Implications of the Dodd-Frank Act for Non-US Banking Organizations, Securities Firms, and Other Financial Companies

December 2, 2010
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New York Breakfast Series
Tab 1: Agenda
Implications of the Dodd-Frank Act for Non-US Banking Organizations, Securities Firms, and Other Financial Companies

Agenda

8:00–8:30 a.m. Breakfast

8:30–8:40 a.m. Welcome and Overview
   A. Patrick Doyle, Partner, Co-Chair, Financial Services Practice, Arnold & Porter, New York, NY

8:40–9:45 a.m. Presentation and Discussion
   Michael F. Griffin, Partner, Derivatives Practice, Arnold & Porter, New York, NY
   D. Grant Vingoe, Partner, Corporate and Securities and Financial Services Practices, Arnold & Porter, New York, NY
   Alan W. Avery, Partner, Financial Services Practice, Arnold & Porter, New York, NY
   Kathleen Scott, Counsel, Financial Services Practice, Arnold & Porter, New York, NY

I. New Regulatory Treatment of OTC Derivatives
II. Changes in US Securities Laws
III. Volcker Rule’s Impact on Non-US Banks
IV. Systemic Risk Provisions and Changes to the US Regulatory Structure

9:45–10:00 a.m. Questions and Answers
Tab 2: Presentation Slides
Implications of the Dodd-Frank Act for Non-US Banking Organizations and Financial Companies

A. Patrick Doyle, Michael F. Griffin, D. Grant Vingoe, Alan W. Avery, Kathleen A. Scott
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Impact of Financial Reform Legislation on Derivatives Market
TITLE VII of the Dodd-Frank Reform and Consumer Protection Act

- The most far reaching and substantial regulation of the over-the-counter derivatives
- Requires exchange trading and clearing for most standardized swaps products
- Affects various types of financial entities including:
  - Banks
  - Large Hedge Funds
  - Insurance Companies
  - Finance Companies

New Requirements

- Types of requirements for dealers and major participants in derivatives and swaps trades include:
  - Registration requirements
  - Posting of margin for trades
  - Capital requirements
  - Reporting and record-keeping
  - Business conduct standards
- As a result of the above requirements financial costs of derivatives transactions will increase substantially for many of the affected financial entities that participate in the derivatives markets
New Requirements (cont’d)

- Title VII of the Dodd-Frank Act provides for a very general regulatory framework for the regulation of the derivatives
- Most of the substance of the new derivatives regulation will come from the upcoming rulemakings in connection with Title VII
- Most of the Rulemakings for Title VII are due 360 days after enactment of the Dodd-Frank Act (July 16, 2011)
- The CFTC has identified 30 areas of the Title VII in which rules will be necessary. Although the rules are not due to be published for public comment until July 2011, the CFTC has been pursuing an ambitious timeframe of having all of the rules published by year-end

Clearing Requirements

- Attempt to Increase Transparency: Mandatory Clearing of Swaps and Security Based Swaps for those swaps that are eligible for clearing
  - Title VII of the Dodd-Frank Act mandates that both clearinghouses and regulators (CFTC and SEC) must determine which type of swaps are eligible for clearing. Clearinghouses are entities that are separate from exchanges and are responsible for settling trading accounts, clearing trades, collecting and maintaining margin, regulating delivery and reporting trade data
  - Most of the types of swaps that will be eligible for clearing will likely be standardized swaps; swaps that are liquid and not too complex. More complex swaps with customized terms will probably be permitted to trade bilaterally, but must be publicly reported
Exchange Trading Requirements

- Mandatory Trading on Registered Exchanges:
  - If a contract is listed for trading and required to be cleared, it must also trade on a registered exchange. Registered Exchanges include Designated Contract Markets or:
  - Newly created Swap Execution Facility.

Swap Execution Facilities

- A SEF is defined in the Dodd-Frank Act as:
  - 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, through any means of interstate commerce, including any trading facility that facilitates the execution of swaps between two persons and is not a designated contract market.
OTC Forex Under Dodd-Frank

- OTC Forex=Swaps
- If it’s OTC and it’s not spot, Dodd-Frank calls it a swap by implication
  - The definition of “swaps” expressly excludes forward contracts on non-financial commodities and securities intended to be physically settled
  - OTC Forex would be subject to same regulatory regime applicable to other swaps (including swaps dealer/major swap participant registration and regulation, capital requirements, margin rules, disclosure requirements, position limits, clearing, ECP counterparty restrictions, etc.)
  - Treasury Secretary’s authority to exclude Forex forwards and swaps from the statutory definition of “swaps”

OTC Retail Forex

- What is “retail” Forex
  - Dodd-Frank amends the definition of “eligible contract participant” and ups the ante
  - Hedge funds/commodity pools as retail Forex customers: the new look-through requirement
  - Repapering accounts and supplemental documentation/due diligence

- The problem for Non-US banks
  - The uneven playing field: Dodd-Frank amends the Commodity Exchange Act “financial institution” retail Forex exemption and limits its scope to “US” financial institutions
  - Will US branches qualify as US financial institutions
OTC Retail Forex (cont’d)

- The problem for all banks (US and Non-US) and registered broker-dealers
  - Dodd-Frank extends the Commodity Exchange Act ban on retail Forex transactions to the otherwise regulated and enumerated entities unless the applicable Federal regulating agency issues authorizing retail Forex transactions
  - The Federal agency rules must include requirements relating to disclosure, documentation, recordkeeping, reporting, business conduct, capital and margin
  - 90-day effective date
- The CFTC issues its retail Forex rules—a template for Dodd-Frank compliance

Swap Dealer Registration

- The Dodd-Frank Act defines a swap dealer as an entity that: holds itself out as a dealer; makes a market in swaps; regularly enters into swaps with counterparties as an ordinary course of business for its own account; or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps
Exemptions for Swap Dealers

- Exemptions for swap dealers under the Dodd-Frank Act include:
  - Entities that are entering into the swaps to hedge their own accounts; or
  - Entities that engage in swaps in a "de minimis" quantity. "De minimis" is yet to be defined by the CFTC, and thus it is not yet known what amount of swaps will fit within the exception.

Major Swap Participants

- Section 721 (a) Definition of Major Swap Participant:
- Major Swap Participants (entities such as banks and insurance companies that could be subject to requirements of the Act) include entities that:
  - Maintain a “substantial position” in swaps for any of the major swap categories as determined by the Commission;
  - Whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the US banking system or markets; or
Major Swap Participants (cont’d)

– 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 maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission.

MSP Exemption

- Exemption: If an entity holds:
  – Positions held for hedging or mitigating commercial risk;
  – Positions maintained for any employee benefit plan.
- “Substantial Position” still needs to be defined by the CFTC in a rulemaking. Final definition will have an impact on types of entities that are included
Bank Push Out Provision

- Initial legislative proposal would have forced banks to divest all swaps activities to an affiliate
- Last minute compromise: Banks may maintain their derivatives business in products that are tied to hedging for the banks own risk
  - Such products would likely include interest rate and foreign exchange instruments as well as certain credit products
  - However, trades in agriculture products, energy swaps, and uncleared commodities would likely have to be spun off to the bank’s affiliates
  - If such trades are not spun off to the bank’s affiliate, the bank will not have access to the Federal Reserve discount window or the federal credit facility
- Also of note in Section 716: Any credit default swaps that remain in the bank, must go through a central clearinghouse

Position Limits

- Position limits are required to be imposed by the regulators on any swaps on nonfinancial commodities (e.g. energy, metals, agricultural commodities) that provide a “significant price discovery function”: considerations for significant price discovery include:
  - Price linkage to traded contracts
  - Liquidity; and
  - The potential for price arbitrage between the swap and a contract on the traded platform.
Enforcement Authority In OTC Context

- Title VII substantially increases the CFTC’s enforcement authority in the context of derivatives trades
- New Liability Provisions for OTC trades
- New fraud liability provisions that parallel Section 10(b) of the Exchange Act with respect to securities. Section 4b of the Commodity Exchange Act amended, adding language that prohibits derivatives participants from:
  - Employing any device, scheme, or artifice to defraud;
  - Making any untrue statement of material fact or omitting any statement of material fact necessary in order to make the statements made misleading; or
  - Engaging in any act, practice or course of business which operates as a fraud or deceit upon any person.

Enforcement Authority In OTC Context (cont’d)

- “Disruptive Practices”: Dodd-Frank provides the CFTC with enforcement authority over market participants that engage in “disruptive practices.” The Act defines such disruptive practices to include: activities violating bids or offers; intentional or reckless disregard for the orderly execution of transactions during the closing period of a market; and “spoofing” (bidding or offering with the intent to cancel the bid or offer before execution)
- Anti-Manipulation: Dodd-Frank also expands the CFTC’s anti-manipulation authority, and broadens the types of activities that are considered manipulation. For instance, it reduces the scienter requirement for manipulation in the reporting context by changing the standard of such conduct to include acting in reckless disregard of the fact that such report is false, misleading, or inaccurate
Investment Advisers, Direct Market Access, and Litigation and Enforcement

Dodd-Frank Investment Adviser Provisions

- Dodd-Frank generally eliminated the fewer than 15 client registration exemption, requiring private fund advisors to register and added new exemptions from registration for
  - “Foreign private advisers” that
    - Have no place of business in the United States;
    - Have fewer than 15 clients or investors in the United States in private funds they advise; and
    - Have less than $25 million in AUM (or such higher amount as the SEC determines) attributable to clients and investors in the United States.
Dodd-Frank Investment Adviser Provisions, (cont’d)

- Advisers whose only clients are “private funds” with aggregate AUM in the United States of less than $150 million. (reporting and recordkeeping obligations will apply) (IAA Section 203(m)). Private funds are issuers that would be an investment company under the Investment Company Act of 1940 if it were not for the exemptions under Section 3(c)(1) (100 or fewer investors) or 3(c)(7) (funds exclusively owned by “qualified purchasers”)
- Advisers whose only clients are venture capital funds (as defined by SEC) (reporting and recordkeeping obligations will apply) (IAA Section 203(l))

Dodd-Frank Investment Adviser Provisions, (cont’d)

- On November 19, 2010, the SEC proposed rules in two releases to implement the Dodd-Frank investment adviser provisions
  - Allocation between SEC and state regulators not relevant to foreign advisers. SEC only.
  - Uniform method of computing “regulatory AUM”—definite and expanded list of assets to be counted (including foreign client and proprietary assets and all assets in managed private funds), no deduction for indebtedness or accrued but unpaid liabilities reflected in assets remaining under management, inclusion of uncalled capital commitments, and required use of fair value for private fund assets
Dodd-Frank Investment Adviser Provisions, (cont’d)

- Proposed defining a venture capital fund as a private fund that:
  - Represents itself to investors as being a venture capital fund;
  - Only invests in equity securities of private operating companies to provide primarily operating or business expansion capital (not to buy out other investors), US treasuries with a remaining maturity of 60 days or less, or cash;
  - Is not leveraged and its portfolio companies may not borrow in connection with the fund’s investment;
  - Offers to provide a significant degree of managerial assistance, or controls its portfolio companies;
  - Does not offer redemption rights to its investors; and
  - Requests comment on whether non-US advisers can rely on the venture capital fund exception, and whether they can provide other advisory services to non-US clients.

- With regard to the $150 million private funds exception, contemplates that non-US advisers can engage in more extensive activities outside the US without losing the exemption and solicits comment on this point
- Foreign advisers relying on this exception could not advise any clients other than private funds offered in the US who meet the SEC Regulation S definition of US person. Adopts a special rule requiring counting of an account of a US person held by a related offshore fiduciary as a US person
- Proposes counting rules toward the 14 person limit, with look-through requirements for private funds, and deeming holders of total return swaps and similar instruments as investors
Dodd-Frank Investment Adviser Provisions, (cont’d)

- Exempt Reporting Advisers—private fund advisers with regulatory AUM less than $150 million and advisers to venture capital funds required to electronically submit and periodically update a limited subset of Form ADV consisting of 7 items and pay related filing fees. Due by August 20, 2011
- This information will be made publicly available through the IARD
- Exempt Reporting Adviser disclosures: Items 1 (Identifying Information), 2.C: (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting), 10 (Control Persons), and 11 (Disclosure Information) and corresponding schedules

Dodd-Frank Investment Adviser Provisions, (cont’d)

- Expands Form ADV disclosure for RIAs regarding private funds they advise, data about business operations and business practices presenting conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements and compensation for client referrals), and non-advisory activities and affiliations. Includes identification of five categories of "gatekeepers" that perform critical roles for advisers and the private funds they manage (i.e., auditors, prime brokers, custodians, administrators and marketers).
- Pay to play rules to apply to exempt reporting advisers and foreign private advisers
CFTC Regulation of Foreign Boards of Trade

- Section 738 of Dodd-Frank:
  - The CFTC is empowered to adopt rules for the registration of foreign boards of trade that afford direct access to their electronic trading and order matching systems to persons located in the US. “Direct access” refers to an explicit grant of authority by a foreign board of trade to an identified member or other participant located in the United States to enter trades directly into the trade matching system of the foreign board of trade.
  - In adopting such rules, the CFTC is required to take into account the comparability of regulation in the foreign jurisdiction and previous findings based upon comparable regulation.

Foreign Boards of Trade—Linked Contracts

- It is unlawful to provide direct access to a US participant to trade any interest that is based on a price used in any interest traded on a CFTC-registered facility unless the CFTC determines:
  - Daily trading information is published by the foreign market comparable to the information published by the domestic market;
  - The foreign market or regulatory authority:
    - adopts position limits (and related hedge exemptions) comparable to those adopted by the domestic entity;
    - has the authority to require or direct market participants to limit, reduce or liquidate positions on the foreign market that it determines to be necessary to prevent or reduce the threat of price manipulation, excessive speculation, price distortion, or disruption of delivery or the cash settlement process;
Foreign Boards of Trade (cont’d)

- agrees to promptly notify the CFTC regarding changes in the foregoing requirements, as well as any other areas of interest expressed by the CFTC;
- provides information regarding large trader positions comparable to that collected by the CFTC for the relevant domestic contracts; and
- provides sufficient information to enable the CFTC to publish aggregate trader positions in the relevant interests.

- Foreign markets that have been previously granted direct market access permission are given time to comply with the foregoing following enactment
- Non-compliance by the foreign market does not make a transaction voidable

On Nov 19th, the CFTC proposed rules to implement the foregoing requirements, with comments due by Jan 18, 2011

Follows the legislation precisely, creating a comprehensive registration system for foreign boards of trade, based in part on comparable, but not identical, foreign regulation

Major elements elaborating on the legislation:
- For markets that have been previously allowed to implement direct market access, a limited application cross-referencing the materials previously submitted would have to be submitted within 120 days after the effective date of the rules, and they could continue to operate pursuant to prior no-action letters pending a CFTC decision on the application
Foreign Boards of Trade (cont’d)

– Access only permitted for identified members and other participants (including affiliates at the 50% level) that:
  1) trade in the US only for their proprietary accounts;
  2) are registered as FCMs with the CFTC and submit orders for execution on behalf of customers; or
  3) are CFTC-registered CTAs or CPOs, or such entities exempt from registration, on behalf of pools they operate or accounts over which they have discretionary authority, subject to a requirement that the transactions are cleared by a registered FCM or foreign firm that has obtained Rule 30.10 relief.

– Contemplates and seeks comment on FBOTs simultaneously registering as a swaps execution facility under the same rules so they can afford direct access for swaps.

Foreign Boards of Trade (cont’d)

– No similar provisions added to facilitate or restrict securities market direct market access.
– The SEC takes a more restrictive view than the CFTC to foreign exchanges affording remote membership or a right of access to US persons to the trading facilities of the foreign securities exchange. The SEC asserts that these features involve a grant of access in the US and thereby creates a facility of the exchange operating from US territory. Such a right of access may trigger the requirement that a foreign securities exchange register as a “national securities exchange” under the Securities Exchange Act of 1934, a practically impossible task for an established non-US exchange.
– Direct market access is the subject of intense regulatory interest because of the May “Flash Crash”, resulting in SEC rules prohibiting so-called “naked” sponsored access. See SEC Release 34-63241 (Nov. 3, 2010).
Litigation and Enforcement Provisions

- Anti-fraud jurisdiction of the federal courts in actions instituted by the SEC is expanded to cover:
  1) Conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
  2) Conduct occurring outside the United States that has a foreseeable substantial effect within the United States. (Sec. 929P, Dodd-Frank).

Litigation and Enforcement Provisions (cont’d)

- This provision was a response to the Supreme Court decision in the Morrison case
  - On June 24, 2010, the US Supreme Court for the first time ruled on the extraterritorial reach of the US securities laws in its Opinion of *Morrison v. National Australia Bank*, significantly limiting the application of a key US statute in litigation brought by private parties where “securities are not registered” on US stock exchanges and the “purchases and sales of securities” at issue occur outside the United States. In affirming the US Court of Appeals for the Second Circuit’s dismissal of the case, the US Supreme Court unanimously ruled that a “foreign-cubed” securities transaction—a transaction involving (1) a foreign plaintiff, (2) suing a foreign issuer in a US court for violations of US securities laws based on securities transactions, in (3) foreign countries—was outside the scope of Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act).
Litigation and Enforcement Provisions (cont’d)

– Section 929P only sought to enable the SEC to bring such actions in the specified circumstances
– Section 929Y of Dodd-Frank directed the SEC to conduct a study of whether this enhanced jurisdiction should be extended to private rights of action
– In SEC Release No. 34-63174, issued on Oct 25, 2010, the SEC requested comment in furtherance of this study, including a request for comments concerning:
  • The scope of such a private right of action, including whether it should extend to all private actors or whether it should be more limited to extend just to institutional investors or otherwise;

Litigation and Enforcement Provisions (cont’d)

• What implications such a private right of action would have on international comity;
• The economic costs and benefits of extending a private;
• Right of action for transnational securities frauds; and
• Whether a narrower extraterritorial standard should be adopted.
• Comments are due by Feb 18, 2011
• Many commentators believe that Sec. 929P, as enacted even in its limited form, is flawed since it confers jurisdiction on federal courts, but does not establish a substantive right of action, which was necessary since the Supreme Court found that one did not exist in foreign cubed circumstances.
Systemic Risk and Regulatory Reform

Systemic Risk Regulation Under Act

- Title I of the Act creates the Financial Stability Oversight Council (FSOC) to identify and respond to systemic risk
  - Chaired by Treasury secretary, FSOC consists of 10 voting members and 5 non-voting members, all either federal or state government agencies except for an independent appointee with insurance expertise

- Responsibilities of the FSOC include:
  - Monitoring financial markets for trends affecting systemic risk;
  - Providing recommendations to, and coordinating regulatory activities of, the financial regulators; and
  - Designating, on a case-by-case basis, nonbank financial companies that are considered to pose systemic risk to be supervised and regulated by Board of Governors of the Federal Reserve System (Federal Reserve).
“Nonbank financial companies” are companies that derive:
- 85% or more of annual gross revenues from financial activities; or
- 85% or more of consolidated assets relate to financial activities.

Factors considered by the FSOC in determining if a nonbank financial company is of systemic risk include:
- The extent and nature of the company’s relationships and transactions with other significant nonbank financial companies and significant bank holding companies, its leverage and its off-balance-sheet exposures;
- The nature, scope, size, scale, concentration, interconnectedness, and mix of the company’s activities;
- The amount and nature of the company’s financial assets and liabilities, including the degree of its reliance on short-term funds; and
- Other risk-related factors.

Potential enhanced prudential measures include more stringent capital and liquidity requirements, leverage and concentration limits, increased risk management requirements, and restrictions on activities.

Large bank holding companies (bank holding companies with total consolidated assets of more than $50 billion as of January 1, 2010) and foreign banks that are treated as bank holding companies under the International Banking Act also are subject to the same prudential measures.

Process, standards for systemic risk designation, and prudential requirements are subject to further regulatory interpretation.
Systemic Risk Regulation Under Act (cont’d)

- In imposing prudential standards on foreign banks and foreign nonbank financial companies, Federal Reserve is to (A) give due regard to the principle of national treatment and equality of competitive opportunity; and (B) take into account the extent to which the foreign nonbank financial company or foreign-based bank holding company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States.

- Intermediate holding company requirements
  - Nonbank financial companies deemed to be of systemic risk may be required to put financial activities in an intermediate holding company subject to supervision of the Federal Reserve.

Systemic Risk Regulation Under Act (cont’d)

- Products and Services
  - Federal Reserve also may impose stricter regulation on certain financial activities or products because the activities may pose systemic risk.

- Annual stress tests
  - Self-tests and tests by Federal Reserve.

- “Living Will” requirements
  - Applicable to large US bank holding companies and nonbank financial companies designated by FSOC as posing systemic risk.
  - Purpose is to provide for the rapid and orderly resolution of the company in the event of material financial distress or failure.
Capital Requirements—Collins Amendment

- The Act imposes a number of more stringent capital requirements on financial institutions
- Most-publicized: Collins Amendment, which directs federal banking agencies to establish, on a consolidated basis, minimum leverage capital and risk-based capital requirements
- These requirements are applicable to:
  - Insured depository institutions
  - Depository institution holding companies
    - Including U.S. intermediate holding companies owned by foreign banks, but not the parent bank itself
  - Nonbank financial companies deemed to be of systemic risk and supervised by the Federal Reserve

Capital Requirements—Collins Amendment (cont’d)

- The minimum leverage and risk-based capital requirements may not be less than what would be applicable to insured depository institutions
- Applies at the holding company level the same capital standards applicable to insured depository institutions
- Effectively excludes hybrid capital instruments, such as trust preferred securities, from being included in tier 1 capital at the holding company level
- Current exemption for intermediate bank holding companies for non-US banks from Federal Reserve capital requirements (SR 01-01) eliminated (5-year phase in period)
FDIC Resolution Authority

- If the Title I measures do not work, Title II is the next step
- Title II not applicable to foreign parent, but to US nonbank financial subsidiary
- FDIC already handles resolutions of insured banking organizations
- The FDIC is given new resolution authority over “financial companies”
  - Definition of “financial company” different than in Title I
  - Process similar to bank receiverships
  - Authority would be invoked if the Treasury Secretary, upon FDIC and Federal Reserve recommendation and in consultation with the President, determines that a failed financial company cannot be resolved under traditional means (i.e., bankruptcy) without posing a systemic risk

Reform of Banking Supervision and Regulation

- One year after enactment (July 2011), the powers of the Treasury Department’s Office of Thrift Supervision (OTS) under Home Owners Loan Act (HOLA) are to be transferred to other agencies, which will apply HOLA; OTS is abolished 90 days after transfer
  - Federal Reserve: savings and loan holding company supervision and regulation
  - Treasury Department Office of the Comptroller of the Currency: federal savings institution supervision (thrift charter not abolished)
  - FDIC: state savings institution supervision
- A study will be undertaken to determine if exceptions from the Bank Holding Company Act for owners of certain types of “banks” should be continued (credit card banks, trust companies, industrial banks, federal savings associations)
- Effect of amendment on foreign bank operations in the United States
Reform of Banking Supervision and Regulation (cont’d)

- Changes in lending limits and affiliate transaction restrictions for national banks also affect foreign banks
  - Foreign banks are subject to the same lending limits as national banks
    • Among other provisions, definition of “loan” for purposes of the lending limit restrictions broadened to include credit exposure to a person arising from a derivative transaction, repurchase (or reverse repurchase) agreement, or securities lending or borrowing transaction between the bank and the borrower
  - Restrictions on transactions on affiliates apply to transactions between US bank subsidiary and foreign parent bank and also to transactions by a US branch, agency or commercial lending company of a foreign bank with certain of its affiliates, such as a broker-dealer
    • Restrictions on transactions between affiliates expanded to include credit exposure arising from derivative transactions and securities borrowing or lending transactions with affiliates

Reform of Banking Supervision and Regulation (cont’d)

- Temporary increase in deposit insurance limit to $250,000 made permanent (retroactive to January 1, 2008 in certain instances)
  - This deposit insurance limit is linked to the initial amount of a deposit that may be accepted at a state-licensed US branch of a foreign bank
    • Previously had been $100,000 prior to change in regulation
  - The temporary requirement that initial deposits be no less than $250,000 is now made permanent
  - Exceptions: Federal branches and insured branches
Reform of Banking Supervision and Regulation (cont’d)

– Systemic risk analysis regarding entry of foreign banks into US and termination of authority to operate in the US

  • When reviewing an application for US entry through a branch, agency or commercial lending company by a foreign bank that has been determined to be a risk to the stability of the US financial system, Federal Reserve must consider whether the home country has adopted, or is making demonstrable progress towards adopting, an appropriate system of financial regulation for the home country’s financial system to mitigate such risk

  • Federal Reserve also can terminate authority of such a foreign bank to operate a branch, agency or commercial lending company in the United States if it determines that the bank’s home country has not in fact adopted an appropriate system of financial regulation or made any such demonstrable progress towards doing so

The Volcker Rule: Issues for Non-US Banks
Overview of the Volcker Rule

- Origins and Policy Objectives
- Summary
  - Subject to exceptions, any “banking entity” is prohibited from:
    - Engaging in proprietary trading
    - Sponsoring or investing in hedge funds or private equity funds
  - Systemically important nonbank financial companies are required to carry additional capital and comply with quantitative limits on proprietary trading and fund-related activities

Who is Covered?

- Ban on proprietary trading and fund-related activities applies to any “banking entity”
  - Insured bank or thrift
  - Any company that controls an insured bank or thrift
  - Any company that is treated as a bank holding company for purposes of the International Banking Act of 1978
    - A non-US bank with a branch or agency office or commercial lending company in the United States
  - Any affiliate of the above entities
- Enhanced capital requirements and quantitative limits on proprietary trading and fund-related activities apply to nonbank financial companies (US or non-US) that are subject to supervision by Federal Reserve due to systemic risk determination
Overview of the Volcker Rule

What is “Proprietary Trading”?
- Engaging as a principal for the “trading account” of a banking entity or systemically important nonbank financial company in purchases or sales of securities, derivatives, commodity futures, options on such instruments, or any other instrument identified by regulators
- “Trading account” is any account used to take positions in designated instruments principally for the purpose of selling in the near term or with the intent to resell in order to profit from short-term price movements, and any other account defined by regulation

Overview of the Volcker Rule

Permitted Trading Activities
- Transactions involving US government or agency obligations, certain GSE obligations or instruments, and state and municipal obligations
- Transactions in connection with underwriting or market-making activities that are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties
- Risk mitigating hedging activities
- Transactions on behalf of customers
- Investments in small business investment companies
- Investments designed to promote “public welfare” (includes qualified Community Reinvestment Act and investments)
Overview of the Volcker Rule

- Permitted Trading Activities (cont’d)
  - Investment qualified under federal and state historic tax credit programs
  - Certain transactions by regulated insurance companies
  - Transactions conducted solely outside the US under Sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act
  - Other activity as permitted by regulation

Overview of the Volcker Rule

- Ban on Sponsoring or Investing in Private Equity or Hedge Funds
  - “Hedge funds” and “private equity funds” are defined as any issuer that that would be an investment companies under the Investment Company Act of 1940 but for Sections 3(c)(1) or 3(c)(7) or similar funds as the regulators may determine
  - “Sponsoring” a fund means to:
    * Serve as general partner, managing member, or trustee of a fund;
    * Select or control (or to have employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of a fund; or
    * Share a name or variant of a name with a fund.
Overview of the Volcker Rule

- Permitted Fund-Related Sponsoring and Investing Activities
  - Organizing and offering a fund (even to the extent of sponsorship), as long as the fund and entity do not share a name or name variant, and certain conditions are met:
    - Organized and offered in connection with the provision of bona fide trust, fiduciary, or investment advisory services;
    - The banking entity may not acquire or retain an equity, partnership, or ownership interest in the fund;
      - Exemptions for seed investments and de minimis investments (see below)
    - Affiliate transaction restrictions;
    - No guarantees of fund performance or obligation by the banking entity
    - Disclosure requirements:
    - Restrictions on directors or employees of the banking entity holding ownership interests in the fund.

- In the case of a fund organized and offered by a banking entity, the banking entity may make:
  - Seed Investments—any investment made or retained (up to 100% of the fund) for the purpose of establishing the fund and providing the fund with sufficient initial equity to permit the fund to attract unaffiliated investors;
  - Other de minimis investments;
  - Conditions to seed investments and de minimis investments.
    - Must “actively” seek unaffiliated investors
    - Investment reduced to not more than 3% of the fund within 1 year (possible extension)
    - Investment is “immaterial” (total of all de minimis and seed investments cannot exceed 3% of Tier 1 capital)
Overview of the Volcker Rule

- Permitted Fund-Related Sponsoring and Investing Activities (cont’d)
  - Acquiring or retaining ownership interests in or sponsoring a hedge fund or private equity fund solely outside the US under Sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act
    - Prohibition on offering to US residents
  - Other activities that regulators determine would promote and protect safety and soundness of the banking entity and US financial stability

Overview of the Volcker Rule

- Not All Fund-Related Activities Prohibited by the Volcker Rule
  - No prohibition on acting as investment manager or investment adviser to a fund, subject to prohibition on “covered transactions” under Section 23A or the Federal Reserve Act
  - Does not prohibit providing certain prime brokerage services (subject to Federal Reserve approval)
  - Does not appear to prohibit “offering” managed (but not sponsored) funds or third-party funds to any person (regardless of whether in connection with trust, fiduciary, or investment advisory services)
  - Should not prohibit offering other services (i.e., referral, brokerage, administrative services, etc.) to funds
  - Other examples
Overview of the Volcker Rule

- Other Limitations
  - No material conflict of interest
  - No material exposure to high risk assets or high risk trading strategies
  - No threat to the safety and soundness of the banking entity
  - No threat to US financial stability

- Timing of Implementation
  - Effective on the earlier of (i) 12 months after issuance of final rules; and (ii) 2 years after date of enactment
  - Two-year transition periods, with three one-year extensions possible
  - Extended transaction period for illiquid funds

Discussion Topics

- Thoughts on the Rulemaking Process
- Key Issues Faced by Regulators
  - Implementing key definitions and concepts
    - “Proprietary Trading”
    - “Trading Account”
    - “Near Term”
    - Other
- Issues for Foreign Banks
  - Scope of “solely outside of the US” exemptions under 4(c)(9) and 4(c)(13)
  - Prohibition on offering fund interests to US residents
  - Impact on non-BHC foreign companies
Discussion Topics (cont’d)

- Interplay with Existing Investment Authorities
  - BHC Act Sections 4(c)(5), 4(c)(6), 4(c)(7), and 4(c)(8)
  - Merchant Banking Authority
  - Bank Permissible Investments
- Fund-Related Issues and Open Questions
- Reactions by Market Participants
  - Moving traders to client-related areas
  - Re-characterizing trading as “market-making”
  - Divesting trading desks and fund operations
  - Other Open Issues
Tab 3: Moderator/Speaker Biographies
A. Patrick Doyle
Partner

Patrick Doyle has a broad background in financial institution regulation and has headed the firm's financial services practice group since 1993.

Mr. Doyle regularly counsels bank holding companies, foreign banks, savings institutions, insurance companies, securities firms, hedge funds, and private equity entities on a wide variety of regulatory matters, including strategic planning, complex regulatory issues, enforcement proceedings (particularly those involving allegations of violations of the "control" regulations), and legislation. In addition, he has represented firm clients on numerous mergers and acquisitions. Mr. Doyle is recognized for his ability to devise creative solutions to complex regulatory issues, developed over 25 years of representing clients on cutting edge regulatory matters. He is currently advising some of the nation's largest financial services companies on the impending reregulation of the financial services industry. He regularly appears before the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Comptroller of the Currency and the Office of Thrift Supervision, and numerous state banking regulators.

Prior to joining Arnold & Porter LLP in 1983, Mr. Doyle served as Deputy General Counsel and Acting General Counsel of the Federal Home Loan Bank Board and earlier served in a variety of legal positions at the US Department of the Treasury, Office of the Comptroller of the Currency, including Counsel to the Multinational Banking Group. Mr. Doyle served on the adjunct faculty of the Morin Center for Banking Law Studies at Boston University School of Law from 1985 to 1993, and currently serves on the Board of Advisors of the University of North Carolina School of Law's Banking Law Institute.

Mr. Doyle is a frequent lecturer both in the US and abroad on topics related to the regulation of the financial services industry.

**Representative Matters**

- **Federal Housing Finance Agency** in connection with its appointment as the conservatorship of Fannie Mae and Freddie Mac.

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- **State Farm Mutual Insurance Company** in connection with the chartering of State Farm Bank.
- **State Farm Bank** in connection with preemption litigation.
- **Farallon Group** in connection with a non-controlling investment in a depository institution holding company.
- **Countrywide** in connection with the conversion of its national bank subsidiary to a federal savings bank. At the time the largest charter conversion in history.
- **Merrill Lynch** in connection with the reorganization of Merrill Lynch Federal Savings Bank’s mortgage banking operations.
- **Ichan Capital Partners (ICP)** in connection with ICP’s non-controlling investment in a savings and loan holding company.
- **Sovereign Bancorp Inc.** in its proxy/control contest with activist shareholder Relational.
- **BB&T Corporation** in more than 30 acquisitions since 1990.
- **M&T Bancorp** in more than 10 acquisitions since 1990.

**Rankings**

- *Chambers USA: America’s Leading Lawyers for Business 2010* for Financial Services Regulation: Banking (Compliance)
- *The International Who's Who of Banking Lawyers 2010*
- *Washingtonian's “Top Lawyers” 2009* for Financial Services

**Articles**


Presentations


Advisories

"Foreign Banks and Nonbank Financial Companies Also Face Challenges from Dodd-Frank." Nov. 2010.


"The Dodd-Frank Act Establishes the Consumer Financial Protection Bureau as the Primary Regulator of Consumer Financial Products and Services." Jul. 2010.

"Savings and Loan Holding Companies and their Subsidiaries Will Be Subject to New Regulatory Regimes under the Dodd-Frank Act." Jul. 2010.


Multimedia


- Alan Avery, David S. Berg, A. Patrick Doyle and David F. Freeman, Jr. "WEBCAST: Private Capital Investments in Financial Institutions: An Update on Key Developments and Regulatory Issues Associated with Investments in Banks, Thrifts, and their Holding Companies" October 29, 2009. (also available as a Podcast)
Michael F. Griffin
Partner

Michael Griffin is a partner in Arnold & Porter LLP’s corporate and securities group in New York. He practices principally in the regulation of the securities, futures, swaps, and related derivative markets with particular emphasis on investment management, investment funds, and brokerage operations. He also represents domestic and offshore hedge funds and hedge fund managers in all aspects of business.

Mr. Griffin’s practice includes general corporate counseling and transactional services; regulatory advice and counseling; investment fund structuring and syndication; creation of derivative and off-exchange products; customer documentation and relations and interfaces with governmental, self-regulatory, and exchange organizations.

Rankings

- *The Legal 500 US, Volume 1: Corporate & Finance 2007* for Investment Funds: Alternative/Hedge Fund Formation; and International Mergers & Acquisitions

Presentations


Advisories

- "Bills to Regulate Hedge Funds and Other Private Investment Funds Introduced." Feb. 2009.

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399 Park Avenue
New York, NY 10022-4690

Practice Areas
Corporate and Securities
Financial Services
Derivatives and Commodities

Education
JD, New York University School of Law, 1980
AB, magna cum laude, Dartmouth College, 1976

Admissions
New York
D. Grant Vingoe
Partner

D. Grant Vingoe is a partner in the New York office of Arnold & Porter LLP. He concentrates his practice in cross-border securities transactions and financial services regulation. Mr. Vingoe has been deeply involved in regulatory policy matters for the Canadian securities industry. He has represented numerous non-US issuers and underwriters in US public offerings and private placements. He has established many financial services affiliates for non-US banks and brokerage firms. He also advises these firms on ongoing compliance, governance, and risk management issues. He has also advised senior management of Canadian and European stock exchanges and self-regulatory organizations concerning regulatory policy matters and cross-border business initiatives. Additionally, he has received the ICD.D director certification from the Institute of Corporate Directors.

Representative Matters

- Advises Canadian and European securities exchanges on new product development.
- Has established numerous broker-dealer and investment management affiliates of non-US banks and brokerage firms and counsels them on U.S. regulatory compliance, corporate finance and risk management issues.
- Advises non-US securities market participants on the impact of US regulatory developments on their operations and competitive positions.
- Represents Canadian and other issuers and underwriters in inbound corporate finance transactions, including Rule 144A and Regulation D private placements and offerings effected under the Multi-jurisdictional Disclosure System.

Rankings

- The Legal 500 US, Volume 1: Corporate & Finance 2007 for Investment Funds: Alternative/Hedge Fund Formation
Professional and Community Activities

Professional Activity

- Guest lecturer on US securities law in the Osgoode Hall Law School LL.M Program
- Investment Industry Regulatory Organization of Canada, Canada's investment industry self-regulatory organization
  - Independent director
  - Chair, Governance Committee
- Previously an independent director and chair of the Governance Committee of Market Regulation Services Inc.
- Appointed in 1999 to a term with the Ontario Securities Commission Securities Advisory Committee
- Member, Securities Industry Association, Compliance and Legal Division
- Member, Ontario Bar Association, Securities Law Subcommittee
- Member, Atlantic Council of Canada
- Member, Institute of Corporate Directors
- Member, National Society of Compliance Professionals

Community Activity

- Director, Reach the World, a New York-based nonprofit that uses a mixture of computer-based and real time connections with sponsored travelers and class visits to enhance elementary and secondary student knowledge of the world beyond their neighborhoods.

Articles


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Alan Avery
Partner

Alan Avery is a member of the firm’s financial services practice and concentrates his practice in federal and state regulation of banking organizations, advising domestic and foreign banking institutions concerning the impact of US Federal and state banking laws on their global operations. Additionally, he advises domestic and foreign banks on regulatory issues, including Bank Secrecy Act (BSA) and anti-money laundering issues and investigatory matters, as well as related corporate and litigation matters.

Mr. Avery regularly counsels bank clients on a wide variety of matters, including permissible activities and investments, forms of organization, internal reorganizations, internal compliance and controls programs, product and geographical expansion, margin regulations, capital adequacy requirements, electronic banking issues, anti-tying rules, privacy regulation, Federal and state consumer lending compliance issues, affiliate transaction regulation, Bank Holding Company Act issues, corporate governance issues, state law fiduciary qualification and regulation issues, USA PATRIOT Act compliance, the BSA and related anti-money laundering regulations, payment systems issues, and pending legislation relevant to their US operations.

Mr. Avery has represented a number of US and non-US financial institutions in regards to Federal and state regulatory approval requirements for bank formations, office establishment and licensing, internal reorganizations, and mergers and acquisitions. He also advises transactional practice groups worldwide on US bank regulations. Additionally, Mr. Avery has represented sovereign wealth funds and private equity funds with respect to investments in US financial institutions.

Articles


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Presentations


Advisories

"Foreign Banks and Nonbank Financial Companies Also Face Challenges from Dodd-Frank." Nov. 2010.


Multimedia


Alan Avery, David S. Berg, A. Patrick Doyle and David F. Freeman, Jr. "WEBCAST: Private Capital Investments in Financial Institutions: An Update on Key Developments and Regulatory Issues Associated with Investments in Banks, Thrifts, and their Holding Companies" October 29, 2009. (also available as a Podcast)
Kathleen Scott
Counsel

Kathleen Scott is a counsel in the financial services group, where she represents banking clients with respect to the regulatory aspects of mergers and acquisitions, establishment of new banking organizations and non-banking affiliates, and other transactions. Ms. Scott concentrates her practice on providing bank advisory legal advice to foreign and domestic banks on a broad range of bank regulatory issues, and interacts regularly with federal and New York state banking regulators. She also counsels banking organizations and other financial institutions on their compliance with federal consumer, privacy, and anti-money laundering legislation and regulations. In addition, she provides US bank regulatory assistance to the firm's transactional practice groups.

Prior to joining the private sector, Ms. Scott served as a senior staff attorney at the New York State Banking Department, where she focused on international banking matters. While at the New York State Banking Department, she also worked on several major enforcement actions, oftentimes in conjunction with other state and federal regulatory agencies, and now in private practice continues to represent clients facing enforcement or other supervisory actions brought by state and federal banking regulators. She also has been a member of the Connecticut Banking Commissioner’s working group, dedicated to international banking matters.

Ms. Scott has extensive experience in bank liquidation matters, having assisted in the liquidation of the New York office of the Bank of Credit and Commerce International, S.A., and the liquidation of Nationar, an uninsured "banker's bank" for the thrift industry. She has also co-drafted many of the amendments to the New York Banking Law that were made after each of these liquidations.

Ms. Scott began her career at the United States Department of the Treasury, in the legal division of a Treasury bureau and then in the Office of the Assistant General Counsel for Enforcement, where she concentrated on financial enforcement matters such as anti-money
laundering statutes and regulations. At the Department of Treasury, her responsibilities included advising on policy positions, drafting regulations, and speaking to the industry on compliance and enforcement issues. She continues to advise financial institutions, other businesses, and non-profit organizations on compliance with their responsibilities under the US anti-money laundering laws, including the enhancements to these laws enacted as part of the 2001 USA PATRIOT Act.

**Representative Matters**

- Obtained federal and state regulatory approvals for numerous clients regarding financial holding company status, mergers, acquisitions, and new products.
- Developed and implemented plan for chartering of a bank by a major non-bank financial institution, including obtaining all state and federal regulatory approvals.
- Obtained the first “complementary to financial” order from the Federal Reserve Board on an insurance-related product.
- Developed and implemented strategies for the US expansion of a major foreign bank, including seeking all state and federal regulatory approvals.
- Negotiated major enforcement actions from both the private sector and public sector sides for US banks and US offices of foreign banks, and assisted clients with enforcement action compliance.
- With respect to the reorganization of a major Italian bank, obtained US federal and New York state regulatory approvals, and coordinated other US state approvals.
- Developed and implemented strategies regarding, and obtained regulatory approvals for, internal reorganizations for certain US banking organizations, including preparation of all corporate documents and regulatory applications.
- Certified as a New York state foreign bank liquidation law expert for purposes of testifying in Bankruptcy Court in a unique bank liquidation case.
- Supervised outside counsel in connection with liquidations by the New York Superintendent of Banks of a state-chartered bank and a state-licensed agency of a foreign bank.
- Responsible for drafting several federal anti-money laundering regulations.
- Assisted in drafting legislation at the federal and state levels, including a major revision of New York laws regarding bank liquidation and the New York state interstate branching law.
- Worked on numerous state and federal regulatory approvals needed for Deutsche Bank AG to acquire Bankers Trust Corporation.
- Represented the receiver of a failed New York bank, who under unique circumstances had been appointed to that position by the New York Superintendent of Banks.

**Awards**

- Annual Gala Honoree, Appleseed Spring Gala, 2006
Rankings

- *New York Super Lawyers* 2009 for Banking

Professional and Community Activities

- Chair, New York City Bar, Banking Law Committee, 2006-2009
- Member, New York State Bar Association, Banking Law Committee

Books


Articles


Presentations


Advisories


"The Dodd-Frank Act Establishes the Consumer Financial Protection Bureau as the Primary Regulator of Consumer Financial Products and Services." Jul. 2010.

"Savings and Loan Holding Companies and their Subsidiaries Will Be Subject to New Regulatory Regimes under the Dodd-Frank Act." Jul. 2010.


Multimedia

Tab 4: Arnold & Porter LLP's Financial Services Practice Overview
FINANCIAL SERVICES

Widely acknowledged as one of the nation's premier financial services practices, the Arnold & Porter LLP team of over 35 lawyers provides US and international financial institution clients with comprehensive regulatory, litigation, legislative and transactional services. The practice group handles complex regulatory and transactional issues, represents clients in legislative matters (including Congressional hearings and investigations) and litigates cases involving the financial services industry at the administrative level and in the state and federal courts, including the US Supreme Court.

The practice group is recognized for developing innovative structures and novel solutions to regulatory issues, which allow clients to optimize their business strategy. Clients include a broad cross-section of bank holding companies, savings institutions, foreign banks, insurance companies, securities firms, investment managers, electronic commerce businesses, and foreign governments.

Located primarily in Washington, DC and New York, the practice group offers extensive experience in dealing with financial institutions and securities regulatory agencies, both federal and state. Several members of the practice group have served in senior positions at the key federal regulatory agencies. The team is supported by the full interdisciplinary resources of Arnold & Porter, including the corporate and securities, antitrust, tax, ERISA, trusts, environmental, and intellectual property practice groups.

Anti-Money Laundering and USA Patriot Act Defense
We have been active in a variety of Patriot Act, anti-money laundering, and computer security matters for our financial services clients, including internal investigations, defense of enforcement actions and civil and criminal litigation, development and documentation of compliance programs, public policy issues, and regulatory counseling. Our information privacy and security team includes former federal prosecutors as well as former senior officials from the US Department of Justice, the Federal Trade Commission, the Central Intelligence Agency, the National Security Administration, the Department of Defense, and the US federal banking agencies.

Antitrust and Competition
Bank mergers are unique in the antitrust world. Both the process and standard of review are different from those followed in the antitrust review of mergers in other industries. We assist clients in analyzing potential transactions and shepherd them through the multiple agency review process. Historically, we have had one of the leading bank mergers and acquisition practices in the US. In this regard, for the last two decades, our team has been involved in shaping some of the most complex divestiture proposals ever designed to cure competitive concerns. Our lawyers were instrumental in preparing the Bank Mergers and Acquisitions Handbook, a leading reference manual devoted to this area of law. In addition, as a full-service firm, we are also able to draw upon the resources of our consistently top-ranked antitrust and competition practice in such instances as when a non-bank is being acquired and FTC issues are raised.

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**Charter Assessment**
We regularly assist clients in assessing which is the optimal charter to operate under to best meet their business goals. We have extensive experience in advising clients on the advantages and disadvantages of the various types of charters—state bank charter, national bank charter, federal savings bank charter, or a specialized or limited purpose charter—and the implications of a charter choice on the parent holding company. As one of the few national firms with a separate, sophisticated thrift practice, we have been at the forefront in developing novel uses for thrift charters, especially by securities and insurance companies, in addition to advising our bank holding company clients on such matters. In the last several years, we have represented several of the nation's largest insurance and securities companies in forming federal savings banks in order to offer banking services to their customers.

**Corporate Control Contests and Corporate Governance**
We help financial institutions develop takeover defenses, handle unsolicited takeover attempts, and prepare shareholders' rights plans, and we advise on corporate governance and shareholder relations issues. We also represent acquirors in takeovers, offering special value in resolving regulatory and antitrust issues raised by proposed transactions.

**Enforcement Counseling and Defense**
We assist individuals and institutions—and their boards of directors and holding companies—with the negotiation of consent agreements, memoranda of understanding and other written settlements, the development of compliance programs, and the defense of enforcement actions in administrative and judicial proceedings, and in addressing financial reporting and disclosure issues presented by agency enforcement initiatives. We also represent officers and directors, accountants, and other professionals in actions by receivers of insolvent financial institutions and in shareholder suits.

We are experienced in such currently high-profile issues as subprime lending, vendor management, privacy, nontraditional lending products and practices, money laundering, bank secrecy, and various activities considered inconsistent with safe and sound practices. In addition, we have substantial experience representing individuals and entities who are alleged to have the control provisions of the Change in Bank Control Act, the Bank Holding Company Act and the Savings and Loan Holding Company Act. Many of our attorneys have served as senior enforcement officials or on the enforcement staffs of the federal banking agencies, adding depth and insight to our representation of clients in enforcement matters.

**Financial Products and Services**
Helping financial institutions enter new lines of business and structure new products and services is a major focus of our financial services practice. We represent clients in establishing, acquiring, and operating lines of business, including securities underwriting and dealing; brokerage; investment advising; mutual and hedge funds; pension servicing; credit, debit, and other card operations; funds and other money transmission; fiduciary and investment management activities; insurance; and leasing.

- **Broker-Dealer and Investment Advisers.** We represent broker-dealers and investment advisers on regulatory matters related to their creation, expansion, services, and operations.

- **Private Investment and Private Banking.** We represent numerous clients in the creation, operation, and offering of private investment funds, in establishing and structuring the management companies that operate private equity and venture capital funds, and in
connection with portfolio investment transactions by the funds. We advise clients on new fund
development and structuring, required documentation, and compliance with state and federal
securities and banking laws. We are also familiar with issues relating to specialized investment
funds, such as SBICs, business development companies, collective investment funds, and
employee securities companies. Drawing on the resources of our trust and estates, ERISA, and
tax attorneys, our financial services team also represents clients in the bank regulatory and
fiduciary law aspects of running a trust department.

- **Special Purpose Institutions.** Our lawyers have helped create special purpose institutions
designed to take advantage of favorable regulatory treatment and exploit niche markets. For
example, we assist clients in establishing non-depository banks and thrifts created to offer trust
services on a nationