be forced to pay the costs of a receivership. There are also several new provisions governing derivatives agreements and the potential consequences to management found to be responsible for a financial company’s collapse.

As is apparent from the discussion that follows, many of the provisions of the Act and the powers delegated to the FDIC and other government authorities may be draconian when implemented. The right to decide whether to initiate receivership proceedings is vested in government authorities, not in financial companies’ boards and management or financial companies’ stakeholders, and is subject only to very limited judicial review that is highly deferential to such authorities. A bridge financial company can be created, with no stakeholder input, that houses a troubled financial company’s “good” assets, while leaving behind the “bad” assets and liabilities. A financial company or a related bridge financial company can be sold to or merged with a private acquirer without notice, with no stakeholder input, and with limited regard for the consequences to them. The government is forbidden from “bailing out” failing financial companies and, in fact, is empowered to “assess” financial companies for the costs of

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<sup>1</sup> Act § 204(a).

<sup>2</sup> See press release, United States House Committee on Financial Services, Dodd-Frank Wall Street Reform and Consumer Protection Act (June 21, 2010).

<sup>3</sup> 12 U.S.C. §§ 1811 *et seq.*

<sup>4</sup> 11 U.S.C. §§ 101 *et seq.*

<sup>5</sup> Federal Housing Finance Regulatory Reform Act of 2008, Pub. Law 110-289, 122 Stat. 2654 (codified in multiple sections of the United States Code) and the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. §§ 4501 *et seq.*

a receivership. The traditional rights of derivatives counterparties are restricted in several important respects. The Act effectively declares open season on failed financial company directors and management.

Ironically, the potential harshness of the Act ultimately may mean that its most salutary effect will be to minimize the circumstances under which it will, in fact, be used. In particular, the Act's broad provisions and the powers vested in the FDIC collectively may work best when used as a threat to compel a private solution, including private solutions that are largely consensual and that rely on a federal receivership solely for quick implementation — and even private solutions that avoid a federal receivership altogether. Indeed, the Act affirmatively requires the Board of Governors, the Secretary and the FDIC to consider private alternatives in deciding whether to recommend and implement receiverships.<sup>6</sup> These attributes might actually cause the prospect of liquidation to foster more thoughtful, value-additive, private solutions that avoid catastrophic collapses and massive bailouts.

### Entities Subject to the Act: Financial Companies

To afford context to the following discussion regarding the entities that are subject to being placed into federal receivership under the Act, it is important to outline which entities may and may not become the subject of existing insolvency regimes. In the United States today, there are four main categories of insolvency laws: the Bankruptcy Code; the FDIA, which governs insolvency proceedings of banks and savings and loans; state laws concerning the rehabilitation and liquidation of insurance companies; and specialized laws governing the liquidation of brokers and dealers. The Bankruptcy Code is by far the most comprehensive of these four regimes. Almost any business entity can become a debtor under the Bankruptcy Code, where it can either liquidate its assets or attempt to reorganize its affairs pursuant to chapter 7 or chapter 11, respectively.<sup>7</sup>

However, banks, savings and loan associations, insurance companies and numerous other statutorily defined financial entities are specifically excluded from becoming debtors under the Bankruptcy Code.<sup>8</sup> Such entities are subject to their own particularized insolvency regimes, including, as noted above, the FDIA in the case of federally chartered banks and savings and loan associations and state laws in the case of insurance companies. Insolvent brokers and dealers typically are liquidated pursuant to the Securities Investor Protection Act ("SIPA"), although stockbrokers also can be liquidated under the Bankruptcy Code.<sup>9</sup>

The insolvency laws governing banks and saving and loans — more specifically, insured depository institutions and insurance companies — remain virtually unchanged by the Act.<sup>10</sup> Accordingly, insured depository institutions and insurance companies will continue to remain subject to existing insolvency

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<sup>6</sup> Act § 203(a)(2)(E).

<sup>7</sup> See 11 U.S.C. §§ 101(41) (defining the word "person") & 109 (who may be a debtor).

<sup>8</sup> 11 U.S.C. § 109(b)(2).

<sup>9</sup> 11 U.S.C. §§ 741 *et seq.* "Stockbroker" is defined under section 101(53A) of the Bankruptcy Code as an individual, partnership or corporation, with respect to which there is a customer, and that is engaged in the business of effecting transactions in securities either for the account of others or with members of the general public, for such entity's own account.

<sup>10</sup> An insured depository institution is defined under section 3(c) of the FDIA as any bank or savings association the deposits of which are insured by the FDIC pursuant to the FDIA. 12 U.S.C. 1813(c). An insurance company is defined under section 201(a)(13) of the Act as any entity that is engaged in the business of insurance; subject to regulation by a state insurance regulator; and covered by a state law that is designed to specifically deal with the rehabilitation, liquidation or insolvency of an insurance company.

laws and, hence, are not eligible to be placed into federal receivership under the Act.<sup>11</sup> Additionally, federal home loan banks, farm credit institutions, government sponsored enterprises (including Fannie Mae and Freddie Mac, as well as any affiliate of either) and government entities are not eligible to be placed into receivership.<sup>12</sup>

However, certain other business entities that currently may become debtors under the Bankruptcy Code are now subject to being placed into federal receivership under the Act. The Act defines this class of business entities as “financial companies.” The Act breaks down the definition of financial company into four categories. The first category includes “bank holding companies,” as defined in section 2(a) of the BHCA.<sup>13</sup> Under this definition, a bank holding company includes any company that has control over any bank, or over any company that is or becomes a bank holding company by virtue of the BHCA.<sup>14</sup> The term “bank” includes banks, the deposits of which are insured in accordance with the terms of the FDIA, and institutions that accept demand deposits or deposits that the depositor may withdraw by check or similar means and that are engaged in the business of making commercial loans.<sup>15</sup>

The second category of financial company covered by the Act includes nonbank financial companies supervised by the Board of Governors, which in turn includes nonbank financial companies that the Council has determined must be supervised by the Board of Governors.<sup>16</sup> Nonbank financial companies are companies “predominantly engaged in financial activities.”<sup>17</sup> A company satisfies this definition if it and all of its subsidiaries derive either 85% of their annual gross revenues or 85% of their consolidated assets from activities that are “financial in nature” or incidental to a financial activity, or from the ownership or control of one or more insured depository institutions.<sup>18</sup>

Section 4(k) of the BHCA includes an extensive list of activities designated as “financial in nature,” including lending, exchanging or investing money or securities; insuring, guaranteeing or indemnifying against loss, harm, damage, illness and death; providing and issuing annuities; providing financial, investment or economic advisory services; issuing or selling instruments representing pools of assets permissible for a bank to hold directly; and underwriting, dealing in or making a market in securities.<sup>19</sup> The Act authorizes the Council, by a vote of not fewer than two-thirds of the members then serving, including an affirmative vote by the chairperson of the Council, to determine that a nonbank financial

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<sup>11</sup>Act § 203(e)(1). Insurance companies technically are within the scope of the Act. However, if an insurance company or insurance company subsidiary otherwise qualifies under the Act, the liquidation or rehabilitation of such entity will be conducted as provided under state law, not the Act — provided that if the appropriate state agency fails to act within 60 days of a determination of the Secretary that an insurance company would otherwise qualify for receivership, then the FDIC may act in place of such agency and pursue relief under state law. Act §§ 202(b) & 203(e).

<sup>12</sup>Act § 201(a)(11).

<sup>13</sup>Act § 102(a)(1); 12 U.S.C. § 1841(a).

<sup>14</sup>A company “has control over a bank or a company,” pursuant to section 2(a) of the BHCA, if (a) it directly or indirectly has the power to vote 25% or more of any class of voting securities of the bank or company; (b) it controls in any manner the election of a majority of directors or trustees of the bank or company; or (c) the Board of Governors determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company. 12 U.S.C. § 1841(a)(2).

<sup>15</sup>12 U.S.C. § 1841(c)(1)(B).

<sup>16</sup>Act § 102(a)(4).

<sup>17</sup>Act §§ 102(a)(4)(A)(ii) & 102(a)(4)(B)(iii).

<sup>18</sup>Act § 102(a)(6).

<sup>19</sup>12 U.S.C. 1843(k).

company will be supervised by the Board of Governors and subject to heightened prudential standards, if the Council determines that material financial distress at such company would pose a threat to the financial stability of the United States.<sup>20</sup>

The third category of financial company covered by the Act includes subsidiaries of the two foregoing categories of financial companies, other than subsidiaries that are insured depository institutions or insurance companies.<sup>21</sup> Finally, the Act applies to brokers and dealers registered with the SEC that are members of the SIPC. While stockbrokers are eligible to become debtors under the Bankruptcy Code as well, they may only liquidate pursuant to chapter 7; they are ineligible to attempt to reorganize under chapter 11. Moreover, as noted above, brokers and dealers are subject to being liquidated pursuant to their own, highly specialized insolvency regime under SIPA.<sup>22</sup>

### **“Systemic Risk Determination”**

The mere fact that an entity is a financial company does not mean that it is eligible to be placed into federal receivership under the Act. To be eligible, the financial company must constitute a “covered financial company,” a term defined with great particularity in the Act. A covered financial company is a financial company as to which a “systemic risk determination” has been made by the authorities identified in the Act.<sup>23</sup> The process for determining whether the insolvency of a particular financial company presents a systemic risk begins with the recommendations of the FDIC and the Board of Governors, with respect to a covered financial company other than a covered broker or dealer; the SEC and the Board of Governors, with respect to a covered broker or dealer; and the director of the Federal Insurance Office and the Board of Governors, with respect to an insurance company.<sup>24</sup>

On their own initiative, or at the request of the Secretary, the FDIC (or the SEC, in the case of a covered broker or dealer, or the director of the Federal Insurance Office, in the case of an insurance company) and the Board of Governors must make a written recommendation regarding whether a financial company presents systemic risk and, hence, whether the Secretary should appoint the FDIC as receiver. Such recommendation is made upon a vote of not fewer than two-thirds of the then-serving members of the Board of Governors and the board of directors of the FDIC (or in the case of a covered broker or dealer, the members of the SEC then serving, and in consultation with the FDIC, and in the case of an insurance company, the director of the Federal Insurance Office), respectively.

These written recommendations must contain, among other things, an evaluation of whether the financial company is “in default or in danger of default” (a phrase defined below); a description of the effect that the default of the financial company would have on the financial stability of the United States; an evaluation of the likelihood of a private sector alternative to prevent the default; an evaluation of why a bankruptcy case is not appropriate for the financial company; and an evaluation of the effects on creditors, counterparties and shareholders of the financial company and other market participants of a receivership under the Act.<sup>25</sup>

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<sup>20</sup>Act § 113.

<sup>21</sup>Act § 201(a)(11)(iv).

<sup>22</sup>Act § 205.

<sup>23</sup>Act § 203.

<sup>24</sup>Act § 203(a).

<sup>25</sup>Act § 203(a)(2).



Upon receipt of the above-referenced recommendations, the Secretary — in consultation with the President of the United States — must seek appointment of the FDIC as receiver for the covered financial company if the Secretary determines, among other things, that:

- the financial company is in default or in danger of default;
- the default of the financial company would have a serious adverse effect on the financial stability of the United States;
- no viable private sector alternative is available to prevent the default;
- the effect on the claims or interests of creditors, counterparties and shareholders of the financial company and other market participants of proceedings under the Act is appropriate, given the impact that any action under the Act would have on the financial stability of the United States; and
- an orderly liquidation would avoid or mitigate such adverse effects.<sup>26</sup>

Three aspects of the foregoing standards warrant emphasis. First, the phrase “in default or in danger of default” is broadly defined and affords the Board of Governors, the FDIC, the SEC and the Secretary broad discretion. Specifically, a financial company is in default or in danger of default if:

- a bankruptcy case has been, or likely will promptly be, commenced with respect to the financial company;
- the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion;
- the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or
- the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the ordinary course of business.<sup>27</sup>

The definition’s repeated use of the forward-looking phrase “is likely to” gives the government discretion to make necessary judgments as events unfold, rather than after the fact.

Second, no financial company can be placed into receivership without an assessment of whether the Bankruptcy Code already provides an appropriate remedy. This requirement is important, as it forces consideration of alternatives under a longstanding and well-understood insolvency regime that affords a comprehensive mechanism for reorganizing a troubled entity, and that affords creditors and other stakeholders significant input into, and control over, the reorganization process — input and control that does not exist with respect to receiverships under the Act. Third, the Board of Governors, the FDIC and the SEC cannot recommend receivership without considering the viability of private sector alternatives. More

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<sup>26</sup>Act § 203(b). In the case of covered brokers and dealers, the FDIC will serve as receiver, but the SIPC will serve as trustee. Upon appointment as trustee, the SIPC must file an application for a protective decree under SIPA. Assets retained by the broker or dealer and not transferred to a covered financial company must be administered pursuant to SIPA. Act § 205(a).

<sup>27</sup>Act § 203(c)(4).

importantly, the Secretary cannot commence a receivership unless the Secretary has determined that “no viable private sector alternative is available.”<sup>28</sup>

These second and third requirements provide significant, common-sense checks on the federal receivership process envisioned by the Act, and undoubtedly reflect the alternatives the government considered as the country faced crisis after crisis in the fall of 2008. Indeed, most experienced members of the bankruptcy bench and bar agree that a troubled company’s most likely source of rescue is its existing stakeholders — those with the greatest, and most vested, interest in a successful outcome. The Bankruptcy Code itself was designed to foster private, negotiated solutions. Restructuring professionals understand that the process works best when the toughest remedies afforded by the Bankruptcy Code are never used in litigation, but are instead used to prod stakeholders to a sensible, private solution. To its credit, the Act requires careful assessment of these considerations and alternatives.

A very recent example of how this process works well is the restructuring of The CIT Group, one of the largest bank holding companies in the country. Although the government infused capital into CIT during the depths of the crisis, it abstained from making further investments despite CIT’s continued troubles. CIT, therefore, was compelled to work with its stakeholders on a series of transactions designed to shed more than \$10 billion in debt. The result was a largely consensual, private solution, financed by the company’s stakeholders, that was implemented via a pre-packaged chapter 11 reorganization plan that limited the company’s stay in bankruptcy to only 40 days. The Act presumably was designed to foster solutions such as this — especially through the Act’s prohibition on government infusions of capital into troubled financial companies (discussed below).

Under the Act, however, if the Secretary determines that there are no private alternatives available for a financial company, then the Secretary must so notify the FDIC and the company. The company is then given the opportunity to consent to appointment of the FDIC as receiver. If the directors and officers of a troubled financial company decide to acquiesce to the appointment of the FDIC as receiver, the Act provides that such directors and officers are absolved of liability to stakeholders for such acquiescence.<sup>29</sup> If they do not consent, then the Secretary is required to petition the United States District Court for the District of Columbia for an order authorizing the Secretary to appoint the FDIC as receiver.<sup>30</sup> The petition must be filed under seal.

The Court is directed to hold a hearing, on a strictly confidential basis, in which the company may oppose the petition. The Court’s task is limited to deciding whether the Secretary’s determinations were “arbitrary and capricious,” a standard that is very deferential to the Secretary and effectively presumes the validity of the Secretary’s determinations.<sup>31</sup> If the Court answers the “arbitrary and capricious” question in the negative, the Court is required to issue an order immediately authorizing the Secretary to appoint the FDIC as receiver.<sup>32</sup> If the Court answers this question affirmatively, the Court is required to provide the Secretary with a written statement explaining its rationale, and must afford the Secretary an immediate opportunity to amend and refile the petition.

If the Court does not make a determination within 24 hours of receiving the petition, the petition will be granted by operation of law, the Secretary will appoint the FDIC as receiver and liquidation under the

<sup>28</sup>Act § 203(a)(2)(E).

<sup>29</sup>Act § 207.

<sup>30</sup>Act § 202(a)(1)(A)(i).

<sup>31</sup>Act § 202(a)(1)(A)(iii).

<sup>32</sup>As noted above, in broker-dealer liquidations, the FDIC is appointed as receiver, but SIPC also must appoint a trustee. Act § 205.

statute will automatically be commenced.<sup>33</sup> The Act provides a process for highly expedited appeals of these determinations.<sup>34</sup>

### Basic Elements of the Liquidation Process

Once the FDIC is appointed receiver of a covered financial company, it assumes virtually complete control over the company and the liquidation process. The role of the courts in the core receivership process ends, and there are limited avenues for challenging the various ancillary decisions that the FDIC may make in pursuing the liquidation. The role of the FDIC in federal receiverships under the Act is akin to its role in connection with insolvency proceedings involving federal banks and savings and loans. It also is akin to the role of state insurance commissioners in connection with liquidation and rehabilitation of insurance companies. This role contrasts sharply with reorganization proceedings under chapter 11 of the Bankruptcy Code, where a debtor's board and management stay in place, the debtor remains in possession of its business, and the normal rules of corporate governance and decision making continue to apply (subject to the requirement that transactions outside the ordinary course of business require advance court approval).<sup>35</sup>

Accordingly, when the FDIC is appointed receiver for a covered financial company, it succeeds to all rights, titles, powers and privileges of the company and its assets, and of any stockholder, member, officer or director of the company.<sup>36</sup> The FDIC may operate the company with all of the powers of the company's shareholders, directors and officers, and may conduct all aspects of the company's business.<sup>37</sup> It may liquidate and wind up the affairs of the company in such manner as it deems appropriate, including through the sale of assets, the transfer of assets to a bridge financial company (discussed in more detail below), or the exercise of any other rights or privileges granted to the receiver.<sup>38</sup> For example, the FDIC may merge the financial company with another company or transfer any asset or liability of the company without obtaining any approval, assignment or consent from any stakeholder.<sup>39</sup>

While the Act affords the FDIC virtually unfettered control in these matters, the Act does identify several principles that guide the FDIC's conduct. For instance, in disposing of assets, the FDIC must use best efforts to maximize returns, minimize losses and mitigate the potential for serious adverse effects to the financial system.<sup>40</sup> In deciding upon a course of action, the FDIC also must determine that such action is necessary for the financial stability of the United States, and not for the purpose of preserving the company; ensure that the shareholders of the covered financial company do not receive payment until

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<sup>33</sup>Act § 205.

<sup>34</sup>Appeals of the District Court's determination may be taken to the United States Court of Appeals for the District of Columbia. The appeal must be filed within 30 days of the District Court's decision and must be heard on an expedited basis. The Court's decision is not subject to any stay or injunction pending appeal. The Appellate Court's decision may be appealed to the United States Supreme Court. Any such appeal must be filed within 30 days of the Appellate Court's decision and heard on an expedited basis. Review is limited to whether the Secretary's determination that a covered financial company is in default or in danger of default and satisfies the definition of a covered financial company is arbitrary and capricious. Act §§ 202(a)(2)(A) & (B).

<sup>35</sup>11 U.S.C. §§ 363(b), 1107 and 1108.

<sup>36</sup>Act § 210(a)(1)(A).

<sup>37</sup>Act § 210(a)(1)(B).

<sup>38</sup>Act § 210(a)(1)(D).

<sup>39</sup>Act § 210(a)(1)(G).

<sup>40</sup>Act § 210(a)(9)(E).

after all other claims are fully paid; and ensure that unsecured creditors bear losses in accordance with the priority of claim provisions. Significantly, the FDIC may not take an equity interest in or become a shareholder of the covered financial company or any covered subsidiary.<sup>41</sup>

The FDIC is given several other powers that are consistent with the powers afforded it in connection with insolvency proceedings of thrifts under the FDIA, the powers afforded SIPC trustees in connection with insolvency proceedings of broker-dealers under SIPA, and the powers afforded bankruptcy trustees in connection with liquidation proceedings under chapter 7 of the Bankruptcy Code. These powers can be grouped into three main categories: resolution and payment of claims; disposition of existing contracts and similar obligations; and recovery of pre-receivership fraudulent conveyances and preferential transfers.

**Resolution and Payment of Claims.** The FDIC is given unilateral authority to review claims and to make determinations either allowing them or disallowing them.<sup>42</sup> This unilateral authority, while similar to that granted the FDIC and SIPC trustees under the FDIA and SIPA, respectively, differs from that afforded chapter 7 trustees under the Bankruptcy Code. Under the Bankruptcy Code, a claim is deemed allowed unless the chapter 7 trustee files an objection to the claim with the bankruptcy court and affords the claimant an opportunity to appear and be heard on the objection.<sup>43</sup> The claim is disallowed only if the claimant fails to appear or the court otherwise determines that the claim should be disallowed. Under the Act, by contrast, a claimant wishing to contest a claim determination by the FDIC must file suit with the district court for the district where the principal place of business of the covered financial company is located.<sup>44</sup>

The Act identifies the priorities in which claims may be paid, with the costs of the receivership being afforded first priority after provision is made for secured claims.<sup>45</sup> Claims owed to the United States come next, followed by all other claims against the covered financial company.<sup>46</sup> Similar to the rules governing other insolvency regimes, the Act requires that all claimants who are similarly situated be treated in a similar manner (except that, as noted above, claims of the United States are paid first). Unlike other insolvency regimes, however, the FDIC may deviate from this principle as necessary to maximize the value of the assets of the covered financial company; to initiate and continue operations essential to implementation of the receivership or any bridge financial company; to maximize the present value return from the sale or other disposition of the assets of the company; or to minimize the amount of any loss realized upon the sale or other disposition of the assets of the company.<sup>47</sup>

**Disposition of Existing Contracts and Related Obligations.** The Act provides that the FDIC may, within a reasonable period of time, disaffirm or repudiate any contract or lease to which the financial company is a party where continued performance is too burdensome or it would otherwise promote orderly administration.<sup>48</sup> It can do so regardless of whether the contract or lease is “executory,” *i.e.*,

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<sup>41</sup>Act § 206.

<sup>42</sup>Act § 210(a)(2).

<sup>43</sup>11 U.S.C. § 502(a).

<sup>44</sup>Act § 210(a)(4).

<sup>45</sup>Act § 210(b)(5).

<sup>46</sup>Act § 210(b)(1).

<sup>47</sup>Act § 210(b)(4).

<sup>48</sup>Act § 210(c)(1)-(c)(2).

whether there are unperformed obligations remaining by both parties. Under the Bankruptcy Code, by contrast, only contracts or leases that are executory may be rejected.<sup>49</sup> With few exceptions, damages for such repudiation are limited to actual, direct compensatory damages; punitive or exemplary damages and claims for lost profits or opportunities are not allowed.<sup>50</sup>

Alternatively, the FDIC may decide to transfer its rights and obligations under a contract or lease to an acquirer of the covered financial company's assets. It may do so notwithstanding so-called "ipso facto" clauses which excuse a counterparty from performing by reason of the company's insolvency, the appointment of a receiver, and similar circumstances.<sup>51</sup> These powers are largely consistent with the powers afforded the FDIC, SIPC trustees and bankruptcy trustees under the FDIA, SIPA and the Bankruptcy Code, respectively, though the process involves significant counterparty input and court supervision in the case of the Bankruptcy Code.

**Fraudulent Conveyances and Preferential Transfers.** Finally, the FDIC has the power under the Act to sue to avoid fraudulent transfers, preferences and improper setoffs.<sup>52</sup> These powers are substantially similar to the powers afforded the FDIC, SIPC trustees and chapter 7 trustees in thrift, broker-dealer and chapter 7 liquidations, respectively.<sup>53</sup> Indeed, the statutory definitions of fraudulent transfers (transfers made while insolvent for less than reasonably equivalent value) and preferences (payments to or for the benefit of a creditor that allow the creditor to receive more than in a liquidation) are almost identical to the statutory definitions of these terms contained in the Bankruptcy Code.<sup>54</sup> Moreover, the statutory defenses available to recipients of allegedly fraudulent or preferential transfers under the Act are the same as under other insolvency regimes.<sup>55</sup>

### Expedited Process for Creation of a Restructured Successor

Although Title II of the Act is titled "Orderly Liquidation Authority," a federal receivership under the Act will not necessarily result in the termination of a covered financial company's business, including the termination of all of its employees. Of course this could be the result not only under the Act, but also in connection with the insolvency of an entity under the Bankruptcy Code or the FDIA. One of the primary purposes of the Act, the Bankruptcy Code and the FDIA, however, is to maximize value and creditor recovery, which is most frequently achieved through some form of restructuring of the troubled company's core business and balance sheet. The Act includes mechanisms for achieving this result, although those mechanisms are much more similar to the mechanisms applicable to banks and savings and loans under the FDIA than the mechanisms under the Bankruptcy Code.

<sup>49</sup>11 U.S.C. § 365. If the FDIC proposes to transfer any "qualified financial contracts," discussed in greater detail below, with a particular counterparty, the FDIC must transfer all of such contracts with that counterparty; alternatively, it must repudiate all such contracts with such counterparty. Act § 210(c)(9)(a).

<sup>50</sup>Act § 210(c)(3).

<sup>51</sup>Act § 210(c)(13).

<sup>52</sup>Act §§ 210(a)(11)(A), 210(a)(11)(B), & 210(a)(12), respectively.

<sup>53</sup>*E.g.*, 12 U.S.C. § 1821(d)(17) (authorizing the FDIC to avoid fraudulent transfers); 12 C.F.R. § 313.20 (authorizing the FDIC to offset); 11 U.S.C. §§ 547, 548 & 553 (authorizing chapter 7 trustee to avoid fraudulent transfers, preferences and improper setoffs, respectively); 15 U.S.C. § 78fff-1(a) (vesting the SIPC trustee with the same powers and title with respect to the debtor and property of the debtor as a trustee in a bankruptcy case).

<sup>54</sup>Compare Act §§ 210(a)(11)(A) & (B) with 11 U.S.C. §§ 547 & 548, respectively.

<sup>55</sup>Compare Act § 210(a)(11)(F) with 11 U.S.C. §§ 547(c), 548(c) & 550; 12 U.S.C. § 1821(d)(17)(C).

In particular, as noted above, the FDIC has broad power to arrange for the sale of selected assets of a covered financial company to one or more private acquirers, subject to any applicable antitrust laws and other applicable agency review. Similarly, it may arrange for an acquisition of a covered financial company by one or more private acquirers, subject to the same antitrust and other regulatory qualifications. In connection with any sale or merger, the FDIC can arrange for the acquirer to assume selected contracts and liabilities, including outstanding derivatives contracts. This is similar to the process under the FDIA and state insurance insolvency laws whereby the FDIC and state insurance commissioners can facilitate the creation of a so-called “good bank” or “good insurance company.” Core assets and related liabilities necessary for a viable, go-forward enterprise are extracted from the estate of a bank or insurance company in rehabilitation, while the non-core assets and related liabilities are left behind in the so-called “bad bank” or “bad insurance company.”<sup>56</sup>

One key aspect of the Act, however, is that the FDIC may facilitate such transactions without advance notice to, input from or consent of creditors, shareholders and contract counterparties. Moreover, no party in interest can challenge any such transaction, as a fraudulent conveyance or otherwise, because the Act divests the courts of power to entertain any challenges to, or to restrain, any such transactions.<sup>57</sup>

This approach contrasts sharply with proceedings under the Bankruptcy Code. Under the Bankruptcy Code, a troubled company can sell its operating business free and clear of, or subject to, selected liabilities, but only after notice to all stakeholders, an opportunity for such stakeholders to be heard, and entry of an order by a bankruptcy court approving the sale as in the best interests of the estate.<sup>58</sup> Also under the Bankruptcy Code, a troubled company can restructure its operations and liabilities pursuant to a plan of reorganization, but only after impaired stakeholders are provided a detailed disclosure statement describing the plan, impaired stakeholders have been afforded an opportunity to vote to accept or reject the plan or to object to it, and the bankruptcy court has found that the plan complies with numerous requirements imposed by the Bankruptcy Code designed to ensure that the plan is fair and feasible.<sup>59</sup>

Arguably, there is an eminently reasonable explanation for the broad authority granted the FDIC under the Act. Put simply, financial services businesses are relatively fragile enterprises. They are not comprised of “bricks and mortar” and do not sell physical goods. Instead, they are comprised of people — ideas and talent — and they sell advice, trust and confidence. These are businesses that cannot easily weather the storm and delays common to so many proceedings under the Bankruptcy Code. Accordingly, if a financial company is to have any chance at salvaging a core enterprise for the benefit of all, the sale and restructuring of that core enterprise must occur very rapidly under the supervision of an independent authority with broad power to broker transactions on very short notice.

Indeed, this is typical of how the FDIC handles many thrift insolvencies. For example, the FDIC may begin working behind the scenes with a troubled bank’s board and possible suitors, then implement a transaction after hours on a Friday afternoon and before the “new” bank opens for business the ensuing Monday morning. This does not ensure that all creditors necessarily will be paid in full, but depositors and other customers necessary to the franchise are protected, at least to some extent, thereby enhancing value for creditors. This was similar to the approach taken by the government in facilitating expedited takeovers of financial firms after Lehman collapsed.

<sup>56</sup>See 12 U.S.C. § 1821(d)(2)(G).

<sup>57</sup>Act §§ 210(a)(8)(D) & 210(e).

<sup>58</sup>11 U.S.C. §§ 363(b) & 363(f).

<sup>59</sup>11 U.S.C. §§ 1123, 1125 & 1129.

The foregoing can be contrasted with the process under the Bankruptcy Code. The Bankruptcy Code does afford bankruptcy courts significant flexibility to conduct expedited processes, but minimum standards of due process reflected in the provisions of the Code and related rules requiring some advance notice and an opportunity to be heard necessarily limit this flexibility. An example of how a bankruptcy court can attempt to strike a balance between these standards, on the one hand, and the need to move quickly, on the other hand, is afforded by the Lehman bankruptcy. Lehman filed its petitions on Sunday, September 15, 2008, followed the next day by an announcement of its intention to sell its business to Barclays. The hearing on the proposed sale occurred only four days later and the sale was promptly approved.

The bankruptcy court was persuaded to follow this virtually unprecedented timeline based upon its conclusion that Lehman's business was a "melting ice cube." Customers were rapidly withdrawing their accounts, resulting in dwindling prospects for Lehman's business. Only by effectuating a rapid sale to a financially stable counterparty could this exodus be stopped. The downside to this approach, however, is that there was considerable confusion at the time regarding the precise scope and value of the assets being sold and the liabilities that ultimately were assumed. Indeed, more than 18 months after the sale was approved, Lehman and Barclays remain embroiled in litigation over the terms of the sale.

The Act provides another mechanism designed to address situations, such as that presented by Lehman, where the government simply may not have enough time to facilitate a private transaction prior to commencing receivership proceedings. In particular, the FDIC is empowered to create a "bridge financial company" to succeed to selected assets and liabilities of the covered financial company or covered broker-dealer.<sup>60</sup> A bridge company can be created without notice to, input from or consent of any creditors or shareholders. It can be created without the need to obtain approval from a court.<sup>61</sup> The bridge company need not be funded with capital or surplus<sup>62</sup> (though the aggregate amount of liabilities assumed by a bridge company may not exceed the aggregate amount of assets that are transferred to it).<sup>63</sup> Once created, the bridge company is to be managed by a board of directors appointed by the FDIC.<sup>64</sup> The bridge company may follow the corporate governance rules of Delaware or the state in which the applicable covered financial company is organized.<sup>65</sup> Upon approval of its articles of association by the FDIC, a bridge financial company created with respect to a covered broker-dealer is established and deemed registered with the SEC and a member of SIPC.<sup>66</sup>

Notwithstanding this broad grant of power to the FDIC, the Act does have certain restrictions with respect to the transfer of assets or liabilities of a covered financial company or broker-dealer. First, the Act requires the FDIC to treat similarly situated creditors equally when transferring the assets or liabilities of the covered financial company to a bridge company.<sup>67</sup> The FDIC need not comply with this principle; however, if it determines that unequal treatment is necessary to maximize the value and returns from

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<sup>60</sup>Act § 210(h)(2).

<sup>61</sup>Act § 210(e).

<sup>62</sup>Act §§ 210(h)(2)(E), 210(h)(5) & 210(h)(2)(G).

<sup>63</sup>Act § 210(h)(5)(F).

<sup>64</sup>Act § 210(h)(2).

<sup>65</sup>Act § 210(h)(2)(F).

<sup>66</sup>Act § 210(h)(2)(H)(i).

<sup>67</sup>Act § 210(h)(5)(E).

the assets or minimize the amount of loss upon sale of the assets.<sup>68</sup> In any event, similarly situated creditors must receive at least the amount they would have received in a liquidation under chapter 7 of the Bankruptcy Code and, with respect to the property of a customer of a covered broker or dealer, the same it would have received in a liquidation initiated by SIPC.<sup>69</sup>

Second, the Act requires that, if the FDIC establishes a bridge company with respect to a covered broker-dealer, all customer accounts of the covered broker-dealer shall be transferred to the bridge company.<sup>70</sup> An exception can be made to this requirement only if the FDIC determines, after consulting with the SEC and SIPC, that the customer accounts are likely to be quickly transferred to another covered broker-dealer, or the transfer of the accounts to a bridge company would materially interfere with the FDIC's ability to avoid or mitigate serious adverse effects on the financial stability of the United States.<sup>71</sup>

A bridge company is not meant to have perpetual existence. Rather, as its name suggests, it is a temporary creation designed to serve as a "bridge" to a permanent transaction with a private acquirer. To ensure a reasonably prompt transaction, a bridge company established under the Act terminates two years after it is granted its charter, although the FDIC has the discretion to extend such status for up to three additional one-year periods.<sup>72</sup> A bridge company will terminate if it merges with or sells the majority of its assets to a company that is not another bridge company.<sup>73</sup> The FDIC, however, is granted the ultimate discretion under the Act to dissolve the bridge company at any time.<sup>74</sup> During the life of a bridge company, the FDIC is not subject to the discretion or supervision of any other governmental agency regarding the assets, liabilities and ultimate disposition of a bridge company.<sup>75</sup>

### Provisions for Paying for the Process

The public's negative response to the recent governmental rescues of numerous financial institutions is reflected in the Act. Indeed, the Act includes several provisions that collectively serve as a statement of principles in this regard. First, the Act provides that "no taxpayer funds shall be used to prevent the liquidation of any financial company under the legislation."<sup>76</sup> Second, to drive home the point, the Act provides that "taxpayers shall bear no losses from the exercise of any authority under this title."<sup>77</sup> Third, the Act provides that creditors and shareholders must bear all losses in connection with the liquidation of a covered financial company<sup>78</sup> and that the FDIC shall not take an equity interest in, or become a shareholder of, any covered financial company.<sup>79</sup> This point is important: Many of the rescues in 2008 and 2009 took the form of government purchases of stock in the troubled companies. The Act closes off that avenue. Finally, the Act provides that "[a]ll funds expended in the liquidation of a financial company under this title shall be recovered from the disposition of assets of such financial company, or shall be the responsibility of financial companies, through assessments."<sup>80</sup>

<sup>68</sup>Act § 210(h)(5)(E)(i).

<sup>69</sup>Act § 210(h)(5)(E)(ii).

<sup>70</sup>Act § 210(a)(1)(O).

<sup>71</sup>Act § 210(a)(1)(O)(i).

<sup>72</sup>Act § 210(h)(12).

<sup>73</sup>Act § 210(h)(13).

<sup>74</sup>Act § 210(h)(15).

<sup>75</sup>Act § 210(h)(15)(B).

<sup>76</sup>Act § 212(a).

<sup>77</sup>Act § 212(c).

<sup>78</sup>Act § 204(a).

<sup>79</sup>Act § 206(5).

<sup>80</sup>Act § 212(b).



While the Act contemplates financial companies being ultimately responsible for the costs of a liquidation if assets are insufficient, the Act affords means by which the FDIC can incur interim debt obligations to fund a liquidation, which can later be recovered through assessments. Specifically, upon appointment as receiver, the FDIC is authorized to issue obligations to the Secretary to fund the liquidation.<sup>81</sup> The Secretary, in turn, may purchase such obligations and may, for such purposes, issue public debt securities.<sup>82</sup> However, the Act limits the amount of debt that the FDIC may incur for each financial company. During the first 30 days after the FDIC's appointment as receiver, the amount of debt is limited to a maximum amount equal to 10% of the financial company's total consolidated assets based on its most recent financial statement. Thereafter, the debt limit equals 90% of the fair value of the total consolidated assets of the financial company that are available for repayment.<sup>83</sup>

No debt provided pursuant to that 90% limit, however, may be incurred unless the Secretary and the FDIC agree to a "specific plan and schedule to achieve the repayment" of any such debt.<sup>84</sup> The plan must demonstrate that income to the FDIC from liquidated assets and assessments will be sufficient to amortize the debt within the period established in the repayment schedule. The Secretary and the FDIC must consult with the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on the terms of any repayment schedule agreement.<sup>85</sup>

Moreover, the FDIC is required to charge "one or more risk-based assessments" if necessary for it to pay in full the obligations issued by the FDIC to the Secretary within 60 months of the date of issuance of the obligations, or at a later date if an extension is necessary to avoid a serious adverse effect on the financial system.<sup>86</sup> These assessments must first be made against any claimant that received additional payments from the FDIC pursuant to its authority to treat some creditors more favorably than others, as described above. Any assessment against a claimant must be in an amount equal to the difference between the aggregate value the claimant received from the FDIC on its claim under the Act, on the one hand, and the value the claimant was entitled to receive solely from proceeds of the liquidation of the covered financial company, on the other hand.<sup>87</sup>

If the funds recouped from claimants are insufficient to satisfy the obligations to the Secretary, then the FDIC may assess "eligible financial companies" and certain other financial companies.<sup>88</sup> "Eligible financial companies" include any bank holding company with total consolidated assets equal to or greater than \$50 billion and any nonbank financial company supervised by the Board of Governors.<sup>89</sup> Assessments must be imposed on a "graduated basis," with financial companies having greater assets being assessed at higher rates.<sup>90</sup> Moreover, in imposing assessments, the FDIC must use a "risk matrix."<sup>91</sup>

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<sup>81</sup> Act § 210(n)(5)(A).

<sup>82</sup> Act §§ 210(n)(5)(B) & (E) (citing chapter 31 of title 31 of the United States Code).

<sup>83</sup> Act § 210(n)(6).

<sup>84</sup> Act § 210(n)(9).

<sup>85</sup> *Id.*

<sup>86</sup> Act § 210(o)(1)(B).

<sup>87</sup> Act § 210(o)(1)(D)(i).

<sup>88</sup> Act § 210(o)(1)(D)(ii).

<sup>89</sup> Act § 210(o)(1)(A).

<sup>90</sup> Act § 210(o)(2).

<sup>91</sup> Act § 210(o)(4).

The council shall make a recommendation to the FDIC on the risk matrix to be used. In recommending or establishing such risk matrix, the council and the corporation, respectively, must take into account a host of factors including, among others, economic conditions generally; the extent to which a particular financial company may already be subject to assessments imposed pursuant to other statutory regimes; the risks presented by the assessed financial company to the financial system and the extent to which it has benefited, or likely would benefit, from the orderly liquidation of a financial company; and any risks presented by the assessed financial company during the 10-year period immediately prior to the appointment of the FDIC as receiver for the covered financial company that contributed to the failure of the covered financial company.<sup>92</sup>

An alternative to recouping losses from financial institutions that was contained in the House Bill and in early versions of the Act was the creation of a pre-funded reserve — \$150 billion in the House Bill and \$50 billion in early versions of the Act.<sup>93</sup> A pre-funded reserve was strongly supported by Sheila C. Bair, Chairman of the FDIC. Chairman Bair argued that having a reserve built up in advance would prevent the need to assess financial institutions during an economic crisis and would allow firms to better manage their expenses.<sup>94</sup> It also would assure that the failed firm contributed to the reserve so that all costs would not be borne by surviving firms.<sup>95</sup> Additionally, a pre-funded reserve would reduce the likelihood of any taxpayer funding.<sup>96</sup>

In a system where assessments are made after the fact, however, the initial funding necessary to provide working capital must be borrowed from the Secretary.<sup>97</sup> Such borrowing could be politically charged because it may be seen as a government bailout.<sup>98</sup> Despite the practical and political reasons to establish a pre-funded reserve, it was argued successfully that the existence of a pre-funded reserve would create a moral hazard and increase imprudent risk taking. Accordingly, the Act adopted the after-the-fact assessment funding mechanism instead.<sup>99</sup>

Funds raised by the FDIC through borrowings from the Secretary and through assessments on the financial sector are to be deposited into the Treasury in a separate fund known as the “Orderly Liquidation Fund.”<sup>100</sup> Amounts in the Fund are available to the FDIC to carry out its responsibilities under the Act, including the payment of principal and interest on obligations it issues to the Secretary.<sup>101</sup> However, the FDIC may utilize amounts in the Fund with respect to a covered financial company only after the FDIC has developed an orderly liquidation plan that is acceptable to the Secretary.<sup>102</sup>

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<sup>92</sup>Act § 210(o)(4).

<sup>93</sup>The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong (2009) § 1609(n) (House bill establishing a \$150 billion pre-funded reserve).

<sup>94</sup>Statement of Shelia C. Bair, Chairman, Federal Deposit Insurance Corporation on the Causes and Current State of the Financial Crisis before the Financial Crisis Inquiry Commission; Room 1100, Longworth House Office Building, January 14, 2010.

<sup>95</sup>*Id.*

<sup>96</sup>*Id.*

<sup>97</sup>*Id.*

<sup>98</sup>*Id.*

<sup>99</sup>Amendment No. SA3827 to Act, proposed by Mr. Shelby (May 5, 2010) (amending Senate bill to delete provision that would have established a pre-funded reserve).

<sup>100</sup>Act § 210(n)(1) & (2).

<sup>101</sup>Act § 210(n)(1).

<sup>102</sup>Act § 210(n)(9).

These detailed provisions for recouping the costs of liquidating a covered financial company through assessments on the financial sector afford the FDIC considerable leverage in attempting to broker private rescues of troubled financial companies. As noted above, private restructuring solutions almost invariably are more value additive, less expensive and less risky than those that must be implemented through a formal process. For this reason, the government frequently attempts to facilitate private, consensual solutions regarding troubled thrifts and other regulated entities. Indeed, for this same reason, stakeholders of other business entities typically try to develop out-of-court solutions among themselves as well.

But with the hammer afforded by these provisions of the Act that allow the FDIC to recoup the costs of a liquidation from other financial counterparties, the FDIC will have significantly greater ability to compel financial counterparties to a troubled entity to develop a solution — and pay for it — themselves, without the need for a receivership. Financial counterparties in such a situation should have an incentive to do so, as the potential fallout and costs of a receivership easily could be much greater than if the parties were able to develop and implement a private, non-receivership solution themselves.

The exemplar of an effective out-of-court process in the financial services industry is the restructuring of Long-Term Capital Management.<sup>103</sup> In 1998, Long-Term Capital was a multibillion-dollar hedge fund that was teetering on the brink of collapse. Given the size of Long-Term Capital — it was party to more than \$1.4 trillion gross national amount in outstanding trades — counterparties and the government feared that the company's failure would cause a chain reaction in the markets, leading to catastrophic losses throughout the financial system.<sup>104</sup> To avoid a systemic failure, the Board of Governors convened an emergency session of a consortium of several major Wall Street investment houses at which it effectively "passed the hat."

All participants at the meeting (other than Bear Stearns) agreed that it was in their interests to prop up Long-Term Capital, even though it was a rival to many of them, rather than risk the potential consequences of its failure. The participants paid a total of \$3.625 billion and received, in exchange, 90% of Long-Term Capital's equity as well as operational control of the company. By 2000, the participants had been repaid.<sup>105</sup> If a similar situation arises in the future, the FDIC can pass the hat again — while telling counterparties that they can "pay now," or they can be forced to "pay later" under circumstances that may entail significantly greater cost.

Finally, while the Act contains broad prohibitions on the use of taxpayer funds to finance a liquidation, financing of liquidations is not prohibited outright. To the contrary, the FDIC may, "in its discretion" and as "necessary or appropriate," make available to the receivership funds for the orderly liquidation of a covered financial company.<sup>106</sup> All such funds are afforded priority in payment.<sup>107</sup> Similarly, the FDIC may provide funding to facilitate transfers to or from a bridge financial company.<sup>108</sup> Lastly, a bridge financial

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<sup>103</sup>House Committee on Banking and Financial Services, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management: Report of the President's Working Group on Capital Markets* 12-14 (April 1999).

<sup>104</sup>*Id.* at 11-12.

<sup>105</sup>Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* 229 (Random House, 2000).

<sup>106</sup>Act § 204(d).

<sup>107</sup>*Id.*

<sup>108</sup>Act § 210(h)(9).

company is authorized to obtain its own financing, including financing secured by a lien that is senior to existing liens.<sup>109</sup> The terms governing such financing are identical to those by which debtors under the Bankruptcy Code may obtain financing.<sup>110</sup>

### Special Provisions Regarding Derivatives

As noted above, the Act contains numerous provisions regarding the transfer and repudiation of contracts and leases and the related rights of non-debtor parties under various scenarios. The Act also contains separate provisions that afford special protections to derivatives agreements and the rights of derivatives counterparties, protections that are not available in connection with other agreements. In this regard, the Act is consistent with existing law regarding the treatment of derivatives under the Bankruptcy Code and the FDIA.

In particular, each of these statutory regimes extends special protections to several classes of derivatives contracts — which are called “qualified financial contracts” under the Act and the FDIA — including repurchase agreements, securities contracts, forward contracts, commodity contracts and swap agreements and, in each instance, specifically defined classes of counterparties.<sup>111</sup> The definitions of each of these categories of agreements and protected counterparties are the same in the Act, the Bankruptcy Code and the FDIA.<sup>112</sup> Each regime provides that selected non-debtor counterparties to such agreements are free to exercise their contractual rights to terminate, close out and liquidate their positions upon the insolvency of their counterparties.<sup>113</sup> This is the reverse of the general rule governing virtually all other agreements: clauses in such agreements that allow a non-debtor to terminate an agreement based upon the financial condition of, or the commencement of insolvency proceedings with respect to, a counterparty are unenforceable.<sup>114</sup>

The ostensible rationale behind the special protections afforded counterparties to qualified financial contracts is that the use of such contracts is so prevalent — the amounts involved are so large; the contracts trade so quickly; and such contracts have resulted in financial institutions becoming so highly interconnected — that non-debtor counterparties must be free to close out their contracts immediately upon an insolvency event, or else the fallout from the failure of one institution will have uncontrollable, cascading effects across countless trading parties and other institutions. By being able to terminate and close out qualified financial agreements immediately, the effects of one firm’s financial collapse will be contained to that one institution, or so the argument goes.

While this has been the long-standing policy behind the special protections afforded qualified financial contracts — it was, in part, what motivated counterparties to support Long-Term Capital — this policy has not been without controversy.<sup>115</sup> Indeed, at one point during the evolution of, and debate over, the bill that ultimately became the Act, Senator Bill Nelson (D - Fla.) proposed an amendment to the bill that would have repealed the Bankruptcy Code protections altogether.<sup>116</sup> The amendment was not adopted,

<sup>109</sup>Act § 210(h)(16).

<sup>110</sup>11 U.S.C. § 364.

<sup>111</sup>Act § 210(c)(8); 11 U.S.C. §§ 555, 556, 559, 560 & 561; 12 U.S.C. § 1821(e)(8).

<sup>112</sup>Act § 210(c)(8)(D); 11 U.S.C. § 101; 12 U.S.C. § 1821(e)(8)(D)(i), respectively.

<sup>113</sup>Act § 210(c)(8); 12 U.S.C. § 1821(e)(8); 11 U.S.C. §§ 555, 556, 559, 560 & 561.

<sup>114</sup>Act § 210(c)(13)(C)(i); 11 U.S.C. §§ 365(e)(1) and § 541(c); 12 U.S.C. § 1821(e)(10)(B).

<sup>115</sup>See, e.g., Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. Bus. L. 61 (2009).

<sup>116</sup>Proposed Amendment to the Act, available at <http://www.creditslips.org/files/ayo10790.pdf>.

but the fact that it was proposed — along with the numerous other provisions of the Act that provide for significant regulation of, and that require far greater transparency with respect to, derivatives trades<sup>117</sup> — clearly indicates that the longstanding policy regarding favorable treatment of qualified financial contracts is not universally shared and has been, at least in part, scaled back.<sup>118</sup>

Indeed, the recent failures of many businesses that rely on derivatives has demonstrated that when the financial condition of a derivatives counterparty begins to decline, events tend to move with alarming speed. This is partly because, under many derivatives contracts, counterparties mark the values of their positions daily, margin calls must be met within one or two days, and counterparties frequently have considerable discretion determining market values and, hence, the amounts of their margin calls. As a result, when a company experiences financial trouble — or even a market rumor of trouble — confidence vanishes; the rate of margin calls can spike, and the company therefore can find itself in a liquidity crisis overnight.

This was the fate of the roughly 150 mortgage lenders who have filed bankruptcy since early 2007. When their counterparties lost confidence, liquidity vanished. Virtually all of these lenders collapsed into bankruptcy court. None of them reorganized in the traditional sense. Their only option was rapid sales of their servicing platforms. Some entities in the mortgage securities business did not even have that option. When markets experienced major dislocations and counterparties of funds sponsored by Bear Stearns and Carlyle Capital marked down the value of their securities and made margin calls, the funds were unable to meet the margin calls, counterparties closed out their positions and liquidated tens of billions of dollars in total asset positions in a matter of days, and each fund was left to dissolve pursuant to offshore liquidation regimes, as there simply was nothing to achieve in a proceeding under the Bankruptcy Code. Finally, in September 2008, one of the largest derivatives counterparties of all — Lehman Brothers Holdings — filed for bankruptcy. Since then, its stakeholders have been left to unwind an estimated one million derivatives trades — a process that will take years.

It is perhaps in part because of the fallout from these recent experiences that the Act contains three important limitations on typical contractual rights of derivatives counterparties. First, the Act prohibits a protected party from terminating, liquidating or netting out its position solely by reason of the appointment of the FDIC as receiver or the financial condition of the financial company in receivership until 5:00 p.m. Eastern Time on the next business day following the date of appointment of the FDIC.<sup>119</sup> A protected party also is precluded from exercising any such contractual rights after it has received notice that its qualified financial contract has been transferred to another financial institution<sup>120</sup> — including a bridge financial company.<sup>121</sup> The Act requires the FDIC to notify a protected party of any such transfer by 5:00 p.m. Eastern Time on the next business day following the date of appointment of the FDIC.<sup>122</sup>

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<sup>117</sup>See “[Regulation of Over-the-Counter Derivatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.](#)”

<sup>118</sup>Ironically, however, only a few short years ago, insolvency laws relating to derivatives actually were expanded. In particular, the Bankruptcy Code and the FDIA were amended in 2005, and again in 2006, to significantly expand the protections afforded derivatives and the rights of non-debtor counterparties. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23 (codified in multiple sections of the United States Code). The changes included much more comprehensive definitions of the categories of protected contracts designed to reflect the dramatic growth in the diversity of sophisticated financial products that occurred in the 1990s and early 2000s. Of particular significance, the definition of qualifying repurchase agreements was expanded to cover mortgage loans and mortgage-related securities.

<sup>119</sup>Act § 210(c)(10)(B)(i)(I).

<sup>120</sup>Act § 210(c)(10)(B)(i)(II).

<sup>121</sup>Act § 210(c)(9)(D).

<sup>122</sup>Act § 210(c)(10)(A).

These provisions have no parallel in the Bankruptcy Code or SIPA, although there are provisions under the FDIA that also provide for a one-day moratorium.<sup>123</sup> Their collective effect is to afford the FDIC one day after its appointment, either to consummate a transfer of a qualified financial contract to a private acquirer, or to transfer it to a newly created bridge company. Absent one of these two types of transfers within the allotted time frame, counterparties may exercise their contractual rights. While this period of time is brief, and while the Act does not afford the FDIC any power to attack pre-receivership terminations and closeouts of qualified financial contracts (except in the case of intentional fraud), this limited moratorium could afford considerable stability in the early days of a receivership, thereby avoiding the type of firestorm that engulfed Lehman Brothers when it filed for bankruptcy as thousands of counterparties terminated their contracts and liquidated their positions.

The second and third limitations on the rights of derivatives counterparties relate to so-called “walk-away” clauses. In the typical derivatives contract, when the contract is terminated, the party who is “out of the money” must pay the party who is “in the money.” A walkaway clause overrides this provision by affording the nondefaulting party the right to walk away from a termination payment it otherwise would owe the defaulting party. It also may give the nondefaulting party the right to suspend periodic payments it otherwise may owe to the defaulting party under the contract, an option the defaulting party may exercise in lieu of termination in the hope that favorable market movements will reduce any amount owed to the defaulting party.

The Act defines a walkaway clause, in part, as follows: “any provision in a qualified financial contract that suspends, conditions, or extinguishes a payment obligation of a party ... solely because of the status of such party as a nondefaulting party in connection with the ... appointment of [the FDIC] as receiver for [a] covered financial company....”<sup>124</sup> The Act provides that no walkaway clause shall be enforceable in a qualified financial contract of a covered financial company in default.<sup>125</sup> It further states that a counterparty may suspend a payment or delivery obligation only for a limited period of time: one day following appointment of the FDIC as receiver.<sup>126</sup> Thereafter, the counterparty must perform.

There are no provisions parallel to these limitations in the Bankruptcy Code or SIPA, although there are similar provisions under the FDIA that provide for a one-day moratorium on payment suspensions.<sup>127</sup> However, these limitations are consistent with two recent rulings by the bankruptcy court presiding over the Lehman liquidation that involved interpretations of broad provisions of the Bankruptcy Code that, by their terms, do not specifically contemplate walkaway clauses. In one case, the bankruptcy court addressed the enforceability of a clause contained in a synthetic collateralized debt obligation transaction.<sup>128</sup> The structure included a swap agreement, along with an agreement between the swap counterparty and the holders of securities that established priorities with respect to collateral for both sets of obligations. Lehman’s rights, as swap counterparty, were senior to those of the securities holders — except that, in the event of a default by Lehman, that priority was to be inverted.

<sup>123</sup>12 U.S.C. § 1821(e)(10)(B).

<sup>124</sup>Act § 210(c)(8)(F)(iii).

<sup>125</sup>Act § 210(c)(8)(F)(i).

<sup>126</sup>Act § 210(c)(8)(F)(ii).

<sup>127</sup>12 U.S.C. § 1821(e)(8)(G)(ii).

<sup>128</sup>*In re Lehman Bros. Holdings Inc. (Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

The *Lehman* bankruptcy court ruled that this priority inversion was unenforceable because the practical effect, given the value of the collateral, would have been that Lehman would be out of the money if the provision was enforced. The *Lehman* court relied, among other things, on a provision of the Bankruptcy Code that renders unenforceable contractual provisions that effect a forfeiture or modification of debtor's rights solely by virtue of the debtor's financial condition or the commencement of a bankruptcy case.<sup>129</sup> The *Lehman* court adopted a similar stance towards a counterparty who suspended payments to Lehman that otherwise would have been due absent Lehman's bankruptcy.<sup>130</sup> The court viewed the counterparty's conduct as inequitable and contrary to a debtor's general right under the Bankruptcy Code to compel a counterparty to continue performing pending the debtor's determination whether to assume or reject.

### Possible Consequences to Directors and Management

Underlying much of the public's dissatisfaction with government bailouts is the sentiment that taxpayers have been made to pay for the perceived misfeasance of the rescued financial companies' management. These sentiments are not new. In 2005, Congress amended the Bankruptcy Code to curtail perceived abuses in the process by which management of companies in bankruptcy historically were compensated: "the executives of giant companies [in bankruptcy] ... lined their own pockets, but left thousands of employees and retirees out in the cold."<sup>131</sup> Prior to the 2005 amendments, it had become standard in bankruptcies to afford management executives periodic payments to induce them to stay with the company and assist it in restructuring its affairs (so-called "pay to stay" compensation). They were often ensured significant severance and incentive compensation packages as well.

These forms of compensation continue in bankruptcy cases today — albeit subject to significant limits imposed by the 2005 amendments. The Bankruptcy Code now effectively prohibits retention payments to insiders of a debtor by limiting such payments to circumstances that are unlikely to ever occur.<sup>132</sup> Similarly, the Code strictly limits severance that may be provided to insiders of a debtor<sup>133</sup> and prohibits the payment of other obligations outside of the ordinary course of business, including incentive compensation, that is "not justified by the facts and circumstances of the case."<sup>134</sup>

<sup>129</sup>11 U.S.C. § 541(c).

<sup>130</sup>*In re Lehman Bros. Holdings Inc.*, Case No. 08-13555 (JMP) (Bankr. S.D.N.Y.) (Transcript of Sept. 15, 2009 Hearing at 99-113) (Docket No. 5261), and *Order Pursuant to Sections 105(a), 362 and 365 of the Bankruptcy Code to Compel Performance of Contract and to Enforce the Automatic Stay* (Docket No. 5209).

<sup>131</sup>*In re Dana Corp.*, 358 B.R. 567, 575 (Bankr. S.D.N.Y. 2006) (quoting Statement of Senator Edward Kennedy on the Bankruptcy Bill (Mar. 1, 2005)).

<sup>132</sup>In this regard, a debtor may only make retention payments to an insider if the bankruptcy court finds that (a) the payment is essential to the retention of the insider because such insider has a bona fide job offer at the same or greater rate of compensation; (b) the insider's services are essential to the company; and (c) either (i) the amount of the payment is not greater than 10 times the amount of the mean payment of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the payment was made, or (ii) if no similar payments were made to such nonmanagement employees during such calendar year, the payment is not greater than 25% of the amount of the mean payment of a similar kind given to nonmanagement employees for any purpose during the calendar year before the year in which the payment was made. 11 U.S.C. § 503(c)(1).

<sup>133</sup>Section 503(c)(2) prohibits the payment of severance to insiders of a debtor unless (a) such severance payment is part of a program that is generally applicable to all full-time employees; and (b) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made. 11 U.S.C. § 503(c)(2).

<sup>134</sup>11 U.S.C. § 503(c)(3).

Despite these limitations, the Bankruptcy Code continues a presumption that the board and management of a company should remain in place while the company reorganizes.<sup>135</sup> Inherent in this presumption is the premise that, absent exceptional circumstances, existing management is best positioned to maximize the value of a debtor's estate<sup>136</sup> — with the further qualification that the board and management of a company in chapter 11 are subject to the supervision of a bankruptcy court and, hence, cannot implement decisions outside the ordinary course of business without advance court permission.

However, more recent expressions of public outrage over bonuses paid to management of rescued companies has resulted in a significant shift in this presumption: The Act provides, in several sections, that management responsible for the condition of the financial company will be severed from its employment.<sup>137</sup> Additionally, those responsible for the financial condition of the financial company may be made to bear economic consequences consistent with their responsibility.<sup>138</sup>

Like the Bankruptcy Code, the Act also provides that any payment made to, or for the benefit of, an insider, or any obligation incurred to or for the benefit of an insider, under an employment contract and not in the ordinary course of business, may be avoided as a fraudulent transfer if the covered financial company received less than reasonably equivalent value in exchange for such payment or transfer.<sup>139</sup> The target of this provision is overly rich severance and buyout payments given to separated executives. Moreover, the Act, like the Bankruptcy Code, provides a limited priority for unpaid claims of employees for wages, salaries, commissions and other benefits. However, unlike the Bankruptcy Code, the Act expressly subordinates any such claims held by senior executives and directors to general unsecured claims.<sup>140</sup>

Even more significantly, the Act outlines the circumstances under which culpable management may be banned from the financial services industry for a term of at least two years.<sup>141</sup> Specifically, the Act provides that management may be banned if the FDIC determines that:

- management directly or indirectly (a) violated any (i) law or regulation, (ii) final cease-and-desist order, (iii) condition imposed in writing by a federal agency in connection with any action, application, notice

<sup>135</sup>11 U.S.C. §§ 1107 and 1108. Similarly, Bankruptcy Code section 1121 grants the debtor the exclusive right to propose a plan of reorganization during the first 120 days of a chapter 11 case. 11 U.S.C. § 1121(b).

<sup>136</sup>H.R. Rep. No. 95-595, at 233 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6192. (“[V]ery often the creditors will be benefited by continuation of the debtor in possession, both because the expense of a trustee will not be required, and the debtor, who is familiar with his business, will be better able to operate it during the reorganization case. A trustee frequently has to take time to familiarize himself with the business before the reorganization can get under way. Thus, a debtor continued in possession may lead to a greater likelihood of success in the reorganization.”).

<sup>137</sup>Act § 206(4) (FDIC shall ensure that management responsible for the financial condition of the covered financial company is removed); Act § 210(a)(1)(C)(ii) (although FDIC may provide for exercise of any function by any member, stockholder, director or officer of any covered financial company, Act requires a “strong presumption” that the FDIC will remove management responsible for such company’s failed condition).

<sup>138</sup>Act § 204(a)(3) (FDIC will take all steps necessary to ensure that all parties “having responsibility for the condition of the financial company [will] bear losses consistent with their responsibility”); § 210(f) (provides for liability of directors and officers for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct); § 210(s) (recoupment of compensation from senior executives and directors for the two-year period prior to the beginning of the receivership, except that, in the case of fraud, no time limit will apply).

<sup>139</sup>Compare 11 U.S.C. § 548(a)(1)(B) *with* Act § 210(a)(11) .

<sup>140</sup>Act § 210(b)(1).

<sup>141</sup>Act § 213(c)(1).



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- or request by the company or such senior executive, or (iv) written agreement with such agency; (b) engaged or participated in any unsafe or unsound practice in connection with any financial company; or (c) committed or engaged in any act, omission or practice which constitutes a breach of fiduciary duty;
- by reason of such violation, practice or breach, management has received financial gain or other benefit and such violation, practice or breach contributed to the failure of the company; and
  - such violation, practice or breach (a) involves management’s personal dishonesty; or (b) demonstrates willful or continuing disregard for the safety and soundness of the company.<sup>142</sup>

These strong measures may motivate boards and management to remove culpable actors and/or otherwise cooperate in connection with pre-receivership negotiations designed to reorganize a troubled financial company without receivership. But they could go too far. Through the “strong presumption” of removal, they have the potential to deprive financial companies of the services of management that might be best positioned to maximize value. Indeed, financial companies in distress may have difficulty retaining or attracting competent management who may be wary of the prospect of being subjected to a presumption of removal notwithstanding their best efforts to avoid liquidation.

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<sup>142</sup>Act § 213(b). Upon a finding of the foregoing, the FDIC or the Board of Governors, as appropriate, may serve upon management a written notice of the intention of the agency to prohibit any further participation by management in the affairs of any financial company for a period of time that such agency determines is commensurate with such violation, practice or breach. The due process requirements and other procedures under FDIA section 8(e) apply to actions taken under this section of the Act. Such requirements include that the notice contain a statement of the facts constituting the grounds for the ban and the time and place at which a hearing will be held thereon. Generally, the hearing must be set for a date not earlier than 30 days nor later than 60 days after the date of service of the notice. Act § 213(c); 12 U.S.C. § 1818(e).



# Regulation of Over-the-Counter Derivatives Under the Dodd-Frank Wall Street Reform and Consumer Protection Act

This article discusses certain key aspects of the new regulatory regime imposed by the Dodd-Frank Act on over-the-counter (“OTC”) derivatives and the market for such derivatives, which until now has developed largely free of regulation. The derivatives legislation is set forth in Title VII of the Act (entitled “Wall Street Transparency and Accountability” and referred to herein as the “Derivatives Title”). However, provisions under other titles of the Act, such as Title VI on banking organizations, also have the potential to significantly affect the OTC derivatives market. In particular, the so-called “Volcker Rule” will ban the proprietary trading of derivatives by bank holding companies and their affiliates and, therefore, could materially affect the derivatives activities of banking organizations that are subject to regulation by U.S. governmental authorities. **See “The Volcker Rule.”** Other provisions of Title VI, such as the inclusion of derivatives exposures under bank lending limits, also could affect the conduct of derivatives business by banking organizations.

With limited exceptions, the provisions of the Derivatives Title become effective on the later of 360 days following enactment and, to the extent a provision requires rulemaking, not less than 60 days after publication of the final rule (referred to herein as the “General Effective Date”). Many key concepts, processes and issues under the Derivatives Title have been left to the relevant regulators, primarily the CFTC and the SEC, to define and address. The rulemaking generally is required to be completed within 360 days following enactment. Accordingly, it is likely to be a number of months before clarity begins to emerge on some key points, including which market participants will be subject to registration and comprehensive regulation as major market participants (as discussed below).

Regardless of the many issues left to the regulators, it is clear that the derivatives legislation will change the operation of the derivatives markets and the regulation of market participants in many significant respects. The primary goals of the legislation and related rulemaking are to increase the transparency and efficiency of the OTC derivatives market and to reduce the potential for counterparty and systemic risk. The main mechanisms for achieving these goals are:

- to require that as many product types as possible be centrally cleared and traded on exchanges or comparable trading facilities;
- to subject swap dealers and major market participants to capital requirements and to margin requirements (to be imposed by clearinghouses for cleared swaps and by regulation for uncleared swaps); and
- to require the public reporting of transaction and pricing data on both cleared and uncleared swaps.

In addition, the Act imposes an array of new prudential regulations and compliance requirements for banks, swap dealers and other regulated (or newly regulated) entities, as well as more sweeping changes to some businesses, particularly banking organizations and companies that become subject to regulation as “significant nonbank financial companies.” **See “Regulation of Banking Organizations,” and “Key Measures to Address Systemic Risk.”**

In the short run, the major changes made by the Act to existing OTC derivatives market practices and to the conduct of business generally by banking organizations, financial entities and other market participants — in combination with transition periods that may be overly aggressive, in view of the necessary adjustments to business operations and practices and the volume of complex issues left to post-enactment rulemaking — could produce market dislocations and other unintended or unforeseen consequences. In addition, while the cost of swaps that become commoditized products generally may decrease due to improved market efficiencies (once the transitional issues have been resolved), the “bespoke,” uncleared transactions that some market participants will require appear likely to become more expensive because they probably will be subject to higher capital charges for their providers and fewer counterparties may be willing or able to provide them. The only swap counterparties likely to be at least partially shielded from higher costs on uncleared swaps are those who meet the requirements, described below, for “end users.” However, the end-user exemption will be unavailable to many types of entities.

The U.S. banks that conduct certain derivatives activities will become subject to a restriction on access to “federal assistance,” a restriction that effectively will require them to cease those activities following a transition period. If a banking organization wishes to continue to conduct the derivatives activities in question, it will be required to create and separately capitalize a nonbank affiliate to do so. The derivatives activities in which those entities will be able to engage will be further constrained by application of the Volcker Rule. See “[The Volcker Rule](#).” Some commentators question whether these requirements will achieve anything other than reducing the profitability of these organizations and suggest that the increased capital and other prudential regulatory requirements contained in the Act may in themselves have been sufficient risk mitigants.

Certain other market participants will become subject to the new registration, capital, margin, reporting and other compliance requirements applicable to Major Participants (as defined below). Particularly for Major Participants that are not currently regulated entities, these requirements seem likely to significantly increase the cost of doing business.

While many market participants could be affected by increased costs and increased regulatory oversight and reporting, the impact on some thinly capitalized, highly leveraged investment funds and structured finance vehicles could be significant and could make certain structures unfeasible. That may be fully intended as a legislative goal, given the widespread perception that the use of certain types of structured finance vehicles or transactions — particularly those based on credit derivatives — may have fueled the recent financial crisis.

Issues that have raised particular concern in recent weeks are (i) whether so-called end users (which, as discussed further below, are generally nonfinancial entities using swaps to hedge commercial risk), who will have the option to enter into uncleared swaps, will be exempt from the margin requirements to be imposed upon uncleared swaps, and (ii) whether margin requirements may be imposed generally on existing swap transactions on a retroactive basis. Although end-user swaps had been understood to be exempt from the margin requirements on uncleared swaps, based on wording in the Senate version of the derivatives legislation, that language was not included in the Act. Moreover, the Act contains no provision exempting swaps entered into pre-enactment from the margin requirements for uncleared swaps under the Act.

On June 30, Senators Dodd and Lincoln released a letter addressed to their counterparts on the Financial Services and Agriculture Committees in the House (Representatives Frank and Peterson) asserting that the legislative intent was for end users not to be subjected to margin and capital require-

ments. The letter also could be read as suggesting, in a statement relating to legal certainty for existing swaps, that margin requirements generally should not be imposed retroactively. However, that is not at all clear, given that the overall focus of the letter is on end users. Until the issue is definitively resolved by a technical corrections bill, rulemaking or both, there will be uncertainty as to both issues. Beyond that, the issues relating to potential retroactive effect for entities that become characterized as Major Participants are somewhat different and may not be fully addressed by any ultimate solution to the end user and margin issues.

### **Division of Regulatory Authority<sup>1</sup>**

The Act divides the regulation of the OTC derivatives market between “swaps” regulated by the CFTC and “security-based swaps” regulated by the SEC based on the characteristics of the underlying instrument or interest. The dividing line between the categories, however, is not entirely clear. Given that the characterization as one or the other type of swap has material consequences, both for compliance purposes and for potential liability under securities laws, it is hoped that these ambiguities will be adequately addressed in the rulemaking process.

Of greater concern, because it is less readily addressed, is the overlapping coverage among the various regulators — primarily the CFTC and SEC, but also the applicable bank regulators — who are charged with regulating various aspects of the derivatives markets. The complexity of the task and the potential jurisdictional conflicts make coordination essential, and such coordination is in fact mandated under the Derivatives Title. Subject to certain exceptions, such as those relating to orders in connection with a violation or potential violation of law, the SEC and the CFTC are required to consult and coordinate with each other and with the relevant “prudential regulators” (primarily the applicable federal bank regulators) before commencing rulemaking or issuing an order on the matters within their respective jurisdiction under the Derivatives Title, in order to ensure regulatory consistency and comparability to the extent possible.<sup>2</sup> In the near term, this could make it difficult to complete the rulemaking process within the required time frames. Longer term, it appears to pose a significant risk in that the regulatory process could be inefficient, potentially to the point of inhibiting new product development or obstructing the ability to effectively monitor and respond to systemic risks.

The appropriate federal banking regulator will have authority over derivatives-related capital and margin requirements for banks and bank holding companies as well as the rulemaking authority for the reporting and other compliance requirements applicable to the derivatives activities of those entities (including implementation and compliance with the Volcker Rule).

“Swap” is broadly defined to include most types of OTC derivatives, subject to a carve-out for “security-based swaps” and certain other specified exceptions.<sup>3</sup> The definition (closely based on Section

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<sup>1</sup> Act § 712.

<sup>2</sup> Act § 712(a). The SEC, CFTC and prudential regulators are also to consult and coordinate with foreign regulatory authorities (in this case, not of course as a condition to their own rulemaking) on the establishment of consistent international standards with respect to the regulation of swaps, security-based swaps, swap entities and security-based swap entities, to the end of achieving consistent international standards for their regulation. The CFTC is similarly required to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation of contracts of sale of a commodity for future delivery and options on such contracts. Act § 752.

<sup>3</sup> Act § 721(a)(21) (to be codified at 7 U.S.C. § 1a).

206A of the Gramm-Leach-Bliley Act, as amended, the “GLB Act”) specifies a number of categories such as (i) puts, calls, caps, floors, collars or similar options of any kind that are for the purchase or sale, or based on the value of one or more interest or other rates, currencies, etc., and (ii) interest rate, currency, total return, equity, credit default, energy, metal, agricultural and commodity swaps, which, among others, are listed as examples of a broadly described category of risk transfer instruments. The definition also includes the broad catchall categories of “an agreement, contract or transaction that is or in the future becomes commonly known to the trade as a swap,” and any combination or permutation of, or option on, any of the described types.<sup>4</sup>

“Security-based swap”<sup>5</sup> means any “swap” based on:

- an index that is a narrow-based security index, including any interest therein or on the value thereof;<sup>6</sup>
- a single security or loan, including any interest therein or on the value thereof; or
- the occurrence, nonoccurrence or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index; *provided* that such event directly affects the financial statements, financial condition or financial obligations of the issuer.<sup>7</sup>

The CFTC and the SEC will jointly prescribe rules and regulations for certain swaps, referred to as “mixed swaps,” that have characteristics of both “swaps” and “security-based swaps” and will be treated as security-based swaps.

The definition of “swap” excludes (and consequently “security-based swap” excludes), among other categories:

<sup>4</sup>The definition of “swap” also expressly includes any “security-based swap agreement” that meets the definition of “swap agreement” as defined in Section 206A of the GLB Act of which a material term is based on the price, yield, value or volatility of any security or any group or index of securities, or any interest therein (which is a description of how “security-based swap agreement” is defined in Section 206B of the GLB Act), and expressly excludes any “security-based swap” (other than a mixed swap) as defined in the Derivatives Title. It is not entirely clear why it was viewed as necessary to incorporate “security-based swap agreement” as defined in the GLB Act, because it is a subset of “swap,” as defined in the GLB Act, and therefore should be viewed as already included without being separately referenced. This may have been simply for avoidance of doubt as to inclusion.

<sup>5</sup>Act § 761(a)(6) (to be codified at 15 U.S.C. § 78c(a)).

<sup>6</sup>In general, subject to certain exceptions, “narrow-based security index” is defined in § 1a(25) of the CEA as an index of securities (i) that has nine or fewer component securities, (ii) in which a component security comprises more than 30% of the index’s weighting, (iii) in which the five highest weighted component securities, in the aggregate, comprise more than 60% of the index’s weighting; or (iv) in which the lowest weighted component securities comprising, in the aggregate, 25% of the index’s weighting have an aggregate dollar value of average daily trading volume of less than \$50 million, or in the case of an index with 15 or more component securities, \$30 million (subject to a specified adjustment if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted 25% of the index’s weighting).

<sup>7</sup>Among other issues that are not entirely clear in the definition is the treatment of an index of loans as opposed to securities. Additionally, while it appears that credit default swaps (other than those on broad-based security indices) are intended to be within the category of security-based swap, some commentators have raised the question whether so-called “pay-as-you-go” credit default swaps on asset-backed securities would fall within the definition of “security-based swap.” The question presumably is prompted by the proviso to the third clause of the definition, in which the events described are not intuitively descriptive of those that typically occur with respect to asset-backed securities.

- options on securities, or groups, or indices of securities, that are subject to the Securities Act and the Exchange Act;
- any contract of sale of commodities for future delivery (or option on such a contract);
- leverage contracts;
- security futures products; and
- certain physically settled forwards.

Foreign exchange swaps and foreign exchange forwards are to be considered “swaps” (within the jurisdiction of the CFTC) unless the Treasury makes a written determination that either or both should not be regulated as swaps under the Derivatives Title and are not structured to evade any rule promulgated by the CFTC under the Act.<sup>8</sup> However, even if the determination is made not to regulate foreign exchange swaps or foreign exchange forwards as swaps, all such products must be reported to a swap data repository (or, if no swap data repository will accept such reporting, the CFTC), and any swap dealer or Major Participant (as defined below) that is a party to such a contract is subject to the business conduct standards under the Commodity Exchange Act (“CEA”) as amended by the Derivatives Title. Moreover, the exclusion from regulation as swaps, if made, would not exempt foreign exchange swaps or forwards that are listed and traded on or subject to the rules of a designated contract market or swap execution facility, or cleared by a derivatives clearing organization, from any provision of the CEA as amended by the Derivatives Title prohibiting fraud or manipulation, and would not affect the existing CFTC regulation of retail transactions.<sup>9</sup>

Many of the requirements set forth in the Act that apply to swaps regulated by the CFTC also apply to security-based swaps regulated by the SEC, including the requirements outlined in this article, except where otherwise indicated.<sup>10</sup>

<sup>8</sup> Act § 721(a)(21) (to be codified at 7 U.S.C. § 1a).

<sup>9</sup> See Act § 721(a)(21) (to be codified at 7 U.S.C. § 1a).

<sup>10</sup> This article, except where otherwise indicated, uses the term “swap” to refer to both swaps and security-based swaps, and “swap dealer” to refer to both swap dealers and security-based swap dealers. The Act defines “[security-based] swap dealer” as:

(A) IN GENERAL, any person who — (1) holds itself out as a dealer in [security-based] swaps, (2) makes a market in [security-based] swaps, (3) regularly enters into [security-based] swaps with counterparties as an ordinary course of business for its own account or (4) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in [security-based] swaps [provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer].

(B) INCLUSION. — A person may be designated as a [security-based] swap dealer for a single type or single class or category of [security-based] swap or activities, and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.

(C) EXCEPTION. — The term [security-based] “swap dealer” does not include a person that enters into [security-based] swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

(D) DE MINIMIS EXCEPTION. — The [SEC/CFTC] shall exempt from designation as a [security-based] swap dealer an entity that engages in a de minimis quantity of [security-based] swap dealing in connection with transactions with or on behalf of its customers. The [SEC/CFTC] shall promulgate regulations to establish factors with respect to the making of this determination to exempt. See Act § 721(a)(21) (to be codified at 7 U.S.C. § 1a) (“swap dealer”) & Act § 761(a)(6) (to be codified at 15 U.S.C. § 78c(a)) (“security-based swap

## Expanded Application of Securities Laws<sup>11</sup>

Since the passage of the Commodity Futures Modernization Act of 2000 (the “CFMA”), the anti-fraud and anti-manipulation provisions of the Securities Act and the Exchange Act as well as the insider-trading provisions of the Exchange Act have applied to “security-based swaps” (as defined in Section 206B of the GLB Act). However, the GLB Act prohibited the SEC from otherwise regulating security-based swaps. Section 762 under the Derivatives Title repeals the provisions enacted under the GLB Act and the CFMA that prohibited the SEC from regulating security-based swaps and significantly expands the regulation of security-based swaps under the Securities Act and the Exchange Act.

The Derivatives Title amends the definition of “security” for purposes of the Exchange Act to include “security-based swaps.”<sup>12</sup> The Derivatives Title also effects numerous other amendments to the Exchange Act including (in addition to the clearing and reporting requirements with respect to security-based swaps) subjecting security-based swaps to the prohibition on the manipulation of security prices under Section 9 of the Exchange Act,<sup>13</sup> and adding a new Section 10B of the Exchange Act that authorizes the SEC to set limits on the size of positions in any security-based swap that may be held by any person.<sup>14</sup>

Also noteworthy are the amendments to Section 13 of the Exchange Act relating to beneficial ownership reporting and short-swing profit recovery. Sections 13(d)(1), 13(f)(1) and 13(g)(1) of the Exchange Act — relating to required disclosure of acquisition of more than 5% beneficial ownership interests and quarterly reporting by institutional investment managers — are amended to provide that certain security-based swaps (as provided in rulemaking by the SEC) may be deemed to constitute beneficial ownership of a registered class of equity securities for purposes of the reporting requirements.<sup>15</sup> The Derivatives Title also adds a new subsection 13(o) to the Exchange Act which provides — for purposes of Sections 13 and 16, relating to disclosure and short-swing profit recovery for directors, officers and beneficial owners of more than 10% — that beneficial ownership of the security underlying a security-based swap may be deemed to have been acquired if the SEC determines that the security-based swap provides incidents of ownership comparable to direct ownership (and that it is necessary to achieve the purposes of Section 13 of the Exchange Act that those swaps be deemed the acquisition of beneficial ownership of the related security). The amendments also give the SEC the authority to require more timely, and frequent, reporting of beneficial ownership interests.

The Derivatives Title sets forth amendments to the Securities Act that, among other things:

- add security-based swap to the definition of “security” under Section 2(a)(1) of the Securities Act;
- provide that the offer or sale of a security-based swap by or on behalf of the issuer of the referenced securities (or an affiliate of the issuer, or an underwriter) constitutes a contract for the sale of or offer to sell the referenced securities under Section 2(a)(3) of the Securities Act; and

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dealer”). The bracketed proviso in clause (A) above is included in the definition only of “swap dealer,” but not “security-based swap dealer.”

<sup>11</sup>Act §§ 761 (to be codified at 15 U.S.C. 78c(a)), 762, 763 (to be codified at 15 U.S.C. 78a *et seq.*), 766 (to be codified at 15 U.S.C. 78a *et seq.*) & 768 (to be codified at 15 U.S.C. 77b(a)).

<sup>12</sup>Act § 761 (to be codified at 15 U.S.C. 78c(a)).

<sup>13</sup>Act § 763(f) (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>14</sup>See “Position Limits” below.

<sup>15</sup>Act § 766(b) (to be codified at 15 U.S.C. 78m).



- subject security-based swaps to the registration requirement of Section 5 of the Securities Act<sup>16</sup> unless the counterparty to the security-based swap is an “eligible contract participant”<sup>17</sup> as defined under the Commodity Exchange Act (the “CEA”).

The treatment of security-based swaps as securities under the Securities Act and the Exchange Act raises questions regarding the extent to which rules and regulations under those Acts, beyond those expressly made applicable to security-based swaps, may apply to security-based swaps. This is of particular concern in view of the lack of clarity as to whether certain types of swaps — which may include certain “bespoke” portfolio swaps used in structured finance transactions and “pay-as-you-go” swaps on asset-backed securities — will be treated as “swaps” or as “security-based swaps.”

### **Mandatory Clearing and Exchange Trading Requirements<sup>18</sup>**

As noted above, the main objectives of the derivatives legislation are to bring transparency to the market for the types of derivatives transactions that have been privately negotiated bilateral trades in the OTC market, and to reduce the potential for counterparty and systemic risk of those products. In addition to the enhanced regulation of financial institutions and other major market participants, the primary means of achieving those goals are to require that the transactions occur on trading platforms — designated contract markets or swap execution facilities for CFTC-regulated products, and security-based swap execution facilities or national securities exchanges for SEC-regulated products — in order to provide transparency to the market, and that the transactions receive the credit protections afforded by clearinghouses regulated by the CFTC or SEC, as applicable.

In general, a clearing organization or clearing agency (also referred to as a clearinghouse, or a central clearing platform) is a member-funded organization that acts as an intermediary in clearing and settling trades and netting offsetting transactions. A clearinghouse typically is relied upon to insulate those trading with it from a default by a member or other counterparties by requiring contributions from its members to serve as a reserve, and to collect margin on each transaction from members and others who trade through it. In the context of commodities and swaps, the clearinghouse collects upfront and mark-to-market collateral (typically referred to in the swap context as “initial” and “variation” margin). The clearing provisions of the Derivatives Title are premised on an expectation that use of the clearinghouse model will reduce counterparty and systemic risk in the newly regulated OTC derivatives market.<sup>19</sup>

<sup>16</sup>Act § 768 (to be codified at 15 U.S.C. 77b(a)).

<sup>17</sup>An “eligible contract participant” is defined under the CEA to mean a person, acting for its own account, that is a financial institution, an insurance company, an investment company, a commodity pool, a corporation or other legal entity, an employee benefit plan, a government entity, or certain other types of entities and individuals, in each case having a minimum required total assets, net worth or total amount invested, as applicable, or meeting other specified requirements.

Section 721(a)(9) (to codified at 7 U.S.C. 1a) under the Derivatives Title amends the existing definition of “eligible contract participant” by:

(1) raising from \$25 to \$50 million the threshold amount required to be owned and invested on a discretionary basis for qualification by a governmental entity, political subdivision, multinational or supranational government entity, or instrumentality, agency or department of any of such entities, and,

(2) requiring individuals to have “amounts invested on a discretionary basis” (as opposed to “total assets,” under the current definition) in excess of \$10 million (or \$5 million if the contract is entered into to manage a risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred by the individual).

<sup>18</sup>Act §§ 723 (to be codified at 7 U.S.C. 2) & 763 (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>19</sup>Demonstrating the importance of clearing in the legislative framework, the Derivatives Title provides that any

**General Rule.** The Act requires swaps to be cleared if they are of a type that the CFTC or SEC, as applicable, determines must be cleared and they are accepted for clearing by a “derivatives clearing organization” (a “DCO”) (in the case of a swap) or a clearing agency (in the case of a security-based swap) unless one of the exemptions described below applies. The regulatory review process for a particular group, category, type or class of swap can be initiated either by a DCO or clearing agency, or by the relevant regulator.

Any DCO or clearing agency is required to submit to the CFTC or SEC, respectively, each swap, or any group, category, type or class of swap that the DCO or clearing agency plans to accept for clearing, and provide notice of the submission to its members. The CFTC or SEC will make such submissions available to the public, make its determination as to whether clearing is required, and provide at least a 30-day public comment period regarding its determination. The determination is to be made by the CFTC or SEC within 90 days following the submission, unless the submitting DCO or clearing agency agrees to an extension.<sup>20</sup> However, the CFTC or SEC, on application of a counterparty to a swap or on its own initiative, may stay the clearing requirement after issuance of such an approval until the CFTC or SEC completes a review of the terms of the swap (or the group, category, type or class of swap) and the clearing arrangement. The review is to be completed within 90 days following the issuance of the stay, again, unless the submitting DCO or clearing agency agrees to an extension. Upon completion of the review, the CFTC or SEC may determine, unconditionally or subject to such conditions as it determines, that the swap, or group, category, type or class of swap, must be cleared, or that the clearing requirement will not apply.

It may not be possible for the CFTC or SEC to address all applications for approval or stays of the clearing requirements on a timely basis if the volume of applications is significant. This could be an issue during the rulemaking period and probably for a significant length of time thereafter, when clearinghouses and counterparties will be eager to determine the status of various products.

The CFTC or SEC also may itself initiate review of any group, category, type or class of swap to determine whether mandatory clearing should apply. The same time frames, including the 30-day public comment period, apply to the regulator-initiated review, except that the stay process does not apply.

Swaps subject to the clearing requirement also must be traded on a board of trade designated as a contract market or a swap execution facility (in the case of a swap) or on a security-based swap execution facility or a national securities exchange (in the case of a security-based swap), unless no relevant facility will make the particular swap available to trade (or, in the case of certain exempt end users, described below, if the end user opts to exercise its clearing exemption). However, uncleared swaps will be subject to the reporting and recordkeeping requirements for uncleared swaps described below under **“Reporting and Recordkeeping Requirements for Uncleared Swaps.”**

Entering into cleared transactions will require swap counterparties to post initial margin and to post (or receive returns of) variation margin at least daily, and potentially on additional occasions, intraday. For

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DCO or clearing agency that knowingly or recklessly evades or participates in or facilitates an evasion of the clearing requirements under the Act will be liable for a civil money penalty in twice the amount otherwise available for a violation of the relevant provisions of the CEA or the Exchange Act, as applicable. Act §§ 741(b) (to be codified at 7 U.S.C. 6b) & 773 (to be codified at 15 U.S.C. 78p-2).

<sup>20</sup>Any swap and any group, category, type or class of swap that is already listed for clearing by a DCO or a clearing agency on the date of enactment of the Act will be considered to be submitted to the CFTC and/or SEC for approval for clearing.

swap users that have been sufficiently creditworthy not to post margin in the OTC market, or to have posted margin in lesser amounts than may be required by DCOs or clearing agencies once the clearing requirements become effective, the change in margin requirements could reduce available liquidity and effectively increase the cost of hedging or otherwise using derivatives.<sup>21</sup> These swap users may see offsetting benefits, however, in terms of increased pricing transparency and liquidity.

One of the many thorny transitional issues to be resolved is whether it will be possible for members of more than one DCO or clearing agency to obtain the benefits of netting and margin posted not only across products, but also across clearing platforms. DCOs have the benefit of a provision that “in order to minimize systemic risk, under no circumstances shall a derivatives clearing organization be compelled to accept the counterparty credit risk of another clearing organization.”<sup>22</sup> But a clearing organization is not prohibited from doing so. The benefits to members would be evident, but such arrangements could be legally and operationally complex.

The clearing requirement under the Derivatives Title<sup>23</sup> has no explicit transition period; therefore, the General Effective Date provision applies, subject to the additional practical consideration that many products will not have been approved for clearing for some time after the General Effective Date.

**Exemption for Certain End Users.** A swap will be exempt from the clearing and exchange trading requirements described above if one of the counterparties to the swap is an end user (as defined below) that is hedging its own commercial risk. The end user can elect to require the swap to be cleared and traded on an exchange or swap execution facility even if the exemption is available.

By definition, an end user cannot be a financial entity (as defined below). The exemption applies only to a swap counterparty that “(i) is not a financial entity; (ii) is using swaps to hedge or mitigate financial risk, and (iii) notifies the [CFTC or SEC], in a manner set forth by the [CFTC or SEC], how it generally meets its financial obligations associated with entering into non-cleared swap.”<sup>24</sup>

“Financial entity” means any of the following:

- A swap dealer or a Major Participant (as defined below for purposes of this article);
- A commodity pool as defined in the CEA;
- A private fund as defined in Section 202(a) of the Investment Advisers Act (a fund that would be required to register as an investment company but for the exemption provided by Sections 3(c)(1) or 3(c)(7) of the 1940 Act);<sup>25</sup>
- An ERISA plan; or

<sup>21</sup>In addition to the increased out-of-pocket and opportunity costs of meeting increased margin requirements, many companies simply may not have a treasury function that is equipped to readily handle daily or intraday posting requirements, and may need to turn to banks to provide these treasury services, coupled with lines of credit to cover margin calls.

<sup>22</sup>Act § 725(h) (to be codified at 7 U.S.C. 7a-1(F)(i)).

<sup>23</sup>Act §§ 723(h) (swaps) (to be codified at 7 U.S.C. 7a-1(F)(i)) & 763(a) (security-based swaps) (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>24</sup>Act §§ 723(a)(3) (to be codified at 7 U.S.C. 2) & 763(a) (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>25</sup>“Private fund” is newly defined in Section 402 of the Act (to be codified at 15 U.S.C. 80b-2(a)). Given this definition, most CDOs and many other types of SPEs and investment funds will be financial entities for purposes of the Derivatives Title.

- A person predominantly engaged in activities that are in the business of banking or financial in nature.<sup>26</sup>

For purposes of the clearing exemption for end users of swaps, the term “financial entity” expressly excludes captive finance companies that meet the following standard: an entity whose primary business is providing financing, and which uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company.<sup>27</sup>

The CFTC or SEC, as applicable, is to consider whether to exempt small banks, savings associations, farm credit system institutions and credit unions with total assets not exceeding \$10 billion.

An affiliate of an end user — including an affiliate predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the end user — may rely on the end-user exemption only if the affiliate, acting on behalf of the end user and as an agent, uses the swap to hedge or mitigate the commercial risk of the end user or other affiliate of the end-user that is not a “financial entity.” However, the affiliate may not rely on the end-user exemption if it is a swap dealer, a Major Participant, an issuer that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the 1940 Act, a commodity pool or a bank holding company with more than \$50 billion in consolidated assets.

A transitional exemption is also provided for an affiliate, subsidiary or wholly owned entity of an end user that is predominantly engaged in providing financing for the purchase or lease of merchandise or manufactured goods of the end user. Such entities are exempt from the clearing requirement and from margin requirements with regard to swaps, or security-based swaps, entered into to mitigate the risk of the financing activities for not less than a two-year period following enactment. This clause appears to be intended to ease the transition for end users whose captive finance companies have activities that will not fit the strict standard for the exclusion from “financial entity.” Certainly those using security-based swaps for hedging purposes would not meet the terms of that exclusion.

The CFTC or SEC, as applicable, may promulgate rules and regulations to prevent abuses of the end user exemption.

An end user that is an issuer of securities registered under Section 12 of the Exchange Act or that is required to file reports under Section 15(d) of the Exchange Act may rely on the end user exemption only if an appropriate committee of the issuer’s board of directors or governing body has reviewed and approved its decision to enter into swaps that are uncleared in reliance on that exemption. It is not clear on the face of the provision whether that review and approval could be on a blanket basis or whether more specific approvals will be required.

**Exemption From Clearing for Grandfathered Swaps.** Swaps entered into prior to enactment (or post-enactment, but prior to the effective date of the clearing requirement) will not be subject to the clearing or exchange trading requirements but will be subject to the reporting and recordkeeping requirements for uncleared swaps described below.

<sup>26</sup>“Financial in nature” is as defined in Section 4(k) of the BHCA.

<sup>27</sup>No parallel exclusion is made for purposes of the clearing exemption in respect of security-based swaps, presumably reflecting an assumption that the hedging instruments typical of the activities of a captive finance company would include interest rate and currency hedges.

### Definitions of Major Swap Participant/Major Security-Based Participant<sup>28</sup>

The Act uses the term “Major Swap Participant” (“MSPs”) to refer to a participant in swaps regulated by the CFTC and “Major Security-Based Swap Participant” (“MSSPs”) to refer to a participant in a security-based swap regulated by the SEC. For purposes of this article, the term “Major Participant” will be used to refer to both MSPs and MSSPs. An entity may be both an MSP and an MSSP for purposes of the Derivatives Title. Major Participants are subject to the regulatory and compliance requirements under the Act described in this article.

A Major Participant is any entity that is not a swap dealer and that satisfies any one of the following alternative conditions:

- It maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC or SEC, excluding positions held for hedging or mitigating commercial risk (or hedging or mitigating any risk directly associated with the operation of an ERISA plan);
- Its outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- It is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency, and it maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC or SEC.

The definitions of MSP and MSSP are identical in substance, except that only the definition of MSP expressly excludes captive finance companies that meet the following standard (which by its terms is not relevant to the swaps done by an MSSP, in its capacity as such):<sup>29</sup> an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company.

The CFTC or SEC, as applicable, is to define “substantial position” (for purposes of the first and third categories of entities described above) at a threshold it determines prudent for the monitoring, management and oversight of entities that are systemically important or can significantly impact the financial system of the U.S.<sup>30</sup> In setting the threshold, the CFTC or SEC is required to consider the person’s relative position in uncleared as opposed to cleared swaps, and may take into consideration the value and quality of collateral held against counterparty exposures. The language of the Derivatives Title does not indicate whether the threshold will be the same for all types of swaps; *i.e.*, it appears it could vary by type of swap or type of entity. In addition, an entity may be designated as either an MSP or MSSP for one type of swap or security-based swap, respectively, without being an MSP or MSSP for all swaps or security-based swaps.<sup>31</sup>

<sup>28</sup>Act §§ 721 (to be codified at 7 U.S.C. 1a) & 761 (to be codified at 15 U.S.C. 78c(a)).

<sup>29</sup>As noted above in connection with discussion of the term “financial entity,” this appears to reflect a legislative assumption regarding the appropriate hedging instruments for captive finance companies.

<sup>30</sup>There is also no definition of “highly leveraged” or certain other concepts used in the definition, all of which are expected to be defined in the rules and regulations to be promulgated by the CFTC or SEC.

<sup>31</sup>The provision refers to an entity being “designated,” which may suggest that the CFTC or SEC, as

### Mandatory Registration, Capital and Margin Requirements<sup>32</sup>

The Act requires swap dealers and Major Participants to register with the CFTC or SEC not later than one year after enactment, and to satisfy capital and initial and variation margin requirements to be established within the same period by the applicable regulatory authority. The CFTC or SEC will set capital and margin requirements for nonbank swap dealers and nonbank Major Participants that are required to register. The appropriate federal banking agency will set the capital and margin requirements for banks that are required to register as swap dealers or Major Participants. A separate time frame for promulgating the rules and regulations specifying the capital and margin requirements is not set forth in the Derivatives Title; accordingly, the general rule requiring the rules and regulations be promulgated within 360 days following passage of the legislation applies.

The CFTC or SEC and the appropriate federal banking authorities are required to consult periodically (but not less frequently than annually) as to the appropriate required capital and margin requirements. In setting capital requirements for an entity designated as a Major Participant for a single type of swaps, the applicable regulatory authority is required to take into account the risks associated with other types of swaps engaged in and the other activities conducted by that entity that are not otherwise subject to regulation by virtue of the status of that entity as a Major Participant. The margin requirements to be set by the CFTC or SEC or the appropriate federal banking agency, as applicable, for swap dealers and Major Participants apply only to uncleared swaps (*i.e.*, the DCO or clearing agency requirements will apply to cleared swaps). Noncash collateral may be permitted to satisfy margin requirements but the use of noncash collateral for that purpose may be restricted by the applicable regulatory authority.

While the actual capital and margin requirements are still unknown, there are indications that they will be significant, and likely higher than the requirements imposed in connection with cleared swaps. The relevant language explicitly refers to the need to “offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared,” and that the requirements shall “(i) help ensure the safety and soundness of the swap dealer or major swap participant; and (ii) be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant.”<sup>33</sup>

The higher capital requirements imposed on swap dealers and Major Participants in connection with uncleared swaps are likely to be reflected in the cost to their counterparties of entering into such swaps. Uncleared swaps also may be generally less liquid than cleared swaps. The combination of higher costs associated with uncleared swaps and reduced liquidity may adversely affect SPEs and other investment vehicles because, for the following reasons, SPEs generally are unlikely to obtain the benefits of clearing. Swaps entered into by SPEs typically are tailored to the particular structure, and even the interest rate and foreign exchange swaps entered into by SPEs and other investment vehicles

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applicable, would review data submitted by swap counterparties and designate those that are MSPs or MSSPs, respectively, and as to which types of swaps or security-based swaps, as opposed to entities being required to register, or not, based on their analysis of criteria to be set by the CFTC and SEC relative to their derivatives positions. If it really is intended that only “designated” entities will be Major Participants, that is a further indication that the “substantial position” threshold will be very high; otherwise, that review and designation process alone could swamp the regulators.

<sup>32</sup>Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>33</sup>Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

may not be considered sufficiently “standard” to be cleared on an exchange. Additionally, unless differently structured in the future, SPEs would be unlikely to have sufficient available funds to post margin in the manner that is required in connection with a cleared swap.<sup>34</sup> Accordingly, though it is too early to predict with any certainty, it seems likely that for structured finance vehicles the new regime will have few benefits, other than the likely availability of better pricing data, and could have increased costs. To some extent, although not to the same degree, this outcome also may be typical of any market participants — other than end users — that for various reasons desire or need to do “bespoke” derivatives.<sup>35</sup>

### **Mandatory Reporting and Other Mandatory Compliance Requirements<sup>36</sup>**

The Derivatives Title requires swap dealers and Major Participants generally to comply with:

- significant financial reporting, annual compliance reporting and other reporting requirements;
- significant recordkeeping requirements;
- business conduct standards; and
- documentation and back office standards to be set forth in rules and regulations promulgated under the Derivatives Title.<sup>37</sup>

Swap dealers and Major Participants also are required to perform certain duties, including:

- monitoring trading;
- establishing risk management procedures;
- disclosing certain information to regulators;
- establishing systems and procedures to obtain necessary information;
- implementing conflicts of interest procedures;
- avoiding anticompetitive practices; and
- appointing a chief compliance officer whose duties will include regulatory reporting.<sup>38</sup>

These mandatory reporting and other mandatory compliance requirements apply to “registered” swap dealers and Major Participants. Registration in those capacities must be made not later than one year after the enactment date.

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<sup>34</sup>It would be far more common for an SPE to have its assets pledged to a trustee or collateral agent for the benefit of all secured creditors in accordance with a priority of payments, than to have large amounts of free cash available to be exclusively dedicated to a single counterparty.

<sup>35</sup>This assumes that the issue of margin requirements for end users is clarified, as discussed above.

<sup>36</sup>Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>37</sup>Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>38</sup>*Id.*

### Reporting and Recordkeeping Requirements for Uncleared Swaps<sup>39</sup>

Uncleared swaps are required to be reported to a swap data repository (as described below) or to the CFTC or SEC if a swap data repository is unavailable. For swaps entered into on or after the date of enactment, this reporting is to be done within a period of time after entering into the swap that the CFTC or SEC is to prescribe by rule or regulation. Pre-enactment swaps also must be reported to a swap data repository or to the CFTC or SEC if a swap data repository is unavailable. However, the Derivatives Title has overlapping and inconsistent provisions addressing this reporting. Under one set of provisions, the deadline for such transitional reporting is no later than 30 days after the effective date of the “interim final rule” (which in turn is required to be finalized within 90 days following enactment) or such other period as the CFTC or SEC determines to be appropriate. Another set of provisions specifies a later date, following the General Effective Date, for each of pre-enactment and post-enactment swaps. These disparities presumably will be addressed by a technical corrections bill or by rulemaking.

It appears that, in general, uncleared swaps are to be reported by, if the transaction involves only one swap dealer or Major Participant, the swap dealer or Major Participant (as applicable), or, if the transaction involves both a swap dealer and a Major Participant, the swap dealer. In all other swaps, the counterparties must choose a reporting party. However, one of the sets of provisions addressing reporting of swaps and security-based swaps, respectively, does not so provide.

If a swap is not cleared or accepted by a swap data repository, each counterparty must maintain books and records available to regulators on the swaps and, if requested in writing by the CFTC or SEC, provide reports as required by the CFTC or SEC. The reports will be open for inspection by the CFTC or SEC, the appropriate prudential regulator (as defined in the Act), and the Council.<sup>40</sup>

### Public Reporting of Swap Transaction Data<sup>41</sup>

The Act requires the CFTC or SEC to promulgate rules and regulations for “real-time public reporting” of swap transaction and pricing data in such form and such times as the CFTC or SEC determines appropriate to enhance price discovery. “Real-time public reporting” is defined as the reporting of data relating to a swap transaction, including price and volume, as soon as technologically practicable after execution for swaps. Real-time public reporting will apply to swaps that are subject to the mandatory clearing requirement described above (including those that are exempted from the requirement pursuant to the end user exemption), and swaps that are not subject to the mandatory clearing requirement but are cleared by a registered DCO or clearing agency. For pre-enactment swaps (and post-enactment swaps entered into prior to the effective date of the clearing requirement) that are not cleared at a registered DCO or clearing agency, and are reported to a swap data repository or to the CFTC or SEC, the applicable regulator will require real-time public reporting of such transactions in a manner that does not disclose the business transactions and market positions of any person.

<sup>39</sup>Act §§ 729 (to be codified at 7 U.S.C. 6o–1) & 766 (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>40</sup>While an SPE is not likely to be responsible for the swap data repository reporting requirements under Sections 729 (to be codified at 7 U.S.C. 6o–1) and 766 (to be codified at 15 U.S.C. 78a *et seq.*) (because most swaps entered into by SPEs that are not themselves Major Participants are likely to have a counterparty that is a swap dealer or a Major Participant, who would be the reporting party), SPEs, like any other party to an uncleared swap, will have to comply with the books and recordkeeping requirements for uncleared swaps.

<sup>41</sup>Act §§ 727 (to be codified at 7 U.S.C. 2(a)) & 763(i) (to be codified at 15 U.S.C. 78a *et seq.*).



The CFTC or SEC is required to include provisions to ensure that participants are not identified and to specify criteria for determining what constitutes a large notional swap transaction (block trade) for particular markets in order to institute appropriate time delays of the reporting of such transactions. In promulgating these rules and regulations, the SEC or CFTC is required to take into account whether public disclosure would materially reduce market liquidity.

The CFTC or SEC may require registered entities to publicly disseminate the swap transaction and pricing data information required pursuant to this provision. The CFTC or SEC will issue semiannual and annual reports on the trading and clearing of major swap categories and the market participants and development of new products.

### Swap Data Repositories<sup>42</sup>

The Derivatives Title requires swap data repositories to accept data from swap counterparties, confirm the accuracy of that data and maintain the data pursuant to standards to be established by the CFTC or SEC, including direct electronic access to the CFTC or SEC and systems for monitoring and analyzing data and making information available to regulators. Swap data repositories are required to register with the CFTC or SEC and to make available on a confidential basis all data obtained by the swap data repository, including individual counterparty trade and position data, to each appropriate prudential regulator, the Council, the SEC, the DOJ, any other person that the CFTC or SEC determines to be appropriate, including foreign financial supervisors (including foreign futures authorities), foreign central banks and foreign ministries, and to establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allows for the timely recovery and resumption of operations and the fulfillment of the responsibilities and obligations of the organization.

### Position Limits<sup>43</sup>

The Act authorizes the CFTC to impose aggregate position limits across markets, in order to (i) diminish, eliminate, or prevent excessive speculation; (ii) deter and prevent market manipulation, squeezes, and corners; (iii) ensure sufficient market liquidity for bona fide hedgers; and (iv) ensure that the price discovery function of the underlying market is not disrupted. Swap positions entered into prior to enactment will be exempt from the position limits imposed by the CFTC.<sup>44</sup>

The SEC, for the purpose of preventing fraud and manipulation, may establish limits on the size of positions in any security-based swap that may be held by any person, and may require reporting by such persons.<sup>45</sup> For that purpose, positions in security-based swaps may be required to be aggregated with positions in the securities or loans that the security-based swap is based upon or references or to which it is related, or any group or index of securities that is the basis for a material term of the security-based swap, or any other instrument relating to the same security or group or index of securities. The SEC also may direct self-regulatory organizations to impose similar requirements with respect to its members or their customers.

<sup>42</sup>Act §§ 728 (to be codified at 7 U.S.C. 24) & 763(i) (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>43</sup>Act §§ 737 (to be codified at 7 U.S.C. 6a(a)) & 763 (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>44</sup>Act § 739 (to be codified at 7 U.S.C. 25(a)).

<sup>45</sup>Act § 763(h) (to be codified at 15 U.S.C. 78a *et seq.*).

### Segregation of Swap Collateral; Bankruptcy Treatment of Swaps<sup>46</sup>

Any person that holds margin for DCO-cleared swaps for customers is required to register with the CFTC as a futures commission merchant (“FCM”). Any person that holds margin for clearing agency-cleared swaps for customers is required to be registered with the SEC as a broker-dealer or security-based swap dealer. The FCM (in the case of a swap) or the broker-dealer or security-based swap dealer (in the case of a security-based swap) is required to segregate property held as margin. The use and investment of segregated funds will be subject to such rules as the CFTC or SEC, as applicable, may promulgate.

The Act provides that a swap cleared through a DCO will be treated as a “commodity contract” for purposes of the U.S. Bankruptcy Code with respect to funds and property of a swap customer received by an FCM or a DCO (*i.e.*, posted margin). The evident intent of this provision is to provide the preferential treatment of such funds and property in the event of the insolvency of the FCM in the same manner that Section 766 of the Bankruptcy Code treats margin posted in respect of commodity contracts in the event of an insolvency of an FCM.

Margin posted by counterparties to “security-based swaps” will be held in a “securities account” by a broker, dealer or security-based swap dealer registered with the SEC. These accounts would be subject to the liquidation procedures applicable to broker-dealers in the event of insolvency.

Uncleared swaps are not subject to the above statutory requirements. However, with respect to uncleared swaps entered into with a swap dealer or a Major Participant, the swap dealer or Major Participant must notify the counterparty at the commencement of a swap transaction that the counterparty is entitled to require the segregation of funds or other property posted as initial margin. If the counterparty so elects, then the swap dealer or Major Participant must, in accordance with such rules and regulations as the CFTC or SEC may promulgate, maintain any initial margin posted by its counterparty in a segregated account separate from the assets and other interests of the swap dealer or Major Participant. If the counterparty does not require funds to be segregated, the swap dealer or Major Participant must report to the counterparty on a quarterly basis that the back office procedures of the swap dealer or Major Participant relating to margin and collateral requirements are in compliance with the agreement of the counterparties. This option of the counterparty does not apply to variation margin.

### Legal Certainty for Swaps<sup>47</sup>

The Act contains an amendment to Section 22(a) of the CEA, entitled “Legal Certainty for Swaps,” intended to remove doubt as to the legality or enforceability of contracts newly subject to regulation that may not meet certain requirements, including clearing requirements, under the CEA. The provision further provides, with express reference to long-term swaps entered into prior to enactment of the Derivatives Title, that neither the enactment nor any provision or requirement of the Derivatives Title will constitute “a termination event, force majeure, illegality, increased costs, regulatory change, or similar event under a swap (including any related credit support arrangement) that would permit a party to terminate, renegotiate, modify, amend, or supplement one or more transactions under the swap.”

This provision may have the intended effect of providing parties to pre-enactment swaps with some protection against having their swaps summarily terminated or pricing changed on the basis that

<sup>46</sup>Act §§ 724 (to be codified at 7 U.S.C. 6d) & 763 (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>47</sup>Act § 739 (to be codified at 7 U.S.C. 25(a)).

passage of the Act constitutes a change of law or other termination event, or triggers an increased costs provision. However, it leaves important questions unanswered. Notably, there is no parallel provision for security-based swaps. Therefore, for those who view the provision as beneficial, the protections are not expressly given to the SEC-regulated products. In addition, an entity that is unable to comply with new requirements (should any be imposed retroactively), which otherwise may have had the ability to rely on a termination provision to terminate at a mid-market price, instead may be effectively compelled to seek a negotiated termination to avoid costs or penalties. Other parties (not only swap dealers) may be deprived of the right to exercise termination or renegotiation rights upon which they would expect to rely if subjected to higher costs or other adverse consequences of changes in law or regulation.

### **Ban on Proprietary Trading of Derivatives for Bank's Own Account<sup>48</sup>**

The Volcker Rule could have far-reaching consequences for the conduct of derivatives activities by banking organizations. The provision prohibits insured depository institutions and their affiliates from engaging in "proprietary trading," except as otherwise provided. For these purposes, "proprietary trading" is defined as engaging as a principal for the trading account<sup>49</sup> of the relevant entity to purchase or sell, or otherwise acquire or dispose of, any security, derivative, contract of sale of a commodity for future delivery, option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate federal banking agencies, the SEC and the CFTC may, by rule, determine. Exclusions from the prohibition include certain underwriting and market-making activities; risk-mitigating hedging activities in connection with positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts or other holdings; and purchases and sales on behalf of customers.<sup>50</sup>

The implementation and effectiveness of the Volcker Rule is subject to a post-enactment study by the Council, which is to make recommendations on implementation within six months following enactment, after which a nine-month period of rulemaking by the federal bank regulators as well as the SEC and CFTC commences. The Volcker Rule is to become effective on the earlier of one year after the adoption of the final agency rules and two years after the enactment of the Act. Following that effective date, there is a transition period of up to two years, after which the FRB has the discretion to grant up to three one-year extensions. **See "The Volcker Rule."**

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<sup>48</sup>Act § 619 (to be codified at 12 U.S.C. 1841 *et seq.*).

<sup>49</sup>"Trading account" is defined in § 619 (to be codified at 12 U.S.C. 1841 *et seq.*) as any account used for acquiring or taking positions in the relevant securities and instruments principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate Federal banking agencies, the SEC, and the CFTC may, by rule, determine.

<sup>50</sup>Also excluded from the prohibition are the purchase, sale, acquisition, or disposition of U.S. government or agency obligations, obligations of any State or political subdivision thereof, and obligations of or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971.

### The Lincoln Provision (Swaps “Push-Out” by Banks)<sup>51</sup>

The Act also includes a controversial provision that prohibits “federal assistance” to any “swaps entity.” Federal assistance is defined for this purpose as the use of advances from any Federal Reserve credit facility or discount window (that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act; *i.e.*, the emergency lending powers), or FDIC insurance or guarantees for a number of specified purposes relating to a swaps entity, including making any loan to a swaps entity, purchasing the assets of a swaps entity, or guaranteeing any loan or debt issuance of a swaps entity. “Swaps entity” is defined as any swap dealer or Major Participant that is registered under the CEA or the Exchange Act, other than a Major Participant that is an insured depository institution. Therefore, an insured depository institution will be a “swaps entity” for purposes of this provision only if it is a swap dealer.

Although substantially moderated in the House-Senate Conference, this provision (referred to herein as the “Lincoln Provision”) effectively requires any bank or other entity with access to Federal Reserve credit or FDIC assistance, and whose derivatives activities constitute acting as a swap dealer, to cease (after a transition period) all swap activities other than those expressly permitted to be conducted within an insured depository institution, as described below. An insured depository institution is permitted to have or establish an affiliate that is a swaps entity, but only if the insured depository institution is part of a bank holding company, or savings and loan holding company, that is supervised by the Federal Reserve, and 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 appropriate, and the Board of Governors, may determine to be necessary. In addition, such an entity would have to independently meet the capital and other requirements imposed by the Derivatives Title to act as a swap dealer, as well as independently satisfying any other standards required as a practical matter to participate in the market, such as requirements of clearing organizations and of counterparties who will only transact with swap providers that have high counterparty ratings. To separately capitalize such an affiliate at the level necessary for it to satisfy those regulatory and market standards may be unfeasible for all but the largest banking organizations. The Lincoln Provision also expressly provides that an insured depository institution is required to comply with the limitation on proprietary trading of derivatives under the Volcker Rule (which should have been clear on the face of the Volcker Rule, without such an additional provision). The combined effect of the Lincoln Provision and the Volcker Rule is to substantially limit the derivatives activities of insured depository institutions and their affiliates, even those conducted in a separate “swaps entity.”

As modified in Conference, the Lincoln Provision permits an insured depository institution to engage in (i) hedging and other similar risk mitigating activities directly related to the insured depository institution’s activities and (ii) acting as a swaps entity for swaps involving rates or reference assets that are permissible for investment by a national bank under the National Bank Act. However, the second permitted category is limited with respect to credit default swaps (including on asset-backed securities) to only those cleared by a DCO or a clearing agency. Taken as a whole, this provision would appear to permit insured depository institutions to engage in interest rate swaps, foreign exchange swaps, gold and silver swaps and cleared credit default swaps referencing investment grade securities, but not other derivatives (except to the extent constituting hedging activities).

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<sup>51</sup>Act § 716.

Because the Lincoln Provision expressly refers only to insured depository institutions as being exempt (to the extent specified) from the general ban on federal assistance to swaps entities, the provisions relating to the permitted activities (and those relating to the transition period) do not on their face apply to U.S. branches of foreign banks. This distinction appears likely to have been an oversight, and it may be an appropriate subject for the contemplated technical corrections bill that was discussed in the final stages of the House-Senate Conference.

The Lincoln Provision seeks to assure no losses to taxpayers through bank swaps activities, by requiring (i) the liquidation of FDIC insured institutions or nonbank financial institutions regulated by the Board of Governors that are put into receivership or declared insolvent as a result of swap or security-based swap activity (a formulation that evidently assumes direct causation would be a clear-cut determination), (ii) that no taxpayer funds be used to prevent such a receivership and (iii) that funds expended on the termination or transfer of the swaps activities in liquidation would be recovered through the liquidation of the assets of the swaps entity and if necessary by assessment, including on the financial sector.

Under the Lincoln Provision the Council is given the ability, on an institution-by-institution basis, to determine that a swaps entity may no longer access federal assistance when other provisions established by the Act are insufficient to effectively mitigate systemic risk and protect taxpayers. Presumably that authority would be used only in extraordinary circumstances, but that clause poses some uncertainty for institutions relying upon the Lincoln Provision to engage in swaps activities and for their counterparties.

The Lincoln Provision does not become effective until two years following the date on which the Derivatives Title is effective.<sup>52</sup> Following the effective date, there is a transition period of up to an additional 24 months during which the insured depository institution is to bring its derivatives activities into compliance, and this period may be extended for up to one additional year by the appropriate Federal bank regulator, after consultation with the CFTC and the SEC. The Lincoln Provision also has a grandfathering provision for swaps entered into before the end of the transition period. Although not free of ambiguity, it appears that the grandfathering is intended to survive the ultimate “push out” date for swaps entered into before that date.

While the transition period should reduce some of the worst short-term disruptive effects that could have been caused to banks and their counterparties by a more precipitous effective date, the provision nevertheless could adversely affect the profitability and risk management of the large U.S. financial institutions that have acted as leading derivatives dealers and potentially cause a loss of business by U.S. banking organizations to non-U.S. competitors.

### **Business Conduct Standards; Special Requirements With Respect to Special Entities<sup>53</sup>**

Under the Derivatives Title, swap dealers and Major Participants generally are subject to comprehensive business conduct standards such as disclosure responsibilities including as to material risks, material incentives and conflict of interests and mark-to-market information.

In addition to these generally applicable standards, the Derivatives Title imposes additional requirements upon swap dealers when acting as an advisor, and to swap dealers and Major Participants when

<sup>52</sup>It is not entirely clear whether this means the General Effective Date that is extendible by the time required for rulemaking, or if this refers to the hard date that would be two years and 360 days following enactment.

<sup>53</sup>Act §§ 731 (to be codified at 7 U.S.C. 1 *et seq.*) & 764 (to be codified at 15 U.S.C. 78a *et seq.*).

acting as a non-advisor counterparty, to a “Special Entity.” A “Special Entity” means a federal agency, a state, state agency, city, county, municipality or other political subdivision of a state, an employee benefit or governmental plan as defined in ERISA, and any endowment. When acting as an adviser, the swap dealer will have a duty to act in the best interests of the Special Entity and will be required to make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap recommended by the swap dealer is in the best interests of the Special Entity. When acting as a non-adviser counterparty to a Special Entity that is not an ERISA plan, a swap dealer or Major Participant must determine that the counterparty is advised by an independent representative that meets certain specified criteria. When acting as a non-adviser counterparty to an ERISA plan, a swap dealer or Major Participant must determine that its counterparty is advised by an ERISA fiduciary.

### **Abusive Swaps and Foreign Entities<sup>54</sup>**

The Act provides that the CFTC or SEC may, by rule or order, collect information and issue a report on which types of swaps, if any, the CFTC or SEC determines are detrimental to the financial stability of financial markets or financial market participants. The intended purpose of such a report would presumably be to strictly regulate or ban any type of swap that the CFTC or SEC determines to be detrimental.

The Act also provides that, if the CFTC or SEC determines that the manner of regulation of swaps or swap markets in a foreign country undermines the stability of the U.S. financial system, the CFTC or SEC, in consultation with the Secretary of the Treasury, may prohibit an entity domiciled in the foreign country from participating in any swap activities in the United States.

### **Rulemaking on Conflicts of Interest<sup>55</sup>**

In order to mitigate conflicts of interest, the Derivatives Title requires the CFTC or SEC to determine, within 360 days following enactment, whether to adopt rules to establish limits on the control of any DCO (in the case of the CFTC) or clearing agency (in the case of the SEC) that clears swaps, any swap execution facility or any board of trade designated as a contract market (in the case of the CFTC) or national securities exchange (in the case of the SEC) that posts swaps or makes swaps available for trading, by a bank holding company<sup>56</sup> with total consolidated assets of \$50 billion or more, a nonbank financial company<sup>57</sup> supervised by the Federal Reserve Board, any affiliate of such a bank holding company or nonbank financial company, a swap dealer, a Major Participant or an associated person of a swap dealer or Major Participant.<sup>58</sup> The Act provides that such rules should be adopted if necessary to, among other things, mitigate systemic risk, promote competition or mitigate conflicts of interest in connection with a swap dealer’s or Major Participant’s conduct of business with a DCO or clearing agency (as applicable), a contract market or national securities exchange (as applicable), or swap execution facility in which such swap dealer or Major Participant has a material debt or equity investment. In adopting rules pursuant to this provision, the CFTC or SEC, as applicable, is required to

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<sup>54</sup>Act §§ 714 & 715.

<sup>55</sup>Act §§ 726 & 765.

<sup>56</sup>As defined in § 2 of the BHCA.

<sup>57</sup>As defined in the Act.

<sup>58</sup>A person “associated with” a swap dealer or Major Participant is defined to include, among others, any partner, officer, director or branch manager of the swap dealer or Major Participant, or any person occupying a similar status or performing similar functions.

consider any conflicts of interest arising from the amount of equity owned by a single investor; the ability to vote, cause the vote of, or withhold votes entitled to be cast on any matters by the holders of the ownership interest; and the governance arrangements of any DCO or clearing agency.

### Preemption of State Regulation<sup>59</sup>

In addition to allocating the jurisdiction of the CFTC and SEC over swaps and security-based swaps, respectively, the Derivatives Title prohibits the regulation of swaps or security-based swaps as insurance contracts under state law.

### Extraterritorial Application<sup>60</sup>

The Derivatives Title specifies certain limitations on the potential extraterritorial scope of its provisions. The Derivatives Title specifies that the provisions of the CEA relating to swaps (in this context, excluding security-based swaps) added by the Derivatives Title do not apply to activities outside the U.S. unless those activities “(1) have a direct and significant connection with activities in, or effect on, commerce of the U.S., or (2) contravene such rules or regulations as the CFTC may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision” of the CEA enacted by the Derivatives Title.<sup>61</sup>

The Derivatives Title specifies that the provisions of the Exchange Act added by the Derivatives Title do not apply to any person “insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States,” unless that person “transacts such business in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate to prevent the evasion of any provision” of the Exchange Act added by the Derivatives Title.<sup>62</sup>

The Derivatives Title does not include any express exemptions for non-U.S. entities from the requirements applicable to swap dealers or Major Participants. Many non-U.S. entities will be subject to regulation as swap dealers because they conduct substantial activities of that type in the U.S. However, the extent to which the Derivatives Title would affect their activities outside the U.S. remains to be clarified during the rulemaking process, and presumably will include coordination with relevant foreign regulatory authorities.

The Derivatives Title also leaves open issues with respect to non-U.S. entities that on the basis of their swap positions may be categorized as Major Participants. For example, it is uncertain whether such entities would be excluded by regulation from the Major Participant category if they enter into swaps only outside the U.S. and only with non-U.S. entities. The intended scope of the definition of “Major Participant,” and in particular the extent to which it may apply to entities outside the U.S., may not be known with certainty until the rulemaking process has been concluded (if then). However, past experience with similar language under the Exchange Act, for example, would suggest that having counterparties or customers in the U.S., or using a clearing or trading facility in the U.S., among other activities, could be a sufficient nexus for a foreign person to be subjected to regulation under the Derivatives Title.

<sup>59</sup>Act §§ 722 (to be codified at 7 U.S.C. 2(a)(1)) & 767 (to be codified at 15 U.S.C. 78a *et seq.*).

<sup>60</sup>Act §§ 722 (to be codified at 7 U.S.C. 2(a)(1)) & 772(b) (to be codified at 15 U.S.C. 78dd).

<sup>61</sup>Act § 722 (to be codified at 7 U.S.C. 2(a)(1)).

<sup>62</sup>Act § 772(b) (to be codified at 15 U.S.C. 78dd).

Coordination with foreign regulatory authorities will involve many challenging issues — in addition to the extraterritoriality issues mentioned above, areas where a complementary approach is to be sought include bank capital requirements and the regulation of derivatives. So far, the European Union and England are only at the talking stage in terms of legislation relating to derivatives and other financial reform issues. While they have voiced support in general terms for action on derivatives for some time, little has been done other than the passage of resolutions, and Germany's somewhat quixotic, unilateral ban on short-selling of certain German financial institutions and credit default swaps on euro-zone government bonds.

On June 15, 2010, for example, the European Parliament issued a resolution, entitled "Derivatives Markets: Future Policy Actions," setting forth in general terms its views on regulatory reform for derivatives, and calling for greater standardization, clearing and reporting of all derivative contracts. The UK Financial Services Authority, on the other hand, does not necessarily agree with the move toward mandatory clearing. The FSA and the UK Treasury recently have expressed concern that the clearing-houses could be forced to clear products that they cannot adequately risk manage, which could cause severe losses. Moreover, neither the UK nor the EU is likely to materially restrict the derivatives business that can be done by banks, which has led to the concern by some U.S. financial institutions, and others, that the Act could result in a loss of business by U.S. banks to their European competitors.

Other countries also have begun to assess their regulatory schemes for derivatives. These include Japan, India, China, Hong Kong, Singapore, South Korea and Taiwan. However, to date, these efforts remain largely or entirely at the task force stage.

It appears that, for the time being, the U.S. will be entering the brave new world of regulated OTC derivatives substantially on its own.

## Conclusions

Although not all of the consequences can be predicted, it is clear that the Dodd-Frank Act will have a material impact on the derivatives market. It also is clear that the Derivatives Title and related portions of the Act are largely a framework, with many difficult determinations left to the rulemaking process. The full impact of the legislation will be revealed through the rulemaking process and the ongoing implementation of the regulatory oversight and interpretive functions associated with it.

The Derivatives Title requires that the majority of the implementing regulations be in place within 360 days of the passage of the legislation. Within that period, the CFTC and the SEC, as well as the respective "prudential regulators" for the various types of banking organizations<sup>63</sup> must coordinate to give content to key concepts that have been left undefined, set thresholds to determine who will be Major Participants, and set margin and capital requirements — not only for a wide range of financial entities, but also for other market participants that currently have no comparable regulatory capital requirements. In sum, those regulators will be charged with implementing an entirely new regulatory regime for the vast variety of financial products that fall under the rubric of OTC derivatives.

The process will be analytically complex and also would appear to involve enormous logistical complexity, given the need for coordination, in a short period of time, among a number of regulators, across a

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<sup>63</sup>The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Farm Credit Administration.



range of regulated entities that potentially includes every type of business enterprise and investment vehicle. These overlapping spheres of jurisdiction also could pose a longer-term challenge to the efficiency and coherence of the regulatory oversight of OTC derivatives.

Moreover, many of the significant players in the OTC derivatives market are global financial institutions and multinational corporations. It seems unlikely that an optimally effective regulatory scheme can be developed without coordination with foreign banking and other relevant regulators. To do so probably would take longer than 360 days, but not to do so could result in conflicting regulations that could cause market anomalies or disruptions, or undesirable competitive advantages.

The Act does not explicitly ban or limit any particular type of derivatives transaction, such as the so-called “naked” credit default swaps that, together with the leveraged products based on them, including synthetic CDOs, have attracted so much adverse commentary in the wake of the financial upheavals of 2007 and 2008.<sup>64</sup> Although this may be disappointing to some constituencies, prohibiting specific products can be insufficiently flexible (*i.e.*, it may simply engender variants that could require further legislative or regulatory action to address) or have unintended consequences, such as the chilling effect that an over-broad or ambiguous proscription could have on productive business activity. Instead, the Derivatives Title and related provisions of the Act rely on a combination of factors to reduce risk in the OTC derivatives market, including:

- increasing transparency of the market and reducing the potential for counterparty and systemic risk by requiring the clearing and exchange-trading of standardized swaps (and the public reporting of transaction and pricing data with respect to both cleared and uncleared swaps);
- imposing margin requirements for cleared swaps and (other than with respect to end users) uncleared swaps involving a swap dealer or Major Participant;
- increasing capital requirements for swap dealers and imposing capital requirements for the newly regulated category of Major Participants; and
- limiting the derivatives activities of banking organizations to a significant extent.

The Derivatives Title also authorizes the CFTC or SEC, by rule or order, to collect information concerning the market for any swap or security-based swap, as applicable, and to issue a report with respect to any types of such instruments that it determines to be detrimental to the stability of a financial market or to participants in a financial market.<sup>65</sup> In addition, Title I of the Act would create the new Council as an inter-agency authority charged with (among other things) identifying and responding to

<sup>64</sup>However, a range of provisions under Title IX of the Act — “Investor Protections and Improvements to the Regulation of Securities,” subtitles C (“Improvements to the Regulation of Credit Rating Agencies”) and D (“Improvements to Asset-Backed Securitization”) — as well as Rule 17g-5 under the Exchange Act, intended to bring increased transparency and competition to the process of rating such securities, which became effective on June 2, 2010, could materially affect the manner in which asset-backed securities and other structured finance securities are structured and offered, including by requiring expanded disclosure, ongoing reporting requirements, and risk retention by persons who organize and initiate asset-backed securities issuances. See “Securitization.” In addition, Section 621 adds a new section to the Securities Act that imposes conflict of interest rules in relation to certain securitizations; on its face, this provision would appear to make it much more difficult for banks to structure synthetic CDOs or similar structures.

<sup>65</sup>Act § 714.

risks to the stability of U.S. financial markets; collecting information relating to and monitoring potential systemic risks; identifying gaps in regulation that could pose risks to the financial stability of the U.S.; and making recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit or other problems spreading among bank holding companies, nonbank financial companies and the U.S. financial markets. Many key provisions of the Derivatives Title contain express references to further standards and requirements that may be adopted by regulation. These provisions collectively would appear to provide the authority to prohibit or otherwise further regulate (such as by the imposition of increased capital charges or position limits) particular derivatives products or practices in the future.

While this approach has the benefit of flexibility, and the potential to adapt to new developments or changing conditions, it may carry the risk of uncertainty in the marketplace. In addition, the proposed limitations on the derivatives activities of banking organizations could have unintended negative consequences, such as reducing the profitability of banks, reducing competition in the providing of derivatives products, increasing the costs of derivatives products, and putting U.S. banks at a competitive disadvantage.

Finally, as noted above, it will require significant time, expense and effort for participants in the market to comply with the terms of the derivatives legislation. In addition to the potential adverse impact on bank profits of the Volcker Rule and the Lincoln Provision, which together materially restrict the derivatives business that can be done by U.S. banks, the legislation may adversely affect certain sectors of the structured finance market. The higher capital charges that are expected to apply to the derivatives activities of swap providers presumably will be passed on by swap dealers to their counterparties. Thus, the Act could significantly challenge the ability to consummate structured finance transactions based on credit derivatives and may adversely affect even the more traditional consumer finance or trade receivables securitizations, to the extent it increases the cost of interest rate and currency hedging transactions. While disincentives to synthetic securities transactions probably are intentional, adversely affecting the ability of traditional structures to hedge interest rate and currency risk may be an additional, unintended effect of the new rules and may reduce or increase the costs of credit available to consumers or manufacturing companies.

# Investor Protection and SEC Enforcement | New Authority and Directed Studies Increase Risks and Costs for Firms

In the immediate wake of the financial crisis, a view held by some was that the SEC would not survive the then-nascent effort to launch financial regulatory reform. In the Dodd-Frank Act, the SEC has not only survived, but emerged with enhanced enforcement authority, potentially greater access to resources, and expanded regulatory authority in a number of areas. The Act also includes provisions relating to the organization of the agency, which appear intended to improve its effectiveness in carrying out its mission.

With few exceptions, the provisions of the Act that bear on investor protection and SEC enforcement make incremental, although collectively significant, changes to the SEC's enforcement regime. Many challenging policy questions relating to investor protection issues that were considered by Congress ultimately were deferred pending the completion of a large number of studies required by the Act and/or subsequent rulemaking. By requiring studies and providing rulemaking authority in many areas to the SEC, the Act may simply be the opening salvo in a period of sustained regulatory reforms.

Interestingly, some studies are directed to the SEC, while others are directed to the U.S. Government Accountability Office ("GAO"). It is not entirely clear why Congress took a bifurcated approach. The GAO, often called the "congressional watchdog," is an independent agency that conducts investigations on behalf of Congress.<sup>1</sup> The relationship of the GAO to other government agencies is one of critical oversight.<sup>2</sup> Some critics of the financial sector have expressed support for GAO studies while criticizing studies conducted by the SEC or other financial regulatory agencies.<sup>3</sup> Thus, the decision by Congress to place certain studies with the GAO may reflect the view that GAO studies are "tougher" or "more independent" than SEC studies. The decision to assign some studies to the GAO also may reflect a recognition

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<sup>1</sup> See "About GAO," available at: <http://www.gao.gov/about/index.html> (last visited June 9, 2009); see also 31 U.S.C. § 702(a) ("The Government Accountability Office is an instrumentality of the United States Government independent of the executive departments.").

<sup>2</sup> See 31 U.S.C. § 712 (requiring the GAO to, *inter alia*, "investigate all matters related to the receipt, disbursement, and use of public money" and "analyze expenditures of each executive agency the Comptroller General believes will help Congress decide whether public money has been used and expended economically and efficiently"); *id.* § 717(b) (requiring the GAO to "evaluate the results of a program or activity the government carries out under existing law" on its own initiative or at the request of Congress).

<sup>3</sup> Mark Schoeff, Jr., "Planners Claim Small Victory in Financial-Reform Legislation," *InvestmentNews*, May 30, 2010 (noting that "[f]iduciary advocates decry the Senate provision [calling for an SEC study of the imposition of a fiduciary duty on broker-dealers] as a way to kill a universal fiduciary standard," but that these same groups are not decrying a GAO study of financial planning oversight); "SEC Studies Financial Reform to Death," *Financial Advisor*, Apr. 12, 2010 ("There are also questions about whether the SEC is the right agency to study itself in some cases — such as examining possible gaps in its own regulatory processes . . . 'If you give it to the SEC, there are all sorts of built-in biases that come into play,' says [Denise Voigt Crawford, president of the North American Securities Administrators Association]. She says the U.S. Government Accountability Office, or GAO, the Congressional watchdog, would be better suited for some of the studies."); Andy Kroll, "Wall St. Reform's Death by Study," *Mother Jones*, Mar. 22, 2010 (characterizing a proposed GAO bankruptcy study as "tough" and "independent" in comparison to a study by a council of financial regulatory agencies, which the author viewed as designed to blunt the impact of the study).

by Congress that the large number of required studies and the limited time to complete them would strain the SEC's resources.<sup>4</sup>

This article outlines and analyzes some of the key provisions of the Act relating to investor protection and SEC enforcement. In particular, the article explores ways in which these provisions may affect financial firms such as broker-dealers and investment advisers.

### **New Authority Will Enhance Robustness of SEC Enforcement Program and Increase Litigation Costs and Risks**

#### **An Aggressively Expanded Whistleblower Bounty Program Will Increase Tips**

**The SEC's New Statutory Authority.** The Act provides the SEC with new authority to pay large cash awards to persons who provide original information that leads to a successful judicial or administrative enforcement action.<sup>5</sup> The whistleblower provision is one of many provisions in the Act that fulfills a specific legislative request by the SEC or its staff,<sup>6</sup> and it dovetails with a cooperation initiative announced earlier this year by Robert Khuzami, Director of the SEC's Enforcement Division, that encourages insiders to report securities law violations to the SEC.<sup>7</sup> The revamped whistleblower bounty program is likely to result in more actionable tips to the SEC. It also carries the risk that current employees or outside advisers may be incentivized to provide incomplete, confidential, privileged, improperly obtained, or otherwise tainted information to the SEC.

For some time, the SEC has possessed authority to award "bounties" in insider trading cases, although for a variety of reasons that authority was rarely used.<sup>8</sup> Decisions whether or not to award a bounty and the amount of any such bounty were left within the unreviewable discretion of the SEC and limited to no more than 10% of the penalty assessed by the SEC or the DOJ in an insider trading case.<sup>9</sup> A recent review of the existing insider trading bounty program by H. David Kotz of the SEC's Office of the Inspector General ("OIG") found that, although the program has existed for more than 20 years, the SEC has only paid \$159,537 to five claimants.<sup>10</sup> In response to the OIG's findings, SEC Enforcement Director Robert Khuzami concurred that the existing bounty program is not effective, and stated that the SEC hopes Congress will pass legislation to create a new whistleblower bounty program "wholly replacing" the existing insider trading bounty program.<sup>11</sup>

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<sup>4</sup> See "SEC Studies Financial Reform to Death," *Financial Advisor*, Apr. 12, 2010 (reporting that former SEC chief accountant Lynn Turner believes each study could require the SEC to devote 10-15 full-time staff members, and stating that the burden "would almost certainly strain an agency that already has resource issues and is trying to reassert its authority and effectiveness in areas of critical importance").

<sup>5</sup> Act § 922.

<sup>6</sup> See Strengthening the SEC's Vital Enforcement Responsibilities: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the S. Comm. on Banking, Hous., & Urban Affairs, 111th Cong. 7 (2009) (statement of Robert Khuzami, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, requesting that Congress enact an SEC whistleblower bounty program).

<sup>7</sup> See Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions, 17 C.F.R. § 202.12 (2010); Robert Khuzami, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks at Press Conference (Jan. 13, 2010).

<sup>8</sup> See 15 U.S.C. § 78u-1(e).

<sup>9</sup> *Id.*

<sup>10</sup> H. David Kotz, *Inspector General, U.S. Sec. & Exch. Comm'n, Assessment of the SEC's Bounty Program* 5 (2010).

<sup>11</sup> See *id.* at 28.

Under the Act, the SEC's authority to award bounties to whistleblowers extends to all judicial and administrative enforcement actions resulting in monetary sanctions (defined to include penalties, disgorgement and interest) of more than \$1 million.<sup>12</sup> Whistleblowers are entitled to payments equivalent to between 10% and 30% of the total amount of monetary sanctions assessed by the SEC, or by the DOJ or other regulatory authorities in related actions.<sup>13</sup> Whistleblowers may be represented by counsel, and award determinations are subject to limited abuse-of-discretion review in an appropriate federal court of appeals.<sup>14</sup>

The minimum-maximum award and judicial review provisions contained in the Act are modeled after the whistleblower bounty program of the Internal Revenue Service established pursuant to the Tax Relief and Health Care Act of 2006.<sup>15</sup> The IRS whistleblower bounty program requires the IRS to pay between 15% and 30% of recoveries on amounts in dispute over \$2 million.<sup>16</sup> In using the IRS's program as a model, the Senate Banking Committee "determined that enforceability and relatively predictable level of payout will go a long way to motivate potential whistleblowers to come forward," and will improve upon the disappointing performance of the SEC's existing insider trading bounty program.<sup>17</sup>

Personal involvement in the misconduct is not necessarily a bar to collecting a bounty, as only a criminal conviction stands as an absolute bar. Moreover, whistleblowers also receive statutory protections under the Act that permit them to retain their anonymity or, if identified, protect them from retaliation. The SEC is prohibited from disclosing information that could reasonably be expected to reveal the identity of the whistleblower, unless and until the information is required to be disclosed to a defendant or a respondent in a proceeding instituted by the government.<sup>18</sup> Additionally, employers are prohibited from retaliating against whistleblowers.<sup>19</sup> Individuals who allege that they were discharged or discriminated against for blowing the whistle have a private cause of action for reinstatement, two-times back pay, and litigation expenses.<sup>20</sup>

Congress took certain steps to support the effectiveness of the SEC whistleblower bounty program. First, to ensure that the whistleblower bounty program does not slip to the bottom of the SEC's list of

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<sup>12</sup>Act § 922(a).

<sup>13</sup>*Id.* In determining the amount of a whistleblower award, the SEC must consider the significance of the information provided, the degree of assistance provided, the programmatic interest of the SEC in deterring securities law violations by paying whistleblowers, and additional factors that the SEC may establish by rule or regulation. *Id.*

<sup>14</sup>*Id.*

<sup>15</sup>*S. Rep. No. 111-176*, at 111 (2010).

<sup>16</sup>See Pub. L. 109-432, § 406, 120 Stat. 2922, 2958-60 (2006) (codified at 26 U.S.C. § 7623).

<sup>17</sup>See No. 111-176, at 112.

<sup>18</sup>Act § 922(a). Without the loss of its status as confidential in the hands of the SEC, the SEC has discretion to share whistleblower information with the U.S. Attorney General, appropriate state or federal regulatory agencies, self-regulatory organizations ("SROs"), state attorneys general in connection with criminal investigations, the Public Company Accounting Oversight Board, and foreign securities and law enforcement authorities. *Id.*

<sup>19</sup>*Id.*

<sup>20</sup>*Id.* The Sarbanes-Oxley Act of 2002 ("Sarbanes Oxley") also prohibits public companies and their officers and employees from retaliating against an employee because of any lawful act done by the employee to provide information to a regulatory or law enforcement agency or to Congress, or to participate in a lawsuit in connection with a violation of the securities laws. 18 U.S.C. § 1514A(a). Employees who experience prohibited discrimination can file a complaint with the Secretary of Labor and, if the Secretary of Labor fails to issue a decision within 180 days, in an appropriate federal district court. *Id.* § 1514A(b). The Act amends Sarbanes-Oxley to clarify that employees of subsidiaries and affiliates of public companies receive the same protection. Act § 929A.

priorities, the Act requires the SEC to establish a separate whistleblower office within the SEC to administer the program.<sup>21</sup> The whistleblower office will report annually to the Senate Banking and House Financial Services Committees.<sup>22</sup> Second, the Act requires the OIG, which has criticized the SEC's current bounty program, to study the whistleblower bounty program.<sup>23</sup> Among other things, the OIG is required to consider whether the SEC rules relating to its whistleblower bounty program are user-friendly, whether the SEC promptly responds to whistleblowers, and whether the minimum and maximum award levels are sufficient to attract information or are so high that they attract false claims.<sup>24</sup> Within 30 months of the enactment of the Act, the OIG is required to submit a report on its findings to the Senate Banking and House Financial Services Committees and post the report on the SEC's website.<sup>25</sup>

**The IRS Experience as a Predictive Model.** The track record of the IRS whistleblower bounty program upon which the SEC program is modeled suggests that the SEC program will probably "work," in that the potential for large cash rewards will attract tips. The IRS experienced a pronounced and sustained uptick in whistleblower claims following the establishment of its whistleblower bounty program. In 2007, the year that the IRS created its whistleblower office, the IRS received 83 claims alleging total underreported income of \$8 billion.<sup>26</sup> In contrast, in 2008, the IRS received 1,890 claims alleging total underreported income of \$65 billion.<sup>27</sup> Indeed, the IRS whistleblower bounty program also led to the growth of law firms that specialize in tax whistleblower claims.<sup>28</sup> The establishment of a more aggressive SEC whistleblower bounty program may lead to the growth of a similar cottage industry among plaintiffs' lawyers who already specialize in securities litigation.

The IRS's experience with its whistleblower bounty program also provides insight into procedural complications that the SEC likely will face when implementing its new whistleblower bounty program. These include thorny problems relating to:

- the receipt and use of privileged and confidential information;
- the possibility that documents or information may have been obtained in violation of relevant professional conduct rules; and
- the possibility that information could be procured in violation of the Fourth Amendment.

These issues are most likely to arise when current employees of investigated entities provide information to the SEC.

The Office of the Chief Counsel of the IRS has issued guidance to assist the IRS staff in dealing with privilege and taint issues in connection with the whistleblower bounty program.<sup>29</sup> Presumably, the SEC

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<sup>21</sup>See Act § 924(d).

<sup>22</sup>*Id.*

<sup>23</sup>Act § 922(d).

<sup>24</sup>*Id.*

<sup>25</sup>*Id.*

<sup>26</sup>*Treasury Inspector General for Tax Administration, Deficiencies Exist in the Control and Timely Resolution of Whistleblower Claims 6* (2009).

<sup>27</sup>*Id.*

<sup>28</sup>Ryan J. Donmoyer, "IRS Whistleblower Claims Quadruple on Informants (Update1)," *Bloomberg.com*, Oct. 1, 2009.

<sup>29</sup>See I.R.S. Chief Couns. Notice CC-2010-004, (Feb. 17, 2010); I.R.S. Chief Couns. Notice CC-2008-011 (Feb. 27, 2008).

will issue similar guidance. The IRS guidance instructs the staff to coordinate with the Chief Counsel's office to conduct taint reviews of potentially privileged or confidential information provided by whistleblowers.<sup>30</sup> If an attorney, accountant or other professional blows the whistle on a client, the taint review considers the potential impact of any ethical duties owed by that person.<sup>31</sup>

The IRS Chief Counsel's guidance further instructs the IRS staff to take certain steps to ensure that the IRS remains a "passive participant" in the collection of information from current employees of investigated entities.<sup>32</sup> This guidance, sometimes called the "one-bite" rule,<sup>33</sup> is designed to ensure that a current employee does not become an "agent" of the IRS such that the person's conduct could be deemed an illegal search and seizure, which could taint any information provided by that person.<sup>34</sup> In February 2010, the IRS Chief Counsel's Office loosened the one-bite rule to permit the IRS staff to have limited follow-up contacts with whistleblowers who are current employees of an investigated entity.<sup>35</sup>

It is not clear that the IRS's procedures are sufficient to contain potentially troubling issues that arise when current employees of regulated entities provide confidential information to the government. Former IRS Chief Counsel Donald Korb has described the IRS whistleblower bounty program as a "ticking time bomb" that "ha[s] the potential to be a real disaster for the tax system."<sup>36</sup> Mr. Korb predicted "some huge scandal with the program" involving a high-level employee of a large company who turns over tainted information, which would "become front-page news."<sup>37</sup> Mr. Korb also criticized the IRS's liberalization of the one-bite rule, calling it "a step in the wrong direction."<sup>38</sup>

In at least one tax collection action, *United States v. Comco Management Corporation*, a federal magistrate judge ordered the return of documents that were taken by an IRS whistleblower from his current employer and provided to the government.<sup>39</sup> The magistrate judge expressed concern regarding the involvement of an Assistant U.S. Attorney in the collection of the documents while the defendant employed the whistleblower.<sup>40</sup> Thus, he ordered the IRS whistleblower office to cease reviewing 25 boxes of documents and return them to the defendant for a privilege review.<sup>41</sup> He also precluded the

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<sup>30</sup>*Id.*

<sup>31</sup>*Id.* at 4. See also *Model Rules of Prof'l Conduct* R. 1.6 (except in specific enumerated circumstances, "[a] lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, [or] the disclosure is impliedly authorized in order to carry out the representation"); *La. Rules of Prof'l Conduct* R. 4.2 (forbidding attorneys to communicate about the subject of a representation with a person they know to be an employee of a represented organization if the person is a supervisory employee or regularly consults with counsel, has authority to obligate the organization, or is a person whose conduct could be imputed to the organization for purposes of liability); *In re Shell Oil Refinery*, 143 F.R.D. 105 (E.D. La. 1992) (ordering plaintiffs' counsel in a class action lawsuit to produce documents that were obtained *ex parte* from an employee of the defendant, noting that such documents may have been procured in violation of La. R. of Prof'l Conduct 4.2, and forbidding plaintiffs to make use of information contained in the documents).

<sup>32</sup>I.R.S. Chief Couns. Notice CC-2010-004, at 1-3; I.R.S. Chief Couns. Notice CC-2008-011, at 1-2.

<sup>33</sup>I.R.S. Chief Couns. Notice CC-2008-011, at 2.

<sup>34</sup>I.R.S. Chief Couns. Notice CC-2010-004, at 1-3.

<sup>35</sup>*Id.*

<sup>36</sup>Jeremiah Coder, "Tax Analysts Exclusive: Conversations: Donald Korb," *Tax Analysts*, Jan. 18, 2010.

<sup>37</sup>*Id.*

<sup>38</sup>Jeremiah Coder, "Chief Counsel Approves More Interaction with Whistleblowers," *Tax Analysts*, Feb. 24, 2010.

<sup>39</sup>See *United States v. Comco Mgmt. Corp.*, No. 8:08-cv-00668 (C.D. Cal. Dec. 1, 2009) (tentative ruling and minute order).

<sup>40</sup>*Id.*, tentative ruling at 3-4.

<sup>41</sup>*Id.*, minute order.

government from using any information contained in documents that ultimately proved to be privileged.<sup>42</sup> The magistrate's order was subsequently vacated, but only pursuant to a stipulated agreement between the parties that still required the government to deliver the documents to the defendant for a privilege review.<sup>43</sup>

The outcome in *Comco Management* calls into question the IRS whistleblower office's role as the initial recipient and reviewer of potentially privileged or tainted information.<sup>44</sup> Similar concerns could bedevil the SEC whistleblower bounty program.

**Importance of Compliance and Remediation Efforts.** The enhanced SEC whistleblower bounty program underscores the importance for broker-dealers, investment advisers, public companies and other organizations that operate under the securities laws to have and vigilantly maintain robust compliance programs well-tailored to their business. It is ever more critical that organizations be in a position to identify and address potential misconduct at the earliest stage.

The existence of the bounty program also will clearly complicate the already difficult judgment of when to self-report indications of potential misconduct, and places renewed emphasis on the need to maintain privilege over initial assessments of misconduct. The prospect of a substantial bounty and the potential job security that may accompany whistleblower status may effectively place a company in competition with its employees to be the first mover. This can create significant pressure on companies to self-report as early as possible to preserve cooperation credit, even if underlying facts are not completely understood.<sup>45</sup> The risk that an insider may bring a whistleblower claim increases over time if a company waits to report confirmed or suspected misconduct, or if more people within the company learn of the possible misconduct outside of a privileged context.

### Other Enhancements to the SEC's Enforcement Program

The Act contains numerous other provisions designed to bolster the effectiveness of the SEC's enforcement program. In many cases, the Act fulfills specific legislative requests, such as a "wish list" of changes to the federal securities laws that the SEC sent to Congress in 2009.<sup>46</sup> Taken together, these provisions of the Act represent a significant buildup of the SEC's enforcement arsenal.

**The Act Increases Remedies Available to the SEC.** The Act provides the SEC with new authority to impose monetary penalties in administrative cease-and-desist proceedings against "any person" for violations of the securities laws, a remedy that previously was available administratively only against registered persons.<sup>47</sup> Previously, the SEC was able to obtain only civil monetary penalties against non-registered persons in enforcement actions filed in federal court.<sup>48</sup> The Act now permits the SEC to choose either forum in all cases.

The Act also permits the SEC to bar securities professionals from association with any regulated entity — including broker-dealers, investment advisers, municipal securities dealers, municipal advisers, transfer

<sup>42</sup>*Id.*

<sup>43</sup>*United States v. Comco Mgmt. Corp.*, No. 8:08-cv-00668 (C.D. Cal. Dec. 18, 2009) (stipulation regarding joint request to vacate the magistrate judge's order).

<sup>44</sup>See William P. Barrett, "IRS Ordered to Surrender Documents," *Forbes*, Dec. 1, 2009.

<sup>45</sup>James Tillen, George Clark, and Kevin Mosley, "Whistleblower Rewards Could Drastically Change FCPA Practice," *Corporate Compliance Insights*, Apr. 1, 2010.

<sup>46</sup>See Rich Edson, "SEC Gives 'Wish List' of 42 Changes it Wants in Securities Law," *FOXBusiness.com*, July 16, 2009.

<sup>47</sup>Act § 929P(a).

<sup>48</sup>15 U.S.C. §§ 77t(d) & 78u(d).



agents, and statistical rating organizations — based on a violation of the securities laws, even if the violation occurred in only one area of the securities industry.<sup>49</sup> Previously, the SEC routinely imposed collateral bars in settled cases, but its authority to do so was foreclosed by a 1999 decision of the U.S. Court of Appeals for the D.C. Circuit.<sup>50</sup> The Act reverses the impact of that decision by providing the SEC with express authority to resume its prior practice of imposing collateral bars, which increases the stakes for potential defendants and respondents in SEC enforcement actions.

**The Act Responds to Litigation Decisions that Limited the Reach of the SEC Enforcement Division.**

The Act amends certain provisions of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) and the Securities Exchange Act of 1934 (the “Exchange Act”) to clarify that the SEC may bring enforcement actions against persons who were associated with certain regulated or supervised entities at the time of alleged wrongdoing, even if they have left the industry.<sup>51</sup> This provision addresses a prior decision finding that enforcement proceedings under Section 19 of the Exchange Act were not available against former officers and directors of a self-regulatory organization (“SRO”).<sup>52</sup>

The Act also codifies the extraterritorial reach of the SEC and the DOJ in actions to enforce the antifraud provisions of the federal securities laws in a way that effectively nullifies the application of a recent Supreme Court decision in the enforcement context. In *Morrison v. National Australia Bank*, the Supreme Court held that Section 10(b) of the Exchange Act does not reach manipulative or deceptive conduct unless it is in connection with (a) the purchase or sale of a security listed on a national exchange, or (b) the purchase or sale of a security in the United States.<sup>53</sup> In so holding, the Supreme Court rejected a long line of cases from the U.S. Court of Appeals for the Second Circuit, which held that application of Section 10(b) could be premised on significant *conduct* in the United States, an *effect* on the American securities market, or some combination of the two.<sup>54</sup>

In *Morrison*, the “conduct” and “effects” tests had been advanced by foreign private plaintiffs arguing for jurisdiction over claims against foreign defendants and relating to transactions on a foreign exchange (*i.e.*, an “f-cubed” case).<sup>55</sup> The Act does not disturb the application of *Morrison* in the context of private claims. However, it does require the SEC to study the possibility of restoring the conduct and effects tests in private actions to enforce the antifraud provisions of the Exchange Act.<sup>56</sup>

Additionally, the Act clarifies that the SEC may impose joint and several liability on control persons under Section 20(a) of the Exchange Act.<sup>57</sup> This provision of the Act resolves a circuit split regarding the SEC’s authority under Section 20(a).<sup>58</sup>

<sup>49</sup> Act § 925.

<sup>50</sup> See *Teicher v. SEC*, 177 F.3d 1016, 1019-21 (D.C. Cir. 1999).

<sup>51</sup> Act § 929F.

<sup>52</sup> See In the Matter of Salvatore F. Sodano, Initial Decision Release No. 333, 2007 WL 2362701, at \*5 (Aug. 20, 2007), *rev’d*, Exchange Act Release No. 59141, 2008 WL 5328801 (Dec. 22, 2007).

<sup>53</sup> *Morrison v. Nat’l Australia Bank*, \_\_\_ U.S. \_\_\_, 2010 WL 2518523, at \*14 (June 24, 2010).

<sup>54</sup> *Id.* at \*6-8 (citing Second Circuit cases).

<sup>55</sup> *Id.* at \*3-4.

<sup>56</sup> Act § 929Y. The SEC is directed to consider, *inter alia*, the scope of any extraterritorial private right of action, the impact of such a right of action on international comity, and the costs and benefits associated with such a right of action, and to submit recommendations to the Senate Banking and House Financial Services Committees within 18 months following the enactment of the Act. *Id.*

<sup>57</sup> *Id.* § 929P(c).

<sup>58</sup> Compare *SEC v. J.W. Barclay & Co.*, 442 F.3d 834, 841-43 (6th Cir. 2006) (holding that the SEC is a “person” for purposes of Exchange Act § 20(a) and thus may maintain an action under that provision) and *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996) (same) with *SEC v. Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974) (holding that the SEC is not a “person” under § 20(a)).

Finally, in addition to rolling back the effect of precedent that limited the SEC's ability to bring enforcement actions in certain contexts, the Act provides the SEC with new authority to serve subpoenas compelling documents and testimony anywhere in the United States.<sup>59</sup> The SEC already had the ability to serve administrative subpoenas anywhere that a witness may be found.<sup>60</sup> In federal injunctive actions, however, the SEC was constrained by a rule that requires federal courts to quash subpoenas purporting to require witnesses to travel more than 100 miles or, in the case of testimony at trial, out of state.<sup>61</sup> The Act suspends that rule in SEC enforcement actions, which enhances the SEC's ability to call witnesses and seek information.

### **The Act Clarifies and Expands the SEC's Authority to Address Conduct by Secondary Actors.**

**SEC Authority.** The Act contains several provisions that expressly give the SEC authority to bring enforcement actions in federal district court against persons who aid and abet violations of the securities laws. Such authority under the Exchange Act had been expressly provided to the SEC by Section 104 of the Private Securities Litigation Reform Act ("PSLRA"),<sup>62</sup> after the Supreme Court held in *Central Bank of Denver v. First Interstate Bank of Denver* that a private plaintiff could not maintain an action under Rule 10b-5 against a bank that allegedly aided and abetted securities fraud, because Section 10(b) of the Exchange Act does not proscribe "giving aid to a person who commits a manipulative or deceptive act."<sup>63</sup>

In a recent line of cases, however, some federal district courts have held that the language of the Investment Advisers Act of 1940 (the "Advisers Act") does not authorize the SEC to seek, or federal courts to impose, civil monetary penalties against aiders and abettors.<sup>64</sup> The Act plugs this regulatory gap by clarifying that the SEC may seek civil monetary penalties in federal district court enforcement actions for aiding and abetting violations of the Advisers Act.<sup>65</sup> The Act also provides the SEC with express authority to bring enforcement actions seeking civil monetary penalties and injunctions against aiders and abettors under the Securities Act of 1933 and the Investment Company Act of 1940, which previously contained no language authorizing suits against aiders and abettors.<sup>66</sup>

The Act also clarifies that persons may be held liable for aiding and abetting if they behave "recklessly."<sup>67</sup> Following the enactment of the PSLRA, the SEC argued that recklessness was sufficient to establish aiding and abetting liability under the Exchange Act, but courts generally disagreed.<sup>68</sup> The Act codifies

<sup>59</sup>Act § 929E.

<sup>60</sup>See, e.g., 15 U.S.C. § 78u(c) ("In case of contumacy by, or refusal to obey a subpoena [sic] issued to, any person, the [SEC] may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on, or where such person resides or carries on business, in requiring the attendance and testimony of witnesses and the production of books, papers, correspondence, memoranda, and other records. . . . All process in any such case may be served in the judicial district whereof such person is an inhabitant or wherever he may be found.") (emphasis added).

<sup>61</sup>Fed. R. Civ. P. 45(c)(3)(A)(ii).

<sup>62</sup>Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, § 104, 109 Stat. 737, 757 (1995) (codified at 15 U.S.C. § 78t).

<sup>63</sup>*Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177-78 (1994).

<sup>64</sup>See *SEC v. Bolla*, 550 F. Supp. 2d 54, 63 (D.D.C. 2008); *SEC v. Gabelli*, No. 08 CV 3868(DAB), 2010 WL 12353603, at \*11-12 (S.D.N.Y. Mar. 17, 2010).

<sup>65</sup>Act § 929N.

<sup>66</sup>*Id.* Act § 929M.

<sup>67</sup>*Id.* Act §§ 929M, 929N, & 929O.

<sup>68</sup>See *SEC v. Fehn*, 97 F.3d 1276, 1287-88 & n.11 (9th Cir. 1996) (holding that aiding and abetting liability under § 20(e) of the Exchange Act requires "knowledge," and that recklessness is insufficient) and *SEC v. KPMG LLP*,

the SEC's litigation position with respect to the level of scienter that is necessary to establish an aiding and abetting violation.

**Private Claims Against Secondary Actors.** The Act leaves intact, for now, Supreme Court decisions barring private claims premised on secondary liability theories. However, it requires the GAO to conduct a study "on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws."<sup>69</sup> The GAO is required to consider the role of secondary actors in companies' issuance of securities, recent judicial interpretations of secondary liability under the securities laws, and the types of lawsuits decided under the PSLRA, and to report to Congress within one year of enactment of Dodd-Frank.<sup>70</sup>

While the provision raises the prospect that the GAO could recommend legislation to expand the scope of potential liability in securities class actions and other private securities lawsuits, the GAO study actually marks a significant victory for issuers and their employees, as well as secondary participants in the capital markets such as investment banks, law firms, accounting firms, and their employees. Senator Arlen Specter (D-PA) and Representative Maxine Waters (D-CA) originally proposed to establish a private right of action against aiders and abettors.<sup>71</sup> Such a provision would, according to Senator Specter, "overturn two errant decisions of the Supreme Court,"<sup>72</sup> *Central Bank and Stoneridge Investment Partners LLC v. Scientific-Atlanta*.<sup>73</sup> The *Stoneridge* decision, which held that Exchange Act Section 10(b) did not permit private plaintiffs to sue secondary actors under a theory of "scheme liability," further restricted securities lawsuits against secondary actors.<sup>74</sup> The GAO study is preferable to legislation imposing secondary liability in private lawsuits, because the core holdings of *Central Bank* and *Stoneridge* are preserved. Moreover, the study provides an opportunity for opponents to air their views. Given that the results of the study will not be released for a year, the legislative and regulatory landscape may change, and cooler heads may ultimately prevail.

**Deadlines for Completing SEC Examinations and Enforcement Actions.** The Act requires the SEC to conclude investigations within 180 days of providing a Wells Notice to any person.<sup>75</sup> Within that time-frame, the staff of the SEC is required either to file an enforcement action or notify the Director of the Enforcement Division that it will not file an action.<sup>76</sup> The 180-day period may be extended as needed by one or more additional 180-day periods if the Director of the Enforcement Division or his designee concludes that a particular investigation is sufficiently complex and notifies the Chairman of the SEC.<sup>77</sup> The Act also requires the SEC to conclude compliance examinations within 180 days and provides a similar mechanism for granting extensions.<sup>78</sup>

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412 F. Supp. 2d 349, 382-83 (S.D.N.Y. 2006) (same). *But see SEC v. Milan Capital Group, Inc.*, No. 00 CIV. 108 (DLC), Fed. Sec. L. Rep. (CCH) P91,256, 2000 U.S. Dist. LEXIS 16204, at \*27-28 (relying on pre-*Central Bank* precedent and holding that recklessness was sufficient to establish aiding and abetting liability where the defendant owed a fiduciary duty of care).

<sup>69</sup>Act § 929Z.

<sup>70</sup>*Id.*

<sup>71</sup>S. Amdt. 3776, 111th Cong. (2010); James Hamilton, "Specter Amendment Having Last Hurrah," *Jim Hamilton's World of Securities Regulation*, June 22, 2010.

<sup>72</sup>155 Cong. Rec. S8558, S8564 (daily ed. July 30, 2009).

<sup>73</sup>552 U.S. 148 (2006).

<sup>74</sup>*Id.* at 770-72.

<sup>75</sup>Act § 929U.

<sup>76</sup>*Id.*

<sup>77</sup>*Id.*

<sup>78</sup>*Id.*

In the past, the SEC has been criticized for being slow to close inactive investigations.<sup>79</sup> The Act addresses this criticism by setting a deadline, and by requiring the Director of Enforcement and the Chairman of the SEC to become involved with granting any extension. These procedures will augment procedures that the SEC has already put in place to expeditiously close inactive investigations.<sup>80</sup>

### Other Remedial Provisions.

**“Bad Boy” Disability Provisions Extended to Regulation D Offerings.** The Act requires the SEC to adopt rules disqualifying persons who are subject to certain final orders by state securities regulators or state or federal banking regulators, or who have been convicted of a felony or misdemeanor relating to securities or false filings with the SEC, from participating in exempt offerings of securities under Regulation D.<sup>81</sup> Thus, under the Act, enforcement actions by state and federal officials will collaterally limit violators’ ability to raise capital through private placements.

The “bad boy” provision represents a victory for venture capitalists and other users of Regulation D. As originally proposed, Section 926 of the Senate Bill would have severely restricted Regulation D by giving state regulators authority over certain offerings that the SEC deemed “not of sufficient size or scope,” as well as offerings that the SEC failed to review within 120 days of filing.<sup>82</sup> The Act does not include those limitations, and Regulation D retains its usefulness as a capital-raising mechanism.

**No-Fault “Clawback” of Executive Compensation In the Event of Restatement.** The Act mandates a corporate governance reform for public companies to impose a regime of no-fault clawback of executive compensation in the event of a restatement.<sup>83</sup> This provision is addressed more fully in the Corporate Governance section of this compendium (see “Corporate Governance”), but bears mention here because of the interplay with the SEC’s recent enforcement efforts under the somewhat similar compensation clawback provisions of Section 304 of Sarbanes-Oxley.<sup>84</sup> There are several important points to note. First, the clawback policy issuers would be required to adopt is much more onerous than that under Section 304. Its application to all executive officers of a registrant is mandatory, whereas Section 304 is limited to the CEO and CFO, and the SEC has discretion to exempt any person from the application of Section 304.<sup>85</sup> Second, since the clawback provision is triggered by mere “material noncompliance with a financial reporting requirement” that results in a restatement, it would seem to capture innocent

<sup>79</sup>See U.S. Gov’t Accountability Office, *Securities and Exchange Commission: Additional Actions Needed to Ensure Planned Improvements Address Limitations In Enforcement Division Operations* 21-23 (2007); see also Doug Halonen, “GAO Urges SEC to Close Inactive Investigations,” *Pensions & Investments*, Oct. 1, 2007 (“‘It creates a cloud,’ said [David Tittsworth, executive director of the Investment Adviser Association, Washington]. ‘As a matter of fundamental fairness, there should be some mechanism for letting these [targeted] firms know what’s going on.’”).

<sup>80</sup>See U.S. Sec. & Exch. Comm’n, *Div. of Enforcement, Enforcement Manual* 13, 38, & 40 (2010) (stating that the Division’s policy is to “close an investigation as soon as it becomes apparent that no enforcement action will be recommended,” and “to notify individuals and entities at the earliest opportunity when the staff has determined not to recommend an enforcement action,” and that Associate Directors or Regional Directors periodically review, *inter alia*, investigations open two years or more without enforcement action).

<sup>81</sup>Act § 926.

<sup>82</sup>See Restoring American Financial Stability Act, S. Amdt. 3739, 111th Cong. § 926 (Apr. 29, 2009).

<sup>83</sup>Act § 954.

<sup>84</sup>15 U.S.C. § 7243.

<sup>85</sup>Compare Act § 954 with 15 U.S.C. § 7243.

mistakes, as well as misconduct.<sup>86</sup> By contrast, Section 304 only reaches material noncompliance that is “a result of misconduct.”<sup>87</sup> Third, in the absence of clear language addressing the existence or non-existence of a private right of action under Section 954, shareholder plaintiffs may argue that they are entitled to bring derivative actions on behalf of the issuer to recover such funds in the event of a restatement. This would again contrast with Section 304, which can only be enforced by the SEC.<sup>88</sup>

### **Increased Funding Will Allow the SEC to Allocate More Resources to Regulation, Examination, and Enforcement**

The Act does not provide the SEC with a “self-funding” mechanism that it sought.<sup>89</sup> Nevertheless, the Act does increase the SEC’s budget and provide the SEC with some budgetary flexibility. Specifically, the Act “authorizes” between \$1.3 billion and \$2.25 billion of funds to be appropriated to the SEC during each year between 2011 and 2015.<sup>90</sup> The SEC’s budget was approximately \$1.11 billion in 2010,<sup>91</sup> so these authorizations indicate Congress’s willingness to allocate additional funds to the SEC.

Second, the Act contains provisions that will enhance the SEC’s ability to obtain the resources it needs to carry out its mission. It requires the SEC’s budget request to be transmitted to Congress in “unaltered” form at the same time it is transmitted to the President.<sup>92</sup> It also provides “match funding” authority, which means that the SEC is required to collect transaction fees and assessments with the goal of recovering the cost of the SEC’s annual budget as appropriated by Congress.<sup>93</sup> While Congress maintains control over the SEC’s purse strings, the “match funding” provision means that the SEC will essentially be funded through user fees. As such, it will separate the SEC from competition with other federal programs over the allocation of scarce general revenue resources during the budget cycle.

Finally, the Act permits the SEC to set aside \$50 million per year in a special reserve fund, the balance of which cannot exceed \$100 million in a given year.<sup>94</sup> In each year, the SEC may spend up to \$100 million as “necessary to carry out the functions of the [SEC].”<sup>95</sup> This fund will permit the SEC to plan for certain long-term expenses, thereby freeing up other funds for use in the SEC’s enforcement and regulatory programs.

<sup>86</sup>See Act § 954.

<sup>87</sup>15 U.S.C. § 7243. The SEC has generally utilized § 304 in actions against executives who are alleged to have violated other provisions of the securities laws. See, e.g., *SEC v. William W. McGuire*, Litigation Release No. 20387 (Dec. 6, 2007). Recently, however, the SEC has begun to use § 304 to claw back incentive compensation from chief executives who are not alleged to have participated in any misconduct. See *SEC v. Diebold, Inc.*, Litigation Release No. 21543 (June 2, 2010); *SEC v. Maynard L. Jenkins*, Litigation Release No. 21149A (July 23, 2009). In this context, one federal district court has held that § 304 does not require personal misconduct — *i.e.*, the misconduct of the issuer is sufficient. See *SEC v. Jenkins*, --- F. Supp.2d ---, 2010 WL 2347020, at \*2-7 (D. Ariz. June 9, 2010). That court did not resolve potential constitutional due process challenges to holding an “innocent” executive liable for others’ misconduct, however. See *id.* at \*4-5.

<sup>88</sup>See *In re Digimarc Corp. Derivative Litig.*, 549 F.3d 1223, 1229-34 (9th Cir. 2008) (holding that § 304 of Sarbanes-Oxley does not create a private right of action).

<sup>89</sup>See Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, Statement Concerning Agency Self-Funding (Apr. 15, 2010).

<sup>90</sup>Act § 991(c).

<sup>91</sup>U.S. Sec. & Exch. Comm’n, *In Brief: FY 2011 Congressional Justification 2* (2010).

<sup>92</sup>Act § 991(d).

<sup>93</sup>*Id.* Act § 991(a).

<sup>94</sup>*Id.* Act § 991(e).

<sup>95</sup>*Id.*

Taken together, the increased authorization and “match funding” provisions provide the SEC with the prospect of significant additional resources. If the SEC allocates additional funds to the Enforcement Division, this will increase the number and complexity of cases that the SEC can bring.

### **Investor Protection and Regulatory Oversight Provisions Impose New Restrictions and May Portend More Significant Regulatory Changes**

#### **A Proposed Study and Rulemaking Will Likely Lead to the Imposition of Some Form of “Fiduciary Duty” on Broker-Dealers**

One of the more contentious debates connected to Congress’ financial reform effort concerns whether broker-dealers should be subject to a “fiduciary duty.” The debate gained momentum in the wake of allegations by the SEC that Goldman Sachs committed fraud while acting in its capacity as a broker-dealer selling a structured financial product to customers.<sup>96</sup>

The Act seeks to advance the debate by requiring the SEC to evaluate the effectiveness of existing standards of care for broker-dealers, investment advisers and associated persons that provide personalized investment advice to retail customers, and whether there are any legal or regulatory gaps or overlaps in those standards that should be addressed by rule or statute.<sup>97</sup> The SEC is required to consider, *inter alia*:

- substantive differences between applicable standards of care for broker-dealers and investment advisers;
- regulatory resources devoted to enforcing applicable standards of care;
- the potential impact on retail customers of imposing upon broker-dealers the standard of care applicable to investment advisers;
- the potential impact of deleting Section 202(a)(11)(C) from the Advisers Act, which exempts broker-dealers from regulation as investment advisers; and
- the ability of investors to understand the different standards of care applicable to investment advisers and broker-dealers.<sup>98</sup>

Within six months of the enactment of the Act, the SEC must submit a report to the Senate Banking and House Financial Services Committees containing the SEC’s findings, conclusions and recommendations.<sup>99</sup>

The Act also enables the SEC to act further on its own by giving it rulemaking authority to establish a uniform “fiduciary duty” for broker-dealers and investment advisers that provide personalized investment advice to retail clients or other customers.<sup>100</sup> The Act specifies that, if the SEC promulgates rules

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<sup>96</sup>See *SEC v. Goldman, Sachs & Co. and Fabrice Tourre*, Litigation Release No. 21,489, 2010 WL 1514183 (Apr. 16, 2010); Francesco Guerrera and Tom Braithwaite, “Goldman Lobbies against Fiduciary Reform,” *Fin. Times*, May 12, 2010.

<sup>97</sup>Act § 913(b).

<sup>98</sup>*Id.* Act § 913(c).

<sup>99</sup>*Id.* Act § 913(d).

<sup>100</sup>*Id.* Act § 913(g).

to establish such a duty, broker-dealers and investment advisers would be required to:

- act in the best interests of their customers without regard to their own financial or other interests; and
- disclose material conflicts of interest, to which a customer could consent.<sup>101</sup>

With respect to broker-dealers specifically, the Act further provides that:

- the receipt of commission compensation and the sale of only proprietary products or a limited range of products would not, in and of themselves, constitute violations of the applicable standard of care; and
- broker-dealers would not be subject to a continuing duty of care or loyalty following the provision of personalized investment advice.<sup>102</sup>

In bringing enforcement actions for violations of the applicable standard of care, the Act also requires the SEC to harmonize its enforcement efforts with respect to violations by both broker-dealers and investment advisers.<sup>103</sup>

In addition to these specific requirements, the Act states that the standard of conduct for broker-dealers and investment advisers that provide personalized investment advice “shall be no less stringent” than the fiduciary standard that has long applied to investment advisers under Section 206 of the Advisers Act.<sup>104</sup> This reference to Section 206 of the Advisers Act appears to be an attempt to incorporate case law interpreting investment advisers’ fiduciary duties.<sup>105</sup> Unfortunately, the parameters of investment advisers’ fiduciary duties are not especially well-defined, particularly as they would relate to broker-dealers.<sup>106</sup> Thus, the most practical and useful guidance is likely to come from the SEC.<sup>107</sup>

The Act permits but does not require the SEC to impose a uniform fiduciary duty on broker-dealers and investment advisers. Nevertheless, it seems likely that the SEC will promulgate relevant rules expressly addressing the duties of a broker-dealer to its customer, at least in the retail context. Throughout the legislative process, there has been substantial support for the outright legislative imposition of a broker-

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> *Id.* Act § 913(h).

<sup>104</sup> *Id.*

<sup>105</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963) (holding that the Advisers Act “reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser — consciously or unconsciously — to render advice which was not disinterested”) (internal citation and quotation marks omitted); see also *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) (“As we have previously recognized, § 206 [of the Advisers Act] establishes ‘federal fiduciary standards’ to govern the conduct of investment advisers . . .”).

<sup>106</sup> See Barbara Black, *Fiduciary Duty, Professionalism and Investment Advice 8* (Corporate Law Center, University of Cincinnati College of Law, Work in Progress, Mar. 26, 2010) (“Neither *Capital Gains* nor *Transamerica Mortgage Advisors* . . . presented the Court with the opportunity to explore concretely the nature of fiduciary duties owed by an investment adviser providing individualized investment advice, and there is very little case law or regulatory guidance on the issue.”) (citations omitted).

<sup>107</sup> See Act § 913(g) (requiring the SEC to “facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest,” and to “examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes”).

dealer fiduciary duty. Legislation passed by the House of Representatives in December 2009 included a statutory fiduciary duty for broker-dealers.<sup>108</sup> As originally proposed, the Senate Bill would have deleted statutory language that excludes most broker-dealers from the definition of “investment adviser,” which would have had the effect of subjecting broker-dealers to the same fiduciary duties as investment advisers in connection with the provision of investment advice.<sup>109</sup> Even after this provision was removed from the Senate bill, several senators introduced amendments during the legislative process that would have imposed some form of fiduciary duty on broker-dealers.<sup>110</sup> Most significantly, SEC Chairman Mary Schapiro, the primary regulator for broker-dealers and investment advisers, has repeatedly expressed her support for a uniform fiduciary duty for broker-dealers and investment advisers.<sup>111</sup>

It is fair to say that the avoidance of a legislatively created duty marks a victory for the brokerage industry. Nevertheless, this is a debate that will remain open as the SEC conducts the mandatory study and commences rulemaking. It will be important for the industry to continue to participate in that debate to assure that any resulting standards are workable and reasonable. In any event, the imposition of a fiduciary duty will raise compliance costs and increase the risk of litigation for broker-dealers.

### **New Rulemaking Authority and Required Studies May Increase Regulation Affecting Broker-Dealers and Investment Advisers**

**Point-of-Sale Disclosures Go Beyond Previous SEC Proposals.** The Act provides the SEC with authority to issue rules requiring certain disclosures prior to retail customers’ purchase of investment products or services (“point-of-sale” disclosures).<sup>112</sup> The point-of-sale disclosure provision is apparently designed to validate previous rulemaking proposed by the SEC in 2004 and re-proposed in 2005, which would have required broker-dealers to provide point-of-sale disclosures regarding costs and conflicts of interest in connection with the sale of certain “covered securities,” including open-end mutual fund shares, certain municipal fund securities, and certain unit investment trusts.<sup>113</sup> The SEC’s proposed point-of-sale rules would have imposed burdensome and costly obligations on broker-dealers. For example:

- broker-dealers would have been required to make impractical and unwieldy oral disclosures when transacting with customers over the telephone;<sup>114</sup>

<sup>108</sup>Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 7103(a) (2009).

<sup>109</sup>Restoring American Financial Stability Act of 2009, Dodd Discussion Draft, 111th Cong. § 913 (2009).

<sup>110</sup>*E.g.*, S.A. 3889 (May 6, 2010) (amendment introduced by Sens. Akaka, Menendez, Durbin, Kaufman, and Franken); S.A. 4009 (May 13, 2010) (amendment introduced by Sen. Collins). One filed Senate amendment would have even imposed criminal penalties on broker-dealers for “willful” violations of their fiduciary duties. See S.A. 3806 (May 4, 2010) (amendment introduced by Sens. Specter and Kaufman).

<sup>111</sup>*E.g.*, Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, Keynote Address at the Compliance and Legal Society of the Securities Industry and Financial Markets Association 2010 Annual Seminar (May 6, 2010) (“I believe that broker-dealers and investment advisers providing the same services, especially to retail investors, should meet that same high fiduciary standard. This is an issue that I hope will be addressed in regulatory reform legislation . . . .”); Letter from Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, to Christopher J. Dodd, Chairman, U.S. Senate Comm. on Banking, Hous., and Urban Affairs (Mar. 9, 2010) (“I urge you to include a provision that would mandate a uniform fiduciary standard of conduct for financial services professionals providing investment advice about securities to investors.”).

<sup>112</sup>Act § 919.

<sup>113</sup>See Confirmation Requirements and Point-of-sale Disclosure Requirements, Securities Act Release No. 8358; Exchange Act Release No. 49,148, Investment Company Act Release No. 26,341, 69 Fed. Reg. 6438, 6445-46 & 6458 (proposed Jan. 29, 2004); Point-of-Sale Disclosure Requirements and Confirmation Requirements, Securities Act Release No. 8544, Exchange Act Release No. 51,274, Investment Company Act Release No. 26,778, 70 Fed. Reg. 10521, 10522 (proposed Feb. 28, 2005).

<sup>114</sup>See Securities Act Release No. 8358, 69 Fed. Reg. at 6460; Securities Act Release No. 8544, 70 Fed. Reg.



- broker-dealers would not have been permitted to satisfy their disclosure obligations through inexpensive and efficient internet-only or email-only disclosure;<sup>115</sup> and
- instead of disclosing costs using standardized payment or investment amounts, individual investors would have been able to request cost disclosures specific to the anticipated amount of their particular investments.<sup>116</sup>

The SEC did not ultimately finalize the proposed rules. It is not clear whether the SEC's failure to finalize the point-of-sale disclosure rules stemmed from the force and weight of opposition to them,<sup>117</sup> or from concern that the SEC might overstep its statutory authority by requiring disclosures relating to municipal securities.<sup>118</sup>

The Act provides the SEC with express authority to require broker-dealers to provide point-of-sale disclosures to retail investors prior to the purchase of an investment product or service.<sup>119</sup> The Act mandates that the disclosures be summary in format and contain concise information about investment objectives, strategies, costs, and risks, as well as compensation or other financial incentives received by broker-dealers and other intermediaries.<sup>120</sup> In crafting point-of-sale disclosure rules, Congress intended for the SEC to utilize investor testing and other new authority provided under the Act.<sup>121</sup>

By sending a clear message of support, Congress increases the likelihood that the SEC will finalize point-of-sale disclosure rules. Moreover, the Act may precipitate imposition of more onerous point-of-sale disclosures than previously proposed by the SEC. For example, while the SEC's previously-proposed rules would have applied only to "covered securities," the Act expressly permits the SEC to craft rules for "investment product[s] or service[s]" generally.<sup>122</sup> Compliance costs, including costs associated with continuously updating disclosure documents, may be substantial, particularly if the SEC continues to take the position that broker-dealers cannot satisfy their obligations through Internet-based disclosure.

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at 10529-30.

<sup>115</sup> See Securities Act Release No. 8358, 69 Fed. Reg. at 6460; Securities Act Release No. 8544, 70 Fed. Reg. at 10530 & 10536.

<sup>116</sup> Securities Act Release No. 8358, 69 Fed. Reg. at 6459; Securities Act Release No. 8544, 70 Fed. Reg. at 10524 & n.17.

<sup>117</sup> See U.S. Sec. & Exch. Comm'n, Comments on Proposed Rule, Confirmation Requirements and Point-of-Sale Disclosure Requirements, available at: <http://www.sec.gov/rules/proposed/s70604.shtml> (last visited May 19, 2010) (reflecting over 7,700 comments on the SEC's point-of-sale disclosure proposal).

<sup>118</sup> See Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 J. Corp. L. 739, 740-41 (2009) (suggesting that the SEC's proposed point-of-sale disclosure rules, insofar as they relate to municipal bonds, may conflict with statements by then-SEC Chairman Cox in 2007, which recognized that the 1975 Tower Amendment to the Exchange Act closely circumscribes the SEC's authority to regulate participants in the municipal securities market).

<sup>119</sup> Act § 919.

<sup>120</sup> *Id.*

<sup>121</sup> S. Rep. No. 111-176, at 108. Specifically, "[t]he [Senate Banking] Committee encourages that [sic] Securities and Exchange Commission to use the consumer testing authorized under Section 912 and the study on financial literacy under Section [917] to inform its scope of disclosures." *Id.* Section 912 clarifies the SEC's authority to conduct investor tests and consult with experts to assess the effectiveness of the SEC's rules and programs. Act § 912. Section 917 requires the SEC to study financial literacy among retail investors, and methods to improve disclosures to permit investors to make informed decisions, and to report to the Senate Banking and House Financial Services Committees within two years. *Id.* § 917.

<sup>122</sup> Act § 919.

**Possible Increase in Access to Registration Information.** The Act may portend the harmonization of requirements for disclosures of registration information for broker-dealers and investment advisers. It also increases the likelihood that both broker-dealers and investment advisers will be required to disclose more registration information to the public. Specifically, the Act requires the SEC to study investors' access to registration information for registered and previously registered broker-dealers, investment advisers, and associated persons.<sup>123</sup> "Registration information" includes "disciplinary actions, regulatory, judicial and arbitration proceedings, and other information."<sup>124</sup> The SEC is directed to analyze advantages and disadvantages associated with further centralizing and simplifying access to the electronic databases in which such information is currently stored (the Central Registration Depository ("CRD") and Investment Adviser Registration Depository ("IARD") for broker-dealers and investment advisers, respectively), including the identification of data pertinent to investors and the best method and format for displaying such information.<sup>125</sup> The SEC is required to complete its study within six months, and within 18 months thereafter, the SEC must implement any resulting recommendations.<sup>126</sup>

The call for an SEC study may reflect Congress' dissatisfaction with actions taken by the SEC and the Financial Industry Regulatory Authority ("FINRA") to date to enhance access to registration information. For example, the CRD and IARD databases (and the systems through which members of the public may gain access to registration information contained in CRD and IARD) are not currently integrated, meaning that investors often must conduct more than one search to find relevant information regarding a broker-dealer that is also an investment adviser.<sup>127</sup> By directing the SEC to analyze the advantages and disadvantages of further centralizing access to these systems, Congress appears to be taking aim at this disparity.

Additionally, investors have not enjoyed consistent access to disciplinary information regarding associated persons of broker-dealers and investment advisers. Until recently, disciplinary information regarding former associated persons of broker-dealers remained available to the public for two years. Following a recent rule change, FINRA's publicly available BrokerCheck website now provides access to "final regulatory actions" involving former associated persons regardless of when they left the industry.<sup>128</sup> BrokerCheck still does not provide access to arbitrations against former associated persons for more than two years, however.<sup>129</sup> Publicly available disciplinary information regarding investment advisers and associated persons goes back only ten years, and such information is not available at all for former associated persons.<sup>130</sup> Information regarding arbitrations against investment advisers and their associated persons is also not publicly available.<sup>131</sup>

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<sup>123</sup>Act § 919B(a).

<sup>124</sup>*Id.*

<sup>125</sup>*Id.*

<sup>126</sup>*Id.* Act § 919B(b).

<sup>127</sup>See Electronic Filing by Investment Advisers, Exchange Act Release No. 42,620, Advisers Act Release No. 1862, 65 Fed. Reg. 20524, 20526 n.28 (proposed Apr. 5, 2000) (stating that the SEC hopes to link CRD and IARD "so that a single search will provide information from both databases").

<sup>128</sup>FINRA Rule 8312(c); FINRA, SEC Approves Changes to FINRA's BrokerCheck Disclosure Rule, Regulatory Notice 09-66 (Nov. 2009); see also FINRA BrokerCheck, available at: <http://www.finra.org/BrokerCheck> (last visited June 10, 2010). "Final regulatory actions" include actions by the SEC, the CFTC, a federal banking agency, any other state or federal regulatory agency, any foreign financial regulatory authority, or any SRO. FINRA Rule 8312(c).

<sup>129</sup>See FINRA Rule 8312(c).

<sup>130</sup>See Form ADV Part I, Item 11, 17 C.F.R. § 279.1, Part 1, Item 11 (requiring disclosure of "the disciplinary history of all [of an investment adviser's] advisory affiliates," which includes, *inter alia*, "current employees (other than employees performing only clerical, administrative, support or similar functions)").

<sup>131</sup>*Id.*; see also Amendments to Form ADV, Exchange Act Release No. 57,419, Advisers Act Release No. 2711,

The Act may prompt the SEC to require more detailed, narrative disclosure of registration information. The SEC previously proposed to amend Form ADV Part II, which investment advisers must provide to current and prospective advisory clients.<sup>132</sup> The amendments would have required “plain English” narrative brochures instead of “check the box” answers to multiple choice and fill-in-the-blank questions.<sup>133</sup> The amendments also would have made these narrative disclosures generally available to the public rather than just current and prospective advisory clients.<sup>134</sup> Although the SEC initially proposed these amendments more than a decade ago, momentum may be building to approve them in the near future.<sup>135</sup>

Increased disclosure obligations will raise compliance costs, particularly if broker-dealers and investment advisers are required to deliver updated disclosure documents to clients both annually and when specified information in prior disclosures becomes stale,<sup>136</sup> or if they must prepare narrative brochures that are unique to each client.<sup>137</sup> Additionally, disclosures regarding individual associated persons could raise privacy concerns.<sup>138</sup> Fortunately, the Act provides for a study prior to any rulemaking, which permits interested members of the industry to communicate their views and concerns to the SEC.

**GAO Study May Result in Restrictions on Mutual Fund Ads.** The Act requires the GAO to study mutual fund advertising.<sup>139</sup> The study requires the GAO to examine, among other things, “the use of past performance data, funds that have merged, and incubator funds.”<sup>140</sup> Within 18 months, the GAO must submit to the Senate Banking and House Financial Services Committees a report making recommendations to improve mutual fund advertisements, protect investors and permit investors to make informed decisions.<sup>141</sup>

Mutual fund advertising, particularly advertising that contains performance data, is already subject to extensive regulation.<sup>142</sup> Notwithstanding the existing panoply of SEC and SRO rules, the study required

73 Fed. Reg. 13958, 13964 (proposed Mar. 3, 2008) (requesting comments regarding whether the SEC should amend Form ADV Part II to require disclosure of arbitration awards and civil damages awards).

<sup>132</sup> See 17 C.F.R. §§ 275.203-1 & 275.204-3.

<sup>133</sup> See Exchange Act Release No. 42,620, 65 Fed. Reg. 20524; Exchange Act Release No. 57,419, 73 Fed. Reg. 13958.

<sup>134</sup> See Exchange Act Release No. 57,419, 73 Fed. Reg. 13958.

<sup>135</sup> At a recent Securities Industry and Financial Markets Association conference, SEC Chairman Mary Schapiro stated that the SEC is “looking to move past the 1960s check-the-box, paper-based approach by requiring a plain English narrative discussion of an adviser’s conflicts, compensation, business activities and disciplinary history.” Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, Keynote Address at the Compliance and Legal Society of the Securities Industry and Financial Markets Association 2010 Annual Seminar (May 6, 2010).

<sup>136</sup> See Exchange Act Release No. 57,419, 73 Fed. Reg. at 13969-70.

<sup>137</sup> See *id.* at 13971-72.

<sup>138</sup> See Kristen McNamara and Shelly Banjo, “Compliance Watch: Disciplining of Brokers to Stay on Record,” *Dow Jones* (Nov. 17, 2009) (reporting statement by Richard Pullano, Associate Vice President and Chief Counsel at FINRA, that FINRA sought to balance investor protection and personal privacy concerns when it expanded access to disciplinary and other registration information for associated persons who leave the industry).

<sup>139</sup> Act § 918(a).

<sup>140</sup> *Id.*

<sup>141</sup> Act § 917(b).

<sup>142</sup> Federal securities laws and SEC and SRO rules prohibit materially misleading mutual fund advertisements. See Section 17(a)(2) of the Securities Act, 15 U.S.C. § 77q(a)(2); Section 34(b) of the Investment Company Act, *id.* § 80a-33(b); Rule 10b-5, 17 C.F.R. § 240.10b-5; NASD Rule 2210(d)(1)(B). Rule 482 under the Securities Act requires performance data to be current, presented in a specific and prescribed manner, and set off by a legend stating, among other things, “that past performance does not guarantee future results.” 17 C.F.R. §§ 230.482(b), (d), & (g). Rule 156 provides further guidance and states that mutual fund advertisements may be misleading if, for example, they imply “that future gain or income may be inferred from or predicted based on past investment performance,” or if past performance is portrayed “in a manner which would imply that gains or income realized in the past would be repeated in the future.” *Id.* § 230.156(b)(2)(ii). Similarly, an

by the Act may lead to even greater restrictions. Some observers have suggested that the study may be a prelude to an outright ban on mutual fund advertisements that feature past performance.<sup>143</sup> Such a ban would deprive investors of information that some observers consider to be valuable in making investment decisions.

**GAO Study of Analyst Conflicts Could Result in More Restrictions.** The Act directs the GAO to study potential conflicts of interest between investment banks and in-house research analysts.<sup>144</sup> There is historical context to this study. Following a series of politically fraught enforcement actions by the New York Attorney General and the SEC,<sup>145</sup> the SEC and other regulators adopted significant new regulations governing relationships between investment banking firms and in-house research analysts.

For example, under Regulation AC, a research analyst associated with a broker-dealer must certify that statements in a research report accurately reflects the analyst's personal views, that no part of the analyst's compensation is tied to views expressed in the report, or that specified portions of the analyst's compensation will be affected by the views expressed.<sup>146</sup> If a broker-dealer distributes research reports prepared by an independent third party, no such certification is required.<sup>147</sup> Regulation AC also requires firms to notify associated persons who publish, circulate, or provide research reports of whether the firm's policies are reasonably designed to prevent the firm or its brokerage employees from influencing the conduct of research analysts or the content of their reports.<sup>148</sup>

In addition to Regulation AC, analyst conflicts are policed by SRO rules. FINRA imposes numerous restrictions on member firms, including that no analyst may be supervised by employees of a member firm's investment banking department, no member may compensate an analyst based on a specific investment banking transaction, no member may promise or threaten specific ratings or price targets, and a member generally cannot issue research reports after acting in certain capacities with respect to a security, such as underwriting or managing an initial public offering.<sup>149</sup> New York Stock Exchange rules contain similar limitations and prohibitions.<sup>150</sup>

Twelve investment banks that were the subject of enforcement actions also became subject to significant affirmative remedies imposed in a 2003 settlement known as the "Global Research Analyst Settlement."<sup>151</sup>

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SRO rule states that "[c]ommunications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast." NASD Rule 2210(d)(1)(D).

<sup>143</sup>Gary Haber, "Financial Reform Bill Cracks Down on Mutual Fund Ads for Companies Like T. Rowe, Legg Mason," *Baltimore Business Journal*, Apr. 30, 2010.

<sup>144</sup>Act § 919A.

<sup>145</sup>See, e.g., Raymond Hernandez, "Finding Fraud On Wall St. May Be a Step To Higher Post," *N.Y. Times*, Apr. 29, 2003, at C4 (reporting that some observers accused then-New York Attorney General Eliot Spitzer of "boosting his own political fortunes" by pursuing the research analyst case, among others); *Hous. Chron.*, "SEC Turned Timid as Corruption became More Complex," Dec. 26, 2003, at 5 ("How did the SEC's staff of more than 3,000 allow Spitzer's investor-protection staff of 84 to grab the enforcement torch? ... [W]hy did the SEC fail to spot almost every major financial scandal in recent years — from improper fund trading to research analysts' conflicts of interest to favoritism in doling out coveted shares in initial public offerings?").

<sup>146</sup>Rule 501, 17 C.F.R. § 242.501(a).

<sup>147</sup>*Id.* § 242.501(b).

<sup>148</sup>Rule 504, 17 C.F.R. § 242.504.

<sup>149</sup>NASD Rule 2711.

<sup>150</sup>NYSE Rule 472.

<sup>151</sup>The SEC alleged that the defendants' investment banking arms inappropriately influenced research analysts' reports, thereby imposing conflicts of interest on the research analysts and, in some instances, causing the defendants to issue fraudulent research reports. Federal Court Approves Global Research

Among other undertakings, the firms agreed: (i) to insulate research analysts from investment banking pressure by prohibiting analysts from receiving compensation for investment banking activities or being involved in “pitches” or “road shows”; (ii) to contract with independent research firms to provide independent analyst reports for a period of five years; and (iii) to disclose analysts’ historical ratings to enable investors to evaluate analyst performance.<sup>152</sup>

The study required by the Act requires the GAO to consider whether to codify undertakings by the individuals and firms that entered into the Global Research Analyst Settlement, and to report back to the Senate Banking and House Financial Services Committees with recommendations within 18 months.<sup>153</sup>

The study may provide an opportunity for reasoned reconsideration of the obligations imposed as a result of negotiations in the enforcement context. Recent efforts to recast those obligations in light of experience have resulted in harsh criticism of the SEC. In August 2009, with the agreement of the SEC, firms that were subject to the Global Research Analyst Settlement moved the U.S. District Court for the Southern District of New York to set aside certain specific restrictions contained therein.<sup>154</sup> Judge William Pauley granted the motion with the exception of one proposed modification.<sup>155</sup> The parties had requested modification of a provision that prohibits communications between research analyst and investment banking employees outside the presence of legal and compliance personnel.<sup>156</sup> The parties argued that permitting certain contacts between research analyst and investment banking personnel promoted efficiency without undercutting investor protection.<sup>157</sup>

Nevertheless, Judge Pauley found that the “proposed amendment is counterintuitive and would undermine the separation between research and investment banking,” and “decline[d] to approve the proposed modification ... because it would be inconsistent with the Final Judgments and contrary to the public interest.”<sup>158</sup> Some commentators criticized the SEC for assenting to the investment banks’ motion to modify the Global Research Analyst Settlement.<sup>159</sup>

Although the GAO study could lead to the rationalization of settlement provisions, it may also lead to additional restrictions on research analysts. To the extent that the GAO recommends that Congress enact legislation codifying provisions of the 2003 Global Research Analyst Settlement, it may even the playing field between investment banks that are currently subject to the Global Research Analyst Settlement and those that are not.

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Analyst Settlement, Litigation Release No. 18438, 81 S.E.C. Docket 1699-79 (Oct. 31, 2003). In addition to undertakings, the global settlement included \$894 million in penalties and disgorgement, \$432.5 million to fund independent research, and \$80 million to fund investor education. *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> Act §§ 919A(b) & (c).

<sup>154</sup> Letter from Lewis J. Liman, Partner, Cleary Gottlieb Steen & Hamilton LLP, to the Honorable William J. Pauley III, U.S. District Court for the S. Dist. of N.Y. (Aug. 9, 2009) (Docket No. 305, *SEC v. Bear, Stearns & Co. Inc.*, No. 1:03-cv-02937-WHP (S.D.N.Y. entered Mar. 17, 2010)) (hereinafter cited as the “Liman Letter”).

<sup>155</sup> Order, *SEC v. Bear, Stearns & Co. Inc.*, No. 1:03-cv-02937-WHP (S.D.N.Y. Mar. 15, 2010) (hereinafter cited as the “Pauley Order”).

<sup>156</sup> Liman Letter at 7.

<sup>157</sup> See *id.*

<sup>158</sup> Pauley Order, at 2-3.

<sup>159</sup> See, e.g., Susanne Craig and Kara Scannell, *SEC Tried to Ease Curbs*, WALL ST. J., Mar. 17, 2010 (“Some outsiders expressed surprise that the nation’s top securities watchdog sided with Wall Street in an effort to unwind a major provision of the \$1.4 billion [Global Research Analyst Settlement].... ‘I am all for judges being the hero, but isn’t the SEC supposed to be?’ said James D. Cox, a law professor at Duke University.”).

**Enhanced Scrutiny of Investment Advisers.** While representatives of the investment adviser profession have pushed Congress to extend fiduciary standards to broker-dealers,<sup>160</sup> some observers have countered that broker-dealers are actually subject to far greater regulatory scrutiny than investment advisers. According to FINRA Chairman and CEO Richard Ketchum, there were approximately 5,000 broker-dealer firms registered with the SEC at the end of 2009, and nearly 55% of them were examined by either the SEC or FINRA on an annual basis.<sup>161</sup> In contrast, there were more than 11,000 registered investment advisers, but due to resource constraints, the SEC expected only 9% of them to be examined during 2009 and 2010.<sup>162</sup> To plug this “regulatory gap,” Mr. Ketchum urged Congress to allocate more resources to the SEC for the purpose of conducting investment adviser examinations.<sup>163</sup> Mr. Ketchum also stated that Congress should empower one or more independent regulatory organizations to oversee investment advisers, and suggested that FINRA could play this role.<sup>164</sup> Even absent new statutory authority, FINRA has already begun investigating dually registered broker-dealers and investment advisers more aggressively.<sup>165</sup>

In response to these concerns, the Act requires the SEC to conduct a study analyzing “the need for enhanced examination and enforcement resources for investment advisers.”<sup>166</sup> The SEC is directed to consider: (i) the number of investment adviser examinations conducted by the SEC during the five years preceding enactment of the Act; (ii) the extent to which an SRO for advisers could improve the frequency of adviser examinations; and (iii) current and potential approaches to examining the investment advisory activities of dually registered investment advisers and broker-dealers.<sup>167</sup> The SEC is instructed to report to the Senate Banking and House Financial Services Committees within six months with recommendations regarding necessary legislation.<sup>168</sup> The SEC also is instructed to use the findings contained in its study to revise its own rules as appropriate.<sup>169</sup>

The study and subsequent SEC rulemaking could result in more frequent investment adviser examinations. Perhaps more significant, the SEC may recommend that Congress designate an SRO to oversee the investment adviser profession. The SEC previously proposed that Congress create an SRO for investment advisers in 1989,<sup>170</sup> and the Bush Administration repeated that request in 2008.<sup>171</sup> Thus, the SEC

<sup>160</sup>See, e.g., *Enhancing Investor Protection and the Regulation of Securities Markets — Part II: Hearing Before the Sen. Comm. on Banking, Hous. and Urban Affairs*, 111th Cong. (2010) (statement of David Tittsworth, Executive Director and Vice President, Investment Adviser Association) (cited hereinafter as “Tittsworth Testimony”).

<sup>161</sup>*Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. (2009) (statement of Richard Ketchum, Chairman and Chief Executive Officer, Financial Industry Regulatory Authority).

<sup>162</sup>*Id.*

<sup>163</sup>*Id.*

<sup>164</sup>*Id.*

<sup>165</sup>See Jed Horowitz, “FINRA’s Ketchum Pitches — Again — for Adviser Oversight,” *InvestmentNews*, Oct. 23, 2009 (“Ketchum ... told a gathering of brokerage firm executives that [FINRA] will be more aggressive about investigating the advisory activities of their brokers — regardless of whether it gets full regulatory authority to oversee investment advisers.”).

<sup>166</sup>Act § 914(a).

<sup>167</sup>*Id.*

<sup>168</sup>*Id.* § 914(b).

<sup>169</sup>*Id.*

<sup>170</sup>Tittsworth Testimony (citing Letter from David S. Ruder, Chairman, U.S. Securities and Exchange Commission to the Honorable Dan Quayle, President of the U.S. Senate (June 19, 1989)).

<sup>171</sup>*The Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure* 125-26 (2008).

may well make such a recommendation once again. To the extent that it does, as discussed, FINRA has made a play to be the organization that assumes self-regulatory control over the investment adviser profession. Representatives of the investment adviser profession have consistently opposed the creation of any SRO, however,<sup>172</sup> and they are staunchly opposed to FINRA acting in that capacity.<sup>173</sup>

### Short Sale Reforms and Anti-Manipulation Provisions

The Act regulates short selling in three important ways. First, it requires the SEC to promulgate rules mandating that institutional investment managers disclose information relating to their short positions, including the name of the issuer, and the title, class, CUSIP number, and aggregate amount of the number of short sales of each security, as well as other information determined by the SEC.<sup>174</sup> Second, the Act prohibits “manipulative” short sales.<sup>175</sup> Third, the Act requires registered broker-dealers to notify customers that they may choose not to allow their securities to be lent in connection with short sales.<sup>176</sup> Additionally, if a broker-dealer utilizes a customer’s securities to effect a short sale, the broker-dealer must notify the customer that the broker-dealer may receive compensation.<sup>177</sup>

In addition to the foregoing short-sale reforms, the Act expands the scope of certain anti-manipulation and short-sale provisions under the Exchange Act. Exchange Act Section 9, which prohibits market manipulation, and Section 10(a)(1), which prohibits short-selling in contravention of SEC rules, are expanded to cover transactions in all securities other than government securities.<sup>178</sup> Previously, those provisions were applicable only to securities listed on a national exchange. Section 9(b), which regulates transactions involving puts, calls, straddles, or options, is expanded to cover transactions that do not “use ... any facility of a national securities exchange . . . .”<sup>179</sup> Section 9(c), which prohibits certain endorsements or guarantees of puts, calls, straddles, options, and privileges, is expanded to cover all broker-dealers, and not just those who are members of a national securities exchange.<sup>180</sup> Finally, Section 15(c)(1)(A), which prohibits manipulative, deceptive, or other fraudulent devices or contrivances, is expanded to cover transactions on a national exchange in addition to over-the-counter transactions.<sup>181</sup>

### Potential Elimination of Mandatory Arbitration

The Act gives the SEC authority to restrict or even prohibit mandatory arbitration in disputes between broker-dealers, investment advisers, and customers.<sup>182</sup> This provision addresses a long-running complaint by some observers that arbitration is biased in favor of the securities industry.<sup>183</sup>

<sup>172</sup> See David G. Tittsworth, Executive Director, Investment Counsel Association of America, Inc., SEC Roundtable on Investment Adviser Regulatory Issues (May 23, 2000) (“The ICAA ... strongly opposed the SEC’s [1989] legislative proposal” and “continue[s] to oppose the creation of a self-regulatory organization for the advisory profession.”); Tittsworth Testimony (“[A]dding a new and additional layer of bureaucracy and cost on the [investment adviser] profession via an SRO will not significantly enhance investor protection.”).

<sup>173</sup> See Tittsworth Testimony (arguing that “FINRA would be an inappropriate SRO for investment advisers” because it is biased in favor of broker-dealers).

<sup>174</sup> Act § 929X(a).

<sup>175</sup> Act § 929X(b).

<sup>176</sup> Act § 929X(c).

<sup>177</sup> *Id.*

<sup>178</sup> Act §§ 929L(1)(A) & 929L(2).

<sup>179</sup> Act § 929L(1)(B).

<sup>180</sup> Act § 929L(1)(C).

<sup>181</sup> Act § 929L(3).

<sup>182</sup> Act § 921.

<sup>183</sup> See, e.g., Karen Donovan, “Fix Arbitration Now,” *Registered Rep.*, Jan. 1, 2007.

Mandatory arbitration has been the norm in the financial services industry since 1987, when the Supreme Court enforced an arbitration clause in a contract between a brokerage firm and two customers.<sup>184</sup> Generally, arbitration is a matter of private contract not within the purview of the SEC. The SEC has limited authority to police arbitration procedures, in that most securities arbitration takes place in FINRA's dispute resolution forum,<sup>185</sup> and the SEC approves FINRA's rules.<sup>186</sup>

Previous studies provide insight into the long-running debate, which the Act asks the SEC to resolve. Studies conducted by the GAO and by St. John's University law professor Michael Perino generally do not support the conclusion that securities arbitration is biased against investors.<sup>187</sup> Additionally, the results of two arbitration pilot programs undermine assertions of pro-industry bias. In 2000, FINRA's predecessor organization NASD Regulation participated in a two-year pilot program to permit securities claimants to arbitrate before non-SRO forums such as the Judicial Arbitration and Mediation Service or the American Arbitration Association instead of NASD Regulation's sponsored forum.<sup>188</sup> Of 277 eligible claimants, only eight elected to use non-NASD forums.<sup>189</sup> This result called into question whether investors would choose non-SRO-sponsored arbitration forums if given a choice.<sup>190</sup> Similarly, in 2008, FINRA initiated a two-year pilot program to give eligible claimants the option of selecting arbitration panels composed entirely of non-industry-affiliated "public" arbitrators.<sup>191</sup> In the first year of the program, approximately half of eligible claimants elected to use an industry panelist even though they were not required to do so.<sup>192</sup> The pilot programs' track records support the conclusion that many securities claimants see value in arbitrating claims before panelists with relevant industry experience and expertise.<sup>193</sup>

On the other hand, an analysis by a securities arbitration claimants' lawyer and a plaintiffs'-side testifying expert witness purports to show that investors do not fare well in arbitration.<sup>194</sup> Additionally, a study by law professors Jill Gross (Pace University) and Barbara Black (University of Cincinnati) shows

<sup>184</sup>See *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 238 (1987).

<sup>185</sup>See About FINRA Dispute Resolution, available at: <http://www.finra.org/ArbitrationMediation/AboutFINRADR/Overview/> (last visited May 21, 2010) ("Today, FINRA is known as the largest and most effective dispute resolution forum in the securities industry – handling virtually all such arbitrations and mediations in the United States.").

<sup>186</sup>See Exchange Act Section 19(b)(1), 15 U.S.C. § 78s(b)(1); see also Self Regulatory Organizations, Exchange Act Release No. 40,109, 63 Fed. Reg. 35299, 35303 n.53 (June 29, 1998) ("[T]he Commission oversees the arbitration programs of the SROs ... through inspections of the SRO facilities and the review of SRO arbitration rules. Inspections are conducted to identify areas where procedures should be strengthened, and to encourage remedial steps either through changes in administration or through the development of rule changes.").

<sup>187</sup>See *U.S. Gen. Accounting Office, Securities Arbitration: How Investors Fare* 6 (1992) (finding "no indication of a pro-industry bias in decisions at industry-sponsored forums"); Michael A. Perino, *Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations* 31-34 (2002) (analyzing data showing that, between 1980 and 2001, 52.26% of SRO arbitrations resulted in awards for customers) (hereinafter cited as the "Perino report").

<sup>188</sup>Press Release, NASD Regulation's Office of Dispute Resolution Participates in SICA's Pilot Program (Jan. 24, 2000).

<sup>189</sup>Perino Report, at 34 (citing *Securities Industry Conference on Arbitration, Final Report on Securities Industry Conference on Arbitration Pilot Program for Non-SRO Sponsored Arbitration Alternatives* (2002)).

<sup>190</sup>Perino Report, at 33-34.

<sup>191</sup>News Release, FINRA to Expand Program Evaluating All-Public Arbitration Panels (Oct. 5, 2009).

<sup>192</sup>*Id.*

<sup>193</sup>*Cf.* Helen Kearney, "Death Knell for Mandatory Arbitration," *On Wall St.*, Aug. 1, 2009 ("Lawyers on both sides say that the industry arbitrator is often actually harder on brokers than the other arbitrators.").

<sup>194</sup>See Edward S. O'Neal, Ph.D. and Daniel R. Solin, *Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fare* (2007) (concluding, *inter alia*, that claimant success rates declined between 1999 and 2004, and that the amount of awards decreased between 1998 and 2004).



investors' subjective views of arbitration may not be favorable.<sup>195</sup>

Restrictions on mandatory arbitration could significantly increase costs for firms. If the SEC limits mandatory arbitration, the incidence of litigation and associated costs will certainly increase. The cost of settling securities claims will also increase. Even if the SEC permits investors to choose between litigation and arbitration, litigation will increase because forum decisions will be based on tactical considerations after disputes have arisen.<sup>196</sup> Additionally, if the SEC changes current arbitration procedures — such as by making arbitration optional or requiring written opinions — administrative costs could increase.

Increased costs could cause broker-dealers and investment advisers to limit risk exposure by declining to deal with small retail investors. Furthermore, limits on mandatory arbitration are of questionable value to investors to the extent that they increase the fees and expenses required to adjudicate claims, or result in more securities disputes being dismissed in civil litigation as a result of higher pleading standards.<sup>197</sup>

### Recordkeeping and Confidentiality Provisions Enhance SEC Oversight

The Act expands recordkeeping and examination requirements for persons with custody over assets belonging to a registered investment company or the client of an investment adviser.<sup>198</sup> The Act also provides that the SEC shall not be compelled to disclose, pursuant to a Freedom of Information Act ("FOIA") request, records and information provided by regulated entities such as broker-dealers, investment companies, and investment advisers, if the records and information are provided in connection with the SEC's surveillance, risk assessment, regulatory or oversight activities.<sup>199</sup>

Furthermore, the Act permits the SEC to share privileged information with other federal, state and foreign regulatory and law enforcement agencies, the Public Company Accounting Oversight Board ("PCAOB") and SROs, without waiving applicable privileges.<sup>200</sup> Similarly, those other agencies will not be regarded as having waived applicable privileges if they share information with the SEC.<sup>201</sup> Additionally, the SEC shall not be compelled to produce, pursuant to a FOIA request, information provided to it by a foreign agency, if the foreign agency determines in good faith that the information is privileged.<sup>202</sup>

Taken together, these provisions of the Act will likely permit the SEC to collect information that it would not have otherwise obtained. This could enhance the SEC's ability to bring enforcement actions. The SEC

<sup>195</sup> Jill I. Gross and Barbara Black, *Perceptions of Fairness of Securities Arbitration: An Empirical Study* (2008) (finding that SRO arbitration participants have differing subjective views with respect to whether arbitrations are efficient and fair, and that customers have more negative subjective views of arbitrations than do other participants).

<sup>196</sup> Cf. David Sherwyn, "Because It Takes Two: Why Post Dispute Voluntary Arbitration Programs Will Fail to Fix the Problems Associated with Employment Discrimination Law Adjudication," 24 *Berkeley J. Emp. & Lab. L.* 1, 21-22, 67-68 (2003).

<sup>197</sup> Compare Fed. R. Civ. P. 9(b) ("In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake.") and 15 U.S.C. § 78u-4(b)(1) (requiring that, in securities fraud actions, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed") with FINRA Code of Arbitration Procedure § 12302(a)(1) (claimants must "specify[] the relevant facts and remedies requested").

<sup>198</sup> Act § 929Q.

<sup>199</sup> Act § 929I.

<sup>200</sup> Act § 929K.

<sup>201</sup> *Id.*

<sup>202</sup> *Id.*

may also step up its cooperation with foreign agencies to bring enforcement actions in transnational fraud cases, particularly in light of the provision of the Act expanding the SEC's extraterritorial reach.

### Expansion of SEC and PCAOB Authority Over Foreign Accounting Firms

In 2002, Congress passed Section 106 of the Sarbanes-Oxley Act, which subjects foreign public accounting firms to the requirements of Sarbanes-Oxley if they perform certain services in connection with an audit of an issuer.<sup>203</sup> The Act amends Section 106 to require the production of foreign public accounting firms' work papers to the SEC or the PCAOB upon request if a foreign public accounting firm:

- performs material services upon which a registered public accounting firm relies in the conduct of an audit;
- issues an audit report;
- performs audit work; or
- conducts interim reviews.<sup>204</sup>

The Act further requires foreign public accounting firms that perform any work at all for a domestic registered public accounting firm to irrevocably designate the domestic firm as an agent upon whom the SEC and the PCAOB can serve requests under Section 106, or process, pleadings, or other papers in an action to enforce Section 106.<sup>205</sup> A foreign public accounting firm must designate an agent for service of process to the SEC or the Commission if it performs a material service upon which a registered public accounting firm relies in the conduct of an audit or interim review, issues an audit report, performs audit work, or performs interim reviews.<sup>206</sup>

Firms are subject to sanction if they willfully fail to comply with the aforementioned requirements.<sup>207</sup> The SEC and the PCAOB have discretion to allow foreign public accounting firms to meet their production obligations by producing requested materials to a foreign regulator, however.<sup>208</sup>

The enhanced disclosure requirements and sanction provision will provide the SEC and the PCAOB with the ability to compel production of work papers from foreign accounting firms and foreign affiliates of domestic accounting firms. Like other provisions of the Act, this may provide the SEC with access to information that it would not otherwise have received, enhancing the SEC's ability to conduct oversight and bring enforcement actions.

### New Entities Within SEC Could Advocate for Greater Regulation

One of the threats that the SEC faced as a result of the financial crisis arose from the view of some that the agency had been "captured" by the industry it regulates, and that its effectiveness was fatally compromised.<sup>209</sup> That view did not carry the day in Congress, but the Act attempts to address such

<sup>203</sup> 15 U.S.C. § 7216(a).

<sup>204</sup> Act § 929J.

<sup>205</sup> *Id.*

<sup>206</sup> *Id.*

<sup>207</sup> *Id.*

<sup>208</sup> *Id.*

<sup>209</sup> See, e.g., "Credit Rating Reform Efforts Moving in Right Direction," *InvestmentNews*, June 7, 2010 ("[A]

concerns through a series of managerial reforms<sup>210</sup> and by creating new entities within the agency that may establish new power centers and institutionalize a counter-industry view within the SEC. These entities may become effective advocates for burdensome regulatory change, particularly to the extent that they are able to access confidential regulatory documents and files.

**Investor Advisory Committee.** First, the Act establishes an Investor Advisory Committee within the SEC.<sup>211</sup> The Committee will consist of:

- the Investor Advocate, which is a new position also created by the Act;
- a representative of the state securities commissions;
- a senior citizen representative; and
- between 10 and 20 SEC-appointed members representing individual and institutional investors.<sup>212</sup>

Members of the Committee will not be deemed SEC employees as a result of sitting on the Committee.<sup>213</sup>

The Committee will advise and consult with the SEC on regulatory priorities and various issues relating to securities regulation. It will submit findings and recommendations to the SEC, including recommendations for proposed legislative changes. The SEC will be required to review them and “promptly” issue public statements assessing the findings or recommendations and disclosing what action, if any, the SEC intends to take.<sup>214</sup>

Actually, the Investor Advisory Committee was created by SEC Chairman Mary Schapiro in 2009, and thus predates the Act.<sup>215</sup> Chairman Schapiro previously relied on authority contained in the Federal Advisory Committee Act,<sup>216</sup> but the Act provides specific statutory authority for the creation of the Committee.<sup>217</sup>

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agency capture’ . . . occurs when employees or leaders of a government agency develop close relationships with those they regulate, leading to lax oversight. The phenomenon appears to have occurred at the SEC, which was supposed to be regulating Wall Street as the mortgage bubble inflated.”). The idea that the SEC is captured or susceptible to capture is not new. See *Susan E. Woodward, Regulatory Capture at the U.S. Securities and Exchange Commission* (1998).

<sup>210</sup>The Act also contains several provisions designed to address perceived managerial shortcomings or “agency capture” at the SEC. Section 965 takes aim at the Office of Compliance, Inspections and Examinations by requiring that SEC examiners be housed within the Division of Trading and Markets and the Divisions of Investment Management, and report to the Directors of those respective divisions. Other provisions do not mandate specific changes, but rather require the conduct of audits or studies of existing internal controls, management structures, and personnel at the SEC. For example, Section 967 is a provision that may seem sweet justice to entities that have operated under SEC settlements. It requires the SEC to hire an independent consultant to examine, *inter alia*, the SEC’s internal operations, structure, and funding, and make recommendations for changes. Thereafter, the SEC will be required to implement the recommendations and make reports to the Senate Banking and House Financial Services Committees on its progress. In a similar vein, Section 962 requires the GAO to report to the Senate Banking and House Financial Services Committees every three years “on the quality of personnel management by the [SEC].” Section 968 requires the GAO to study the “revolving door” at the SEC. This study entails, among other things, a review and recommendations for improving rules to ensure that SEC staff who are later employed by regulated entities do not assist those entities in circumventing applicable rules and regulations while employed with the SEC, and a determination whether greater post-employment restrictions are necessary.

<sup>211</sup> Act § 911.

<sup>212</sup> *Id.*

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> See *U.S. Sec. & Exch. Comm’n Investor Advisory Comm. Charter* (2009).

<sup>216</sup> *Id.*

<sup>217</sup> See Act § 911 (“The Federal Advisory Committee Act . . . shall not apply with respect to the Committee and

Some current members of the Investor Advisory Committee have expressed support for regulation that could burden financial firms. For example, Mercer Bullard, a University of Mississippi law professor, mutual fund investor advocate, and former SEC Assistant Chief Counsel, chairs the Investor as Purchaser Subcommittee of the Investor Advisory Committee.<sup>218</sup> Professor Bullard advocated strongly in favor of eliminating the broker-dealer exclusion from the Advisers Act, which would have made broker-dealers fiduciaries without clarifying how a fiduciary standard would apply in the context of broker-dealers' business models.<sup>219</sup>

**Office of the Investor Advocate.** Second, the Act establishes an Office of the Investor Advocate.<sup>220</sup> The Investor Advocate will be appointed by and report to the Chairman of the SEC.<sup>221</sup> Following consultation with the Chairman, the Investor Advocate will have authority to hire independent counsel, as well as his or her own research and service staff.<sup>222</sup>

The Investor Advocate is tasked with:

assisting retail investors in resolving significant problems with the SEC or with SROs;

- identifying areas where investors would benefit from regulatory changes;
- identifying challenges that investors face in their interactions with financial firms and investment products; and
- analyzing the impact on investors of proposed SEC regulations and SRO rules.<sup>223</sup>

To mitigate problems and promote the interests of investors, the Investor Advocate may propose to the Commission that changes be made to regulations or orders, and to Congress that changes be made to relevant laws, or that particular agency personnel be replaced. To carry out the functions of the office, the Investor Advocate will have full access to SEC and SRO documents.<sup>224</sup>

The Investor Advocate will submit annual reports to the Senate Banking and House Financial Services Committees.<sup>225</sup> The reports will include, *inter alia*, summaries of the most serious problems encountered by investors and recommendations for administrative and legislative action. To preserve the independence of the Investor Advocate, the reports will be submitted directly to Congress without prior review or comment by the Commission, or by the President's budget overseer, the Office of Management and Budget. The SEC will be required to formally respond to the Investor Advocate's reports.<sup>226</sup>

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its activities.”).

<sup>218</sup>Investor Advisory Committee Members, available at: [http://www.sec.gov/spotlight/investoradvisory-committee/committee\\_members.shtml](http://www.sec.gov/spotlight/investoradvisory-committee/committee_members.shtml) (last visited May 21, 2010).

<sup>219</sup>See Letter from Denise Voigt Crawford, President, N. Am. Sec. Adm'rs Ass'n, Mercer Bullard, Founder & CEO, Fund Democracy, Barbara Roper, Dir. of Investor Protection, Consumer Fed'n of Am., and David P. Sloane, Senior Vice President, Gov. Relations & Advocacy, AARP, to Christopher J. Dodd, Chairman, and Richard C. Shelby, Ranking Member, Senate Comm. on Banking, Hous. and Urban Affairs (Feb. 2, 2010) (urging the Senate Banking Committee to include a provision in the Senate Bill eliminating the broker-dealer exemption, and disparaging an alternative proposal to permit the SEC to promulgate rules clarifying the scope of a broker-dealer fiduciary duty as “fiduciary duty lite”).

<sup>220</sup>Act § 915.

<sup>221</sup>*Id.*

<sup>222</sup>*Id.*

<sup>223</sup>*Id.*

<sup>224</sup>*Id.*

<sup>225</sup>*Id.*

<sup>226</sup>*Id.*

**Ombudsman.** The third new entity created by the Act is the Ombudsman.<sup>227</sup> The Ombudsman will be appointed by and report directly to the Investor Advocate. To the extent practicable, the Ombudsman will be limited to utilizing the staff of the SEC.<sup>228</sup>

The Ombudsman will: (i) act as a liaison with the SEC for “retail investors” who experience problems with the SEC or an SRO; (ii) review procedures for presenting compliance questions to the Investor Advocate; and (iii) establish safeguards to protect the confidentiality of investors submitting those types of questions. The Ombudsman will submit semiannual reports to the Investor Advocate, and the Investor Advocate will include those reports in its own submissions to Congress.<sup>229</sup>

**Exemption of Certain Insurance Contracts From Regulation as Securities.** The Act exempts from SEC regulation “any insurance or endowment policy or annuity contract or optional annuity contract ... the value of which does not vary according to the performance of a separate account.”<sup>230</sup> To qualify for this exemption, the policy or contract must satisfy “standard nonforfeiture laws or similar requirements of the applicable State at the time of issue” or, if such laws or requirements do not exist, satisfy the “Model Standard Nonforfeiture Law for Life Insurance or Model Standard Nonforfeiture Law for Individual Deferred Annuities, or any successor model law, as published by the National Association of Insurance Commissioners.”<sup>231</sup> Additionally, the policy or contract must be issued after June 16, 2013, in a state, or by an insurance company domiciled in a state, that adopts rules governing certain suitability and sales requirements.<sup>232</sup>

In June 2008, the SEC proposed Rule 151A, which would have redefined fixed indexed annuities as securities, rather than insurance contracts.<sup>233</sup> Rule 151A would have required additional registration and licensing of both the products and the agents selling them, causing companies offering fixed indexed annuities to seek additional marketing relationships for their sale. After the approval by the SEC of Rule 151A in December 2008,<sup>234</sup> certain insurance companies that sold fixed indexed annuities petitioned to the United States Court of Appeals for the District of Columbia to have the rule overturned. In July 2009, the court held that the SEC could regulate fixed indexed annuities as securities, but remanded the rule to the SEC to consider further whether the rule was necessary or appropriate.<sup>235</sup> The SEC consented to an extension on the enforcement of Rule 151A, and the rule has not yet taken effect.<sup>236</sup> The Act would nullify Rule 151A, and return regulation of fixed indexed annuities to state insurance regulators, which historically have had authority to regulate these products.

<sup>227</sup> Act § 919D.

<sup>228</sup> *Id.*

<sup>229</sup> *Id.*

<sup>230</sup> Act § 989J(a).

<sup>231</sup> *Id.*

<sup>232</sup> *Id.*

<sup>233</sup> See Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release No. 8933, Exchange Act Release No. 58022, 73 Fed. Reg. 37752 (proposed June 25, 2008). Section 3(a)(8) of the Securities Act exempts from SEC regulation certain insurance annuity contracts. 15 U.S.C. § 77c(a)(8).

<sup>234</sup> See Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release No. 8996, Exchange Act Release No. 59221, 74 Fed. Reg. 3138 (Jan. 16, 2009).

<sup>235</sup> See *Am. Equity Investment Life Ins. Co. v. SEC*, 572 F.3d 923 (D.C. Cir. 2009).

<sup>236</sup> Brief of the Securities and Exchange Commission, *Am. Equity Investment Life Ins. Co. v. SEC*, No. 09-1021 (D.C. Cir. Dec. 8, 2009).



# Consumer Protection Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act includes two titles that will profoundly affect consumer lending in the United States and increase government scrutiny of providers of consumer financial services. Title X of the Act — known as the Consumer Financial Protection Act of 2010 — creates a new Bureau of Consumer Financial Protection (the “Bureau”) and endows it with wide-ranging authority to issue new regulations, supervise institutions, enforce consumer financial services laws and regulations, analyze data from institutions through significant new data collection and reporting obligations, and otherwise prevent “abusive” conduct by lenders and other financial service firms. Title XIV — known as the Mortgage Reform and Anti-Predatory Lending Act — prohibits or restricts many previously common mortgage lending practices and limits a lender’s ability to compensate loan officers and brokers. The Dodd-Frank Act also expands the role of state regulators over federally chartered institutions. In all, the Dodd-Frank Act will significantly limit lender practices and will substantially increase the risk that lenders and other financial service providers will face investigations and enforcement actions alleging discriminatory or abusive conduct affecting consumers.

In Part I of this article, we describe the key provisions of Title X and Title XIV. In Part II, we explore the business and policy implications of those provisions.

## I. Key Provisions

The two most significant features of Title X are: (i) the creation of the Bureau, which is charged with the sole mission of regulating consumer financial products and services, and (ii) the expansion of state authority to regulate consumer financial services and enforce federal consumer financial services laws. It also enacts a number of “regulatory improvements.” Title XIV prohibits or restricts a number of loan features or practices that Congress determined to have been abusive. Under the new provisions, mortgage loans that meet a number of stringent “plain-vanilla” criteria will be deemed “qualified mortgages,” and “non-qualified mortgages” will be strongly disincentivized. Substantive changes also include modifications to the rules for mortgage appraisers, expansion of the definition of a “high-cost” loan, and provisions for increased counseling for borrowers, including through the creation of a new “Office of Housing Counseling.” Title XIV also mandates a number of studies that could lead to new regulations, enforcement actions, or additional legislation. Finally, both Titles significantly increase reporting requirements for lenders and implement a number of provisions that will increase fair lending and unfair or deceptive act or practice (“UDAP”) risk.

### The Bureau of Consumer Financial Protection

The Bureau will be a new federal consumer financial regulator with broad rulemaking, supervisory and enforcement powers. The Bureau will be headed by a director appointed by the President to a five-year term, subject to confirmation by the Senate, and will consist of several different functional units.<sup>1</sup>

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<sup>1</sup> Act §§ 1011-1013.

- The Research Unit will analyze trends in the provision of consumer financial products.
- The Community Affairs Unit will focus on educating consumers about consumer financial products and ensuring broad access to financial products.
- The Complaints Unit will maintain a website and toll-free number to centralize collection and monitoring of consumer complaints regarding consumer financial products and services, and will route complaints to other federal and state agencies where appropriate.

The Act establishes several offices within the Bureau:

- The Office of Fair Lending and Equal Opportunity will enforce federal laws relating to fair lending, which the Act defines as “fair, equitable, and nondiscriminatory access to credit for consumers.”<sup>2</sup>
- The Office of Financial Education will develop programs to improve consumers’ financial literacy and familiarity with consumer financial products.<sup>3</sup>
- The Office of Service Member Affairs will focus on issues relevant to service members, such as the Servicemembers Civil Relief Act.<sup>4</sup>

The Act also establishes two bodies to advise and interact with the Bureau:

- The Financial Stability Oversight Council, comprised of senior government officials, has broad powers to identify and respond to threats to the stability of the banking and financial systems, including the power to set aside any regulation of the Bureau that it determines to be such a threat.<sup>5</sup>  
**See “Key Measures to Address Systemic Risk.”**
- The Director is required to establish a Consumer Advisory Board comprised of experts in fields such as consumer protection, fair lending and financial services, which will consult with the Bureau on the exercise of its functions and advise it of emerging national and regional trends in the consumer financial products or services industry.<sup>6</sup>

**Independence of the Bureau.** Although the Bureau will be housed within the Federal Reserve, the Act prohibits the Federal Reserve from intervening in any matter before the director (including enforcement actions and examinations), exercising any appointment or removal powers over Bureau employees, and merging or consolidating any powers of the Bureau with those of divisions or offices of the Federal Reserve and its member banks. The Federal Reserve also is prohibited from exercising approval power over, delaying or preventing the Bureau’s issuing of any rule or order.<sup>7</sup>

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<sup>2</sup> Act § 1013(c).

<sup>3</sup> Act § 1013(d).

<sup>4</sup> Act § 1013(e).

<sup>5</sup> Act §§ 111 & 1023.

<sup>6</sup> Act § 1014.

<sup>7</sup> Act §§ 1011 & 1012.



**Funding.** The Bureau is funded through the budget of the Federal Reserve System based on an amount determined by the director (with several restrictions on the amount the director may request). We expect that the Bureau will be well funded, and the Act authorizes use of those funds to hire a substantial staff of lawyers, economists and examiners.<sup>8</sup>

**Purpose and Functions of the Bureau.** The purpose of the Bureau is to “seek to implement and, where applicable, enforce federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive.”<sup>9</sup> Under the Act, the Bureau is broadly empowered to regulate the offering and provision of “consumer financial products or services,”<sup>10</sup> which include:

- Brokering, extending and servicing loans or other credit;
- Extending or brokering leases of personal or real property;
- Real estate settlement and appraisal services;
- Deposit-taking activities and transmission and exchange of funds;
- Selling, providing, issuing or reloading stored value or payment instruments (*e.g.*, gift cards) if the seller exercises substantial control over the terms or conditions of the stored value instrument;
- Check cashing, collection or guaranty services;
- Providing financial advisory services or advice on an individualized basis, such as credit counseling and assistance with debt modification;
- Providing consumer credit reports expected to be used in connection with the provision of any consumer financial product or service; and
- Collecting debt related to any consumer financial product or service.

A broad catch-all provision gives the Bureau jurisdiction over any other “financial product or service,” if the Bureau determines that it was entered into with an intention to evade federal consumer laws.<sup>11</sup> The Bureau also has jurisdiction over any product that a bank or financial holding company is allowed to offer — except insurance — that is likely to have a material impact on consumers.

As set forth below, the functions of the Bureau include supervising covered institutions for compliance with certain enumerated consumer laws; issuing rules, orders, and guidance implementing those laws; and enforcing those laws and its own regulations.

**Supervisory and Examination Authority.** The Bureau has varying supervisory and examination authority over three classes of institutions:

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<sup>8</sup>Act §§ 1012, 1013 & 1017.

<sup>9</sup>Act § 1021.

<sup>10</sup>Act §§ 1002(5), 1002(15) & 1021.

<sup>11</sup>Act § 1002(15)(xi)(I).

- The Bureau has examination and primary enforcement authority over insured depository institutions with total assets of \$10 billion or more and their affiliates. The Bureau must coordinate its supervisory activities with such institutions' prudential regulators and state bank supervisors.<sup>12</sup>
- The Bureau has the discretion to have its examiners participate in a sampling of the prudential regulators' regular examinations of insured depository institutions with total assets less than \$10 billion. The Bureau may also require reports from these institutions.<sup>13</sup>
- The Bureau has supervisory, examination and enforcement authority over non-depository institutions that broker, originate or service mortgage and home equity loans. Separately, certain "larger participants" of markets for other consumer financial products or services, as determined by the Bureau and the Federal Trade Commission ("FTC"), also are subject to supervisory, examination and enforcement authority by the Bureau.<sup>14</sup> The Bureau must negotiate an agreement with the FTC for coordinating enforcement actions with respect to any of these institutions, which shall include procedures for notifying the other agency prior to initiating a civil action.

**Carveouts.** The individuals and institutions over which the Bureau may not exercise any rulemaking, supervisory and enforcement authority include attorneys, accountants, real estate brokers, tax preparers, insurance companies and merchants not significantly engaged in the business of selling financial products or services.<sup>15</sup> Auto dealers also are exempted from general coverage by the Act, unless they provide real estate financing or other non-auto-related credit to consumers, or provide retail credit or leases that they do not merely originate and assign to third parties.<sup>16</sup>

**Rulemaking, Investigation and Enforcement Authorities.** The Act transfers to the Bureau rulemaking authority with respect to several federal consumer financial laws, including the Equal Credit Opportunity Act ("ECOA"), the Truth In Lending Act ("TILA"), the Real Estate Settlement Procedures Act ("RESPA"), the Fair Credit Reporting Act ("FCRA"), the Fair Debt Collection Practices Act ("FDCPA"), portions of the Gramm-Leach-Bliley Act relating to information privacy, and several other statutes.<sup>17</sup> As noted above, the Bureau also is authorized and charged with preventing covered persons or service providers from committing or engaging in an unfair, deceptive or abusive act or practice under federal law.<sup>18</sup>

In carrying out its mandate under the Act, the Bureau has the authority to investigate potential violations of the enumerated federal consumer financial laws and to conduct hearings, subpoena testimony and records, and issue civil investigative demands. If the Bureau determines that a person has violated a federal consumer financial law, it may issue a notice to the person to appear and contest the issuance of a cease and desist order. The Bureau also may pursue civil actions for violations of federal consumer financial laws. The Bureau has no criminal prosecutorial authority, but it is authorized to refer potential criminal matters to the Department of Justice.<sup>19</sup> In addition, the Bureau is required to refer potential violations of tax law to the Internal Revenue Commissioner.<sup>20</sup>

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<sup>12</sup>Act § 1025.

<sup>13</sup>Act § 1026.

<sup>14</sup>Act § 1024.

<sup>15</sup>Act § 1027.

<sup>16</sup>Act § 1029.

<sup>17</sup>Act §§ 1002(12) & 1022.

<sup>18</sup>Act § 1031.

<sup>19</sup>Act §§ 1052-1056.

<sup>20</sup>Act §§ 1024(b)(6), 1025(b)(5) & 1026(b)(3).

**Reporting Responsibilities.** The Act mandates that the director appear semiannually before the Senate’s Committee on Banking, Housing and Urban Affairs and the House’s Committee on Financial Services. Concurrent with these appearances, the director must file reports that include details of significant problems faced by consumers shopping for or obtaining consumer financial products or services; supervisory and enforcement actions taken by the Bureau, and by state regulators and attorneys general with respect to federal consumer financial laws; significant rules and orders adopted by the Bureau; and analyses of consumer complaints received.<sup>21</sup>

### Substantive Changes to Lending Law

The Act includes a number of substantive provisions that will significantly affect lenders, servicers and borrowers.

**Ban on “Abusive” Acts or Practices.** Section 1031 of the Act empowers the Bureau to prevent a covered institution from engaging in an “unfair, deceptive, or abusive act or practice in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.” Although “unfair” and “deceptive” acts or practices have been prohibited for some time under Section 5 of the Federal Trade Commission Act and similar state laws, the prohibition of “abusive” acts or practices is new. While the Act itself provides little guidance as to what constitutes an “abusive” act or practice, the Bureau is expected to provide direct guidance through its regulations and indirect guidance through its enforcement actions.

The Act does articulate one limitation on the authority of the Bureau to define what is abusive, which is notable insofar as it signals what conduct will probably be deemed abusive. According to the Act, the Bureau shall have no authority to declare an act or practice abusive in connection with the provision of a consumer financial product or service unless the act or practice (i) materially interferes with a consumer’s ability to understand the product or service or (ii) takes unreasonable advantage of the consumer’s lack of understanding, inability to protect his or her interests, or reasonable reliance on a covered person to act in the interests of the consumer.<sup>22</sup>

**Qualified Mortgages.** The Act creates a safe harbor for compliance by defining an important new category of loans called “qualified mortgages.”<sup>23</sup> For example, creditors and assignees may presume that qualified mortgages satisfy the requirement that loans be underwritten based on the borrower’s ability to repay. A qualified mortgage must meet several criteria, including a requirement that the points and fees total less than 3% of the loan amount. The designation of a qualified mortgage, along with the safe harbor that it provides, is very important because borrowers can raise inability to repay underwriting standards as a foreclosure defense against creditors and assignees, without regard to any statute of limitations. As such, there may be very limited appetite in the secondary market for non-qualified mortgages.<sup>24</sup>

**Compensation Prohibitions and Steering Provisions.** Section 1403 of the Act amends the TILA to prohibit loan originators from paying loan officers or brokers compensation that varies based on the

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<sup>21</sup>Act § 1016.

<sup>22</sup>Act § 1031(d).

<sup>23</sup>Act § 1412.

<sup>24</sup>Act § 1414.

terms of the loan, other than the amount of the principal. Loan originators also may not arrange for a consumer to finance any origination fees or costs except *bona fide* third-party settlement charges not retained by the creditor or loan originator.<sup>25</sup> These provisions are intended to prevent lenders from placing borrowers in loans with rates and fees that are higher than appropriate in light of the borrowers' qualifications.

Additionally, the Act prohibits originators from steering borrowers from a qualified mortgage to a non-qualified mortgage; to a loan that the consumer lacks the ability to repay; and to a loan that has "predatory characteristics (such as equity stripping, excessive fees or abusive terms)."<sup>26</sup>

Finally, the Act empowers the Bureau to issue regulations to prohibit "abusive or unfair lending practices that promote disparities among consumers of equal creditworthiness but of different race, ethnicity, gender, or age." The contours of this provision, like many others in the Act, will not be fully known until the Bureau issues its regulations, but one may expect that the regulations will lead to limitations on discretionary underwriting, product selection or pricing practices. Violation of the ban on steering incentives can be raised as a foreclosure defense by a borrower against a creditor or assignee without regard to any statute of limitations.<sup>27</sup>

**Ban on Originating Loans Where Borrower Has No "Reasonable Ability" to Repay.** One of the most important provisions of the Act sets forth "minimum standards for residential mortgage loans," one of which requires mortgage lenders to determine, "based on verified and documented information," that the consumer has a "reasonable ability to repay the loan."<sup>28</sup> Creditors are required to make the ability to pay determination based on the consumer's credit history, income, obligations, debt-to-income ratio, employment status and other information, utilizing a fully amortizing payment schedule, and lenders should document their consideration of these factors. The statute provides guidance for compliance with this section and provides a limited exception for certain streamlined refinance loans that meet several requirements. The Act does not clearly explain how lenders can determine that a borrower has a reasonable ability to repay balloon loans apart from general guidelines based on the APR and any Board of Governors regulations. The Act also invites the Board of Governors to issue regulations making balloon loans presumptively repayable under certain circumstances.<sup>29</sup> As discussed below, this section raises significant implementation challenges. Like the ban on steering incentives, violation of the ban on considering the borrower's ability to repay for underwriting can be raised as a foreclosure defense by a borrower against a creditor or assignee without regard to any statute of limitations, unless the loan meets the criteria for a qualified mortgage, as explained below.<sup>30</sup>

**Ban on Prepayment Penalties for Certain Loans.** The Act amends the TILA to prohibit prepayment penalties on residential mortgage loans other than qualified mortgages, which the provision defines as residential mortgages that, among other things, do not have adjustable rates and do not result in negative amortization.<sup>31</sup>

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<sup>25</sup>Act § 1403.

<sup>26</sup>Act § 1403.

<sup>27</sup>Act § 1413.

<sup>28</sup>Act § 1411.

<sup>29</sup>Act § 1412.

<sup>30</sup>Act § 1413.

<sup>31</sup>Act § 1414.

**Lowered HOEPA Threshold.** The Act lowers the pricing threshold at which a loan will be subject to the restrictions in the Home Ownership and Equity Protection Act (“HOEPA”).<sup>32</sup> The new HOEPA triggers are: points and fees exceeding 5% of the loan amount on mortgage loans of at least \$20,000, or 8% or a certain dollar amount on loans below \$20,000; an APR exceeding the average prime offer rate by 6.5% on first lien loans for \$50,000 or more, or 8.5% on smaller loans and second lien loans; or a prepayment penalty provision applicable more than three years after the closing of the loan or that exceeds 2% of the prepayment. Also, the Act expands the definition of points and fees for calculating the HOEPA trigger.

**Ban on Arbitration Agreements in Mortgage Loans; Likely Ban in Other Contexts.** Mandatory arbitration clauses are prohibited in mortgage or home equity loans.<sup>33</sup> The Act does not directly ban mandatory pre-dispute arbitration agreements between covered persons and consumers in other types of loans, but Section 1028 requires the Bureau to report to Congress on the use of binding arbitration agreements in the consumer financial products or services industry generally. The Act then authorizes the Bureau, consistent with the findings of its study, to prohibit or limit such agreements if the Bureau finds that doing so is “in the public interest and for the protection of consumers.”<sup>34</sup>

**Requirements for Use of Consumer Credit Reports.** The Act amends the Fair Credit Reporting Act by requiring a lender to provide a consumer with the consumer’s numerical credit score as well as the factors that affected the score if the lender took any adverse action (including a denial or a higher interest rate) against the consumer based at least in part on that credit score.<sup>35</sup>

**Debit and Credit Card Fees and Restrictions.** The Act amends the Electronic Funds Transfer Act to require that transaction fees charged to merchants by debit card networks (interchange fees) be “reasonable and proportional to the actual cost incurred” by the card network in effecting the transaction. Card networks will not be allowed to prevent merchants from offering discounts based on the form of payment that a consumer uses (such as credit, debit or cash), and a ban on requirements that debit cards can be used only on certain networks will leave merchants free to select which card network they use to process debit card transactions. Reloadable debit cards are excepted from the Act’s mandates, and the Act does not limit transaction maximums or minimums that card networks may set.<sup>36</sup>

**Enhanced Disclosures.** The Act directs the Bureau to propose a new joint RESPA/TILA disclosure statement and requires a number of enhanced loan disclosures, including new TILA disclosures to be included on each monthly mortgage statement,<sup>37</sup> a notice that an ARM loan with an initial fixed rate is going to reset,<sup>38</sup> a negative amortization feature disclosure,<sup>39</sup> and disclosure of the loss of protection under state laws prohibiting deficiency judgments after foreclosure.<sup>40</sup>

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<sup>32</sup>Act § 1431.

<sup>33</sup>Act § 1414.

<sup>34</sup>Act § 1028.

<sup>35</sup>Act § 1100F (incorporating 15 U.S.C. § 1681g(f)(1)(B)-(E)).

<sup>36</sup>Act § 1075. See also “[Payment Card Transactions](#)” for a detailed discussion of Section 1075.

<sup>37</sup>Act § 1420.

<sup>38</sup>Act § 1418.

<sup>39</sup>Act § 1414.

<sup>40</sup>*Id.*

**Counseling Programs and Tools.** The Act amends the Department of Housing and Urban Development Act (“Housing Act”) to establish an Office of Housing Counseling within the Department of Housing and Urban Development (“HUD”) with responsibility for, among other things, the development and funding of housing counseling programs and foreclosure rescue education programs.<sup>41</sup> In addition, the Act amends the Housing Act to require the HUD Secretary to provide for the certification of various computer software programs for consumers to use in evaluating different residential mortgage loan proposals, which shall take into account the consumer’s financial situation, the amount of time the consumer expects to remain in the home and any other relevant factors that the Secretary identifies.<sup>42</sup> The HUD Secretary must make these software programs widely available through the Internet and at public locations, including public libraries. The HUD Secretary also must conduct an extensive study of the root causes of default and foreclosure of home loans and create a database of such information in consultation with the federal bank regulatory agencies.<sup>43</sup> In reporting the results of the study to Congress, the HUD Secretary must make recommendations for new legislation.<sup>44</sup>

**New Servicing Requirements.** The Act amends the TILA to enumerate circumstances in which creditors must establish escrow accounts for the payment of taxes and hazard insurance for first lien loans on borrowers’ principal dwellings. These include when such an account is required by federal or state law; when the loan is made, guaranteed or insured by a state or federal entity; and when the original principal amount and interest rates meet the Act’s threshold requirements.<sup>45</sup> The Act also amends the Real Estate Settlement Procedures Act to define when and how a servicer may obtain force-placed hazard insurance on behalf of a borrower, to prohibit servicers from charging certain fees and to mandate responsiveness to certain borrower requests.<sup>46</sup> In addition, the Act amends the TILA to prohibit servicers from failing to credit a payment to the consumer’s loan account as of the date of receipt, except when a delay does not result in any charge to the consumer or in the reporting of negative information to a consumer reporting agency.<sup>47</sup> The Act also has several provisions designed to enhance transparency in the Administration’s Home Affordable Modification Program (“HAMP”), both in information provided to denied applicants and in public availability of certain criteria employed in assessing applications.<sup>48</sup>

**Increased Penalties and Longer Limitations Period for TILA Violations.** The Act amends TILA to double the monetary fines levied as civil penalties for TILA violations. In addition, the Act extends the statute of limitations period for federal authorities to prosecute TILA violations from one year to three years.<sup>49</sup>

### Fair Lending Reporting Provisions

The Act expands the type of loan-level data that lenders must collect and report to the government to enable the government to investigate potential fair lending violations.

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<sup>41</sup>Act § 1442.

<sup>42</sup>Act § 1443(a).

<sup>43</sup>Act §§ 1446-1447.

<sup>44</sup>Act § 1447.

<sup>45</sup>Act § 1461(a).

<sup>46</sup>Act § 1463(a).

<sup>47</sup>Act § 1464(a).

<sup>48</sup>Act § 1482(a)-(c).

<sup>49</sup>Act § 1416(a),(b).

**Additional Data Collection Requirements.** Lenders have been required for many years to collect and report to the federal government certain information about mortgage loan applications and originations under the Home Mortgage Disclosure Act (“HMDA”). The primary purpose of the law has been to help identify potential discrimination by lenders. HMDA initially required lenders to collect and report aggregate lending data by Census tract.<sup>50</sup> The law was then amended to require data on the race, ethnicity and sex of applicants, as well as the application decision.<sup>51</sup> A later amendment required lenders to disclose pricing information for loans that exceeded a rate threshold.<sup>52</sup> Because lenders were not required to report information regarding the applicant’s credit, HMDA was a very blunt tool for determining whether a lender was discriminating against borrowers. One purpose of the HMDA amendments in the Act is to sharpen that tool.

In particular, Section 1094 amends HMDA to require lenders to collect and report an applicant’s credit score. The section also requires lenders to collect and report other information, including the borrower’s age, total points and fees information, loan pricing, prepayment penalty information, house value (for loan-to-value ratios), period of introductory interest rate, interest-only or negative amortization information, term of the loan, and channel of origination.

**Small Business Loans.** In addition to increasing the amount of mortgage data that must be collected and reported, the Act will require lenders to collect and report small business loan data to the Bureau. Section 1071 of the Act amends the ECOA in order to “facilitate enforcement of fair lending laws and enable communities, governmental entities, and creditors to identify business and community development needs and opportunities of women-owned and minority-owned small businesses.” This provision requires a lender to inquire whether a small business is women- or minority-owned. The lender must also ask about the “race and ethnicity of the principal owners of the business,” and collect other information such as the gross annual revenue of the business and the amount of credit that the business is seeking.

### Preemption and State Authority

The Act redefines the role of state regulation over federally chartered institutions by enhancing the states’ authority to enforce state and federal law against federal banks and other institutions. First, the Act provides that if a majority of states enacts a resolution in support of the establishment or modification of a consumer protection regulation, the Bureau must promulgate a notice of proposed rulemaking relating to the proposal. The Bureau is not, however, required to enact such a final regulation.<sup>53</sup> In addition, the Act provides that state consumer financial laws apply to subsidiaries of federally chartered banks to the same extent that those laws apply to other persons or institutions.<sup>54</sup> It also provides that states may sue national banks and federal savings banks in their own name to enforce regulations promulgated by the Bureau under the Act, but not to enforce the provisions of the Act itself.<sup>55</sup> However, before a state brings suit against a federally chartered bank, it must provide a copy of the complaint to the Bureau and the bank’s prudential regulator. Thereafter, the Bureau has the right to intervene, remove the action to federal court, be heard in court and appeal the judgment just like any other party.<sup>56</sup>

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<sup>50</sup>Federal Financial Institutions Examination Council, History of HMDA, <http://www.ffiec.gov/HMDA/history2.htm> (last visited July 1, 2010).

<sup>51</sup>*Id.*

<sup>52</sup>*Id.*

<sup>53</sup>Act § 1041(c).

<sup>54</sup>Act § 1044(e).

<sup>55</sup>Act § 1042(a).

<sup>56</sup>Act § 1042(b).

The Act also expressly codifies the Supreme Court's decision in *Cuomo v. Clearing House Association*,<sup>57</sup> by providing that no restriction on state exercise of "visitorial" powers shall prevent a state from bringing an action against a federal bank to enforce any "applicable" law (presumably meaning any law that is not substantively preempted).<sup>58</sup> Furthermore, it explicitly preserves current National Bank Act provisions relating to the interest rates that banks may charge.<sup>59</sup> With respect to institutions other than federal banks, the Act states that the Bureau is not authorized to impose a national usury limit.<sup>60</sup>

**State Laws Preempted Only if "Inconsistent" With the Act.** The Act itself preempts state laws only to the extent that they are "inconsistent" with the Act.<sup>61</sup> Further, it provides that if a state law provides greater protections than the Act, this will not render the state law "inconsistent" with the Act. Finally, the Act clarifies the preemption standard generally by identifying three situations in which a state law will be deemed to be preempted. First, if a state consumer financial law would have a discriminatory effect on federal banks, as compared with banks chartered in that state, the law is preempted. Second, the OCC can preempt state statutes on a case-by-case basis if the Comptroller determines, based on "substantial evidence," that the state law forbids or significantly impairs national bank activities under the standard articulated in *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner*.<sup>62</sup> Third, any express preemption of state law set forth in a federal law will remain in effect.

### Miscellaneous Provisions and Additional Studies

The Act amends TILA to prohibit the financing of single-premium credit insurance in connection with any mortgage or consumer loan secured by a borrower's home.<sup>63</sup> TILA also is amended to impose several new appraisal independence requirements, including: (i) prohibiting appraisers or appraisal management companies from having direct or indirect interests in the property or transaction at issue, (ii) requiring lenders to compensate appraisers only at a customary and reasonable rate for the property's locality, (iii) prohibiting use of Broker Price Opinions as the primary basis for determining the value of a piece of property being purchased as a consumer's principal dwelling, and (iv) setting forth minimum requirements to be applied by states in the registration of appraisal management companies.<sup>64</sup>

Finally, the Act sets forth the "sense of Congress" regarding the importance of Fannie Mae and Freddie Mac and the need to enact meaningful structural reforms of those institutions.<sup>65</sup> It also requires the Comptroller General to conduct a study of the current interagency efforts to crack down on mortgage foreclosure rescue scams and loan modification fraud and to submit a report to Congress with legislative recommendations.<sup>66</sup>

<sup>57</sup>129 S. Ct. 2710 (2009).

<sup>58</sup>Act § 1047.

<sup>59</sup>Act § 1044(a).

<sup>60</sup>Act § 1027(o).

<sup>61</sup>Act §1041(a).

<sup>62</sup>517 U.S. 25 (1996).

<sup>63</sup>Act § 1414(a).

<sup>64</sup>Act §§ 1471 & 1473.

<sup>65</sup>Act § 1491(a)-(b).

<sup>66</sup>Act § 1492(a)-(b).



## II. Business and Policy Implications

The Act changes many of the basic rules of the road in consumer financial services while at the same time appointing a strong, new traffic cop to enforce those rules and write new rules. The substantive provisions of the Act reflect a sea change away from the disclosure-based regime reflected in prior consumer statutes and toward more of a rules-based regime. Under the Act, it is no longer enough for lenders to provide full and accurate disclosures to allow consumers to make decisions based on their own self-interest. In many respects, the loan officers and lenders themselves are now required to make those decisions for the borrowers. To a large degree, therefore, the Act represents a policy choice by Congress to limit freedom of contract by banning or effectively banning certain loans, loan features, and loan practices that Congress determined to have been applied in an abusive manner by certain lenders in the past. From a more practical standpoint, the Act significantly increases both the ways in which a provider of consumer financial services may run afoul of the law and the power of the government to investigate and enforce violations.

Although the ultimate impact of these far-reaching changes may not be apparent for several years, we foresee a number of practical and policy implications of the Act.

### **New Regulatory Framework**

Above all, the Act changes how financial institutions are regulated from a consumer compliance perspective. For the first time, a federal governmental agency will be devoted exclusively to financial consumer compliance issues, with separate offices overseeing fair lending or equal opportunity issues and financial literacy issues. The Bureau itself will become the primary enforcement agency only for the largest financial institutions (those with assets of over \$10 billion) and their affiliates, as well as previously unregulated institutions directly involved with the offering or servicing of consumer financial products. However, the impact of the Bureau's actions will be felt in all corners of the financial services industry. Indeed, even those institutions that will not be directly supervised by the Bureau should anticipate that their own regulators may have new examiners, new procedures, new regulations and new expectations.

Financial institutions should expect that the creation of the Bureau and the changes in regulatory enforcement authority required by the Act will result in two high-level shifts. First, the Act and the creation of the Bureau likely will lead to additional consumer protection rules and regulations — some of which will clarify existing ambiguities and some of which may well create new ones. Second, passage of the Act will result in an atmosphere of significantly increased consumer compliance scrutiny, including more frequent examinations of consumer compliance and fair lending issues, as well as likely disagreement among the agencies and between the federal and state governments about how new regulations should be interpreted and enforced.

By granting authority to the Bureau to issue rules and regulations implementing consumer protection statutes, the Act effectively opens the door to new, if not rewritten, requirements under the statutes. Among other things, a fresh review of the regulations by Bureau staff will probably clarify some disputed or unclear issues under current regulations, including those addressing unfair or deceptive acts or practices and Real Estate Settlement Procedures Act rules. However, the Bureau's authority will probably also lead to additional burdens on financial institutions, including the reporting of additional information under HMDA and the prohibition against tying loan officer compensation to the terms of the loan, both

of which are addressed directly in the Act. We expect the Bureau to issue additional fair lending regulations as well.

The Act sets forth requirements for a fairly complicated bureaucracy. The speed with which the Bureau acts and the direction it takes will be influenced not only by the staff but by the President's choice of the director of the Bureau. Without doubt, however, passage of the Act will lead to additional focus by regulators on consumer compliance supervisory issues long before all of the Act's provisions are implemented. The consumer focus may, however, lead to some conflict. For example, the prudential regulators can be expected to fight to preserve their independence and stature relative to the new Bureau. In the short term, this means that financial institutions may experience quick resolution of pending examination matters and the issuance of public orders, as well as the opening of new examination matters and fair lending inquiries. The establishment of a new Office of Fair Lending and Equal Opportunity within the Bureau likely will increase significantly the number of investigations of potential discrimination in lending, and may lead to the development of new fair lending theories of liability or statistical methodologies.

In addition, some institutions may be subject to competing or conflicting mandates from their prudential regulator, on the one hand, and the Bureau, on the other hand. For instance, certain fees, interest rate options, or other practices that are approved from a safety and soundness perspective may be viewed as having consumer protection implications, thus putting the institution in a difficult position.

Regardless of how effectively the agencies work together in implementing the Act, however, they are all likely to view the Act as a mandate for increased scrutiny of consumer compliance issues.

### **Changes to Loan Officer and Broker Compensation**

For many lenders, the prohibition on paying loan officers or brokers more money for loans with higher interest rates, fees or other features will significantly alter their relationships with these parties. One likely result will be lower overall income for brokers and loan officers. This new rule also may lead to fewer product and rate choices for consumers with strong bargaining power. As loan origination turns into more of an education and processing task, with potentially reduced compensation, there may well be significant turnover in the loan officer ranks.

### **Changes to Lending Requirements**

The requirement that loan officers determine that borrowers have a reasonable ability to repay will have both short-term and long-term ramifications. Previously, the "ability to pay" requirement was market-based, set by investors or lenders. With this change, the federal government will directly involve itself in the underwriting process as it relates to risk. This federal regulation may lead to inconsistencies across loan products and vague standards for determining what constitutes a "reasonable ability to repay." For example, it is not clear whether the ability to pay standard will be universal across loan products or will be different based on the circumstances of each loan. Nor is it clear what exceptions, if any, will be allowed, and on what basis. Lenders and loan officers should expect a great deal of uncertainty from the federal regulators as this provision is implemented.

The Act also includes provisions to make it easier for borrowers to compare mortgage loan proposals that could affect the evaluation of lenders' compliance with the "ability to pay" requirement. In particular, the requirement that the Secretary of Housing and Urban Development make available software programs

designed to aid borrowers as they evaluate their options based on several income and expense factors could expose lenders who do not properly take into account the new requirement. Finally, the outright prohibition of certain loan features, such as single premium credit insurance, signals a skepticism of the efficacy of disclosure for certain products and borrowers and a new willingness by Congress to make choices on behalf of consumers.

### **Prohibition of Unfair, Deceptive or Abusive Acts**

The authority of the Bureau under Section 1031 to take action to prevent unfair, deceptive or abusive acts or practices raises questions about how this new provision will be enforced and whether it has broader policy implications. For example, while the “unfairness” and “deception” doctrines were defined generally by the FTC decades ago, it is not clear what, if any, changes the Bureau will make to their meanings as applied to financial institutions.

In addition to inviting new definitions of “unfair” and “deceptive,” the Act also appears to give regulators broad authority to inquire about the consumer’s knowledge of the terms of the loan under the new “abusive” standard. Indeed, Section 1031 contemplates that government intervention should occur where a product or service takes “unreasonable advantage” of “the inability of the consumer” to protect his or her own interests. This provision, combined with the requirement that loan officers determine that borrowers have a reasonable ability to repay a loan before making the loan, augurs a more paternalistic approach to the regulation of consumer financial services by calling into doubt the very decisions made by consumers themselves. In addition, Section 1403 amends TILA to require the Board of Governors to prohibit abusive or unfair lending practices that “promote disparities among consumers of equal credit worthiness but of different race, ethnicity, gender, or age.” This prohibition gives regulators a new and somewhat vague legal theory for pursuing fair lending claims outside of the current disparate impact and disparate treatment regime.

Ultimately, these changes could signal a broader policy shift that will extend beyond consumer financial services. The new paternalism also may lead to a reduction in the amount of credit offered by lenders, as lenders will increasingly seek to minimize or avoid subjective, after-the-fact assessments of their decisions.

### **Enhanced Tracking of Consumer Complaints**

The Act requires significant attention by the Bureau to consumer complaints, which have until now received less formal attention from bank regulators. In particular, the Bureau will devote an entire division to tracking complaints against individual banks and other lenders. That division will produce an annual summary of the complaints, which will be provided to Congress. Given the enhanced emphasis on consumer complaints under the proposed system, institutions should expect to see an increase in complaint campaigns akin to political lobbying efforts. Institutions should begin preparing for these changes by developing strong complaint tracking and response systems. In addition, it will be important that any such system accurately differentiates between frivolous and legitimate complaints and assist the institution in moving quickly to provide remedies where appropriate to borrowers with legitimate complaints.

### **New Fair Lending Reporting Requirements**

The Act will lead to additional fair lending scrutiny because it significantly expands the data required to be reported by financial institutions under the HMDA, as well as the way small businesses’ data is maintained and reported under the ECOA.

The additional fields required by the HMDA and ECOA likely will influence how the regulators conduct fair lending statistical screening tests going forward. Currently, regulators identify HMDA “outlier” institutions based principally on the geographic dispersion of their loans, denial disparity rates, and the frequency and magnitude of rate spreads above specified levels. Because the data is limited, this screening cannot answer the question of whether an institution has treated “similarly situated” applicants consistently. As a result, federal regulatory inquiries are often based on “false positives,” or instances where raw HMDA data indicates potential lending disparities, but the consideration of other factors used by the institution in its lending decisions (such as credit score and loan-to-value ratio) demonstrates that there are, in fact, no disparities. With this new information, the regulators can further refine their statistical screening practices to control for additional factors such as credit score and loan-to-value ratio, thus theoretically reducing the number of “false positives” and allowing regulators to use their resources more efficiently.

The emphasis on credit score, however, could lead to false positives based on an incomplete understanding of the role that credit score plays in a lender’s underwriting or pricing practice. The focus on a single credit score may have the effect of penalizing lenders that consider multiple credit factors — not just a third-party score. This in turn may encourage lenders to abandon a nuanced approach for a one-size-fits-all credit score approach.

Finally, there is little doubt that there will be increased scrutiny of small business fair lending compliance, given the greater availability of data required by the ECOA.

### **Employee Whistleblower Protections**

Section 1057 of the Act prohibits a covered institution from taking any retaliatory action against an employee for providing any information about a potential violation to the Bureau, other federal authorities, or state authorities. The Act also protects an employee who refuses to do something that he or she “reasonably believed to be in violation of any law, rule, order, standard, or prohibition, subject to the jurisdiction of, or enforceable by, the Bureau.”<sup>67</sup> For example, covered financial institutions may not terminate the employment of loan officers who raise concerns about compliance with the new provision in the Act that loan officers determine that borrowers have a reasonable ability to repay before making the loan.<sup>68</sup> This new protection will complicate certain personnel decisions. For example, a lender may wish to terminate a loan officer with low production volume. However, the loan officer may protest, arguing that his low volume is due to his strict compliance with the ability to pay requirement. In such a situation, the lender will have to exercise particular caution to ensure that the personnel action does not run afoul of the Act’s requirements.

### **New Servicing Requirements**

In many respects, the new servicing rules codify longstanding practices of servicers with respect to force placed insurance and payment posting. However, the new requirements relating to the creation of escrow accounts may lead to confusion about when an escrow account is required, how long the account is required to be maintained and when a borrower may waive the account. In addition, the new requirements for servicers to disclose their NPV calculations for HAMP modifications may lead to additional

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<sup>67</sup>Act § 1057.

<sup>68</sup>*Cf.* Act § 1411 (requirement that lenders assess reasonable ability to repay).

scrutiny of servicers' efforts to comply with HAMP and to ensure that borrowers are able to stay in their homes.

### **Additional Oversight by State Regulators**

The Act gives state attorneys general additional latitude to enforce their own consumer protection statutes and any regulations issued by the Bureau against federally chartered banks and their operating subsidiaries.

Institutions should anticipate that the new provisions regarding preemption and visitorial powers will lead to greater involvement by state attorneys general in promulgating and enforcing consumer protection laws. First, as described above, the Act removes the preemption barrier protecting subsidiaries of federal banks, which means that states will have significantly broader authority to enforce state laws against such institutions. In addition, the Act moves the states significantly closer to gaining a seat at the table for deliberations regarding federal regulations by requiring a notice of proposed rulemaking whenever a majority of states enacts a resolution in support of the establishment or modification of a consumer protection regulation. This unique provision could affect jurisprudence on federalism issues and serve as a precedent for federal-state interactions in other industries.

In anticipation of these changes, federal banks may need to prepare for strict regulation of their subsidiaries by state attorneys general. Likewise, all financial institutions — national and state — should expect that the states will issue new and broader consumer protection regulations, many of which will be more comprehensive than the federal regulations. Finally, because the Act strips the subsidiaries of federal banks of their federal preemption, institutions may choose to move lending operations that had been structured as operating subsidiaries to be within the depository institution itself.

### **Potential Additional Legislation**

While the Act will profoundly change the landscape, financial institutions should not expect it to be the final word on the subject of consumer protection. To the contrary, there almost certainly will be further legislation covering many of the same issues, particularly as interest groups, industry participants, and legislators seek to expand, contract, or fine-tune changes affected by the Act.

Some members of Congress may attempt to amend the Act to include additional substantive provisions. For example, the Act's prohibition on the establishment of a national usury limit and the preservation of a national bank's ability to export interest rates may be revisited in the future, especially given that they arguably are in tension with other goals of the Act.

Additionally, interest groups may seek future legislation to exempt certain industry participants from coverage under the Act. In fact, since the Administration proposed the initial draft of the Act, some of the most significant changes have been restrictions to the authority of the Bureau over smaller institutions and other industry participants that have raised concerns about burdensomeness and have stressed their history of responsible practices. It is likely that, after the enactment of the Act, other categories of industry participants may similarly seek to exempt themselves from the Bureau's examination and enforcement authority.

Another area that may ultimately be revisited by future legislation is the regulation of the business of insurance. While the regulation of insurance has traditionally been the domain of the states, certain

provisions of the Act explicitly contemplate possible future federal regulation of the industry. Indeed, the Federal Insurance Office, a new agency that is created by the Act, is charged with conducting a study of, among other things, the “consumer protection for insurance products and practices, including gaps in state regulation” and several different aspects of the “potential federal regulation” of insurance. While the ultimate conclusion of this study is unknown, it could well point toward a future of increased federal regulation of the business of insurance. [See “Insurance.”](#)

Finally, the Act mandates a number of studies and surveys that could serve to spur amendments or new legislation. For example, the Act requires the Secretary of Housing and Urban Development to conduct a study regarding the root causes of default and foreclosure and to recommend legislation to address any issues identified in the study. An initial draft of a report to Congress based on this study is required by the middle of 2011. In addition, the Act requires the Comptroller General to study efforts by the federal government to stop foreclosure rescue scams and loan modification fraud, as well as studying the Act’s impact on minorities’ access to affordable credit relative to other borrowers. The results of these studies also could lead to additional legislation affecting lenders and servicers.

# Glossary

<b>1940 Act</b>	Investment Company Act of 1940, as amended
<b>ABS</b>	asset-backed securities
<b>Advisers Act</b>	Investment Advisers Act of 1940, as amended
<b>Bankruptcy Code</b>	United States Bankruptcy Code
<b>BHCA</b>	Bank Holding Company Act
<b>Board of Governors</b>	Board of Governors of the Federal Reserve System
<b>Bureau</b> or <b>CFPB</b>	Consumer Financial Protection Bureau
<b>CDO</b>	collateralized debt obligation
<b>CDS</b>	credit default swap
<b>CEA</b>	Commodity Exchange Act
<b>CFMA</b>	Commodity Futures Modernization Act of 2000, as amended
<b>CFTC</b>	Commodity Futures Trading Commission
<b>Commodity Exchange Act</b>	Commodity Exchange Act
<b>Council</b> or <b>FSOC</b>	Financial Stability Oversight Council
<b>CRA</b>	Community Reinvestment Act
<b>CRD</b>	Central Registration Depository
<b>DCO</b>	derivatives clearing organization
<b>Dodd-Frank Act</b> or <b>the Act</b>	Dodd-Frank Wall Street Reform and Consumer Protection Act
<b>DOJ</b>	Department of Justice
<b>ECOA</b>	Equal Credit Opportunity Act
<b>ERISA</b>	Employee Retirement Income Security Act of 1974, as amended

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<b>Exchange Act</b>	Securities Exchange Act of 1934, as amended
<b>FCM</b>	futures commission merchant
<b>FCRA</b>	Fair Credit Reporting Act
<b>FDCPA</b>	Fair Debt Collection Practices Act
<b>FDIA</b>	Federal Deposit Insurance Act
<b>FDIC</b>	Federal Deposit Insurance Corporation
<b>Federal Reserve Act</b>	Federal Reserve Act of 1913, as amended
<b>FINRA</b>	Financial Industry Regulatory Authority
<b>FOIA</b>	Freedom of Information Act
<b>FTC</b>	Federal Trade Commission
<b>GAO</b>	U.S. Government Accountability Office
<b>GLB Act</b>	Gramm-Leach-Bliley Act
<b>HAMP</b>	Home Affordable Modification Program
<b>HOEPA</b>	Home Ownership and Equity Protection Act
<b>HOLA</b>	Home Owners' Loan Act
<b>HMDA</b>	Home Mortgage Disclosure Act
<b>House</b>	House of Representatives
<b>House bill</b>	The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173
<b>HUD</b>	Department of Housing and Urban Development
<b>IARD</b>	Investment Adviser Registration Depository
<b>IRS</b>	Internal Revenue Service

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<b>MSP</b>	Major Swap Participant, a participant in swaps regulated by the CFTC
<b>MSSP</b>	Major Security-Based Swap Participant, a participant in a security-based swap regulated by the SEC
<b>NAIC</b>	National Association of Insurance Commissioners
<b>NFC</b>	nonbank financial company
<b>NRSRO</b>	nationally recognized statistical rating organization
<b>OCC</b>	Office of the Comptroller of the Currency
<b>OFR</b>	Office of Financial Research
<b>Office</b>	Federal Insurance Office
<b>OIG</b>	Securities and Exchange Commission Office of Inspector General
<b>OTC</b>	over-the-counter
<b>OTS</b>	Office of Thrift Supervision
<b>PCAOB</b>	Public Company Accounting Oversight Board
<b>PSLRA</b>	Private Securities Litigation Reform Act
<b>RESPA</b>	Real Estate Settlement Procedures Act
<b>SEC</b>	Securities and Exchange Commission
<b>Secretary</b> or <b>Treasury Secretary</b>	Secretary of the Treasury
<b>Securities Act</b>	Securities Act of 1933, as amended
<b>Senate bill</b>	The Restoring American Financial Stability Act of 2010, S. 3217
<b>SIPA</b>	Securities Investor Protection Act
<b>SIPC</b>	Securities Investor Protection Corporation
<b>SPE</b>	special purpose entity or special purpose vehicle

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<b>SRO</b>	self-regulatory organization
<b>TARP</b>	Troubled Asset Relief Program
<b>TILA</b>	Truth in Lending Act
<b>Treasury</b>	Department of The Treasury

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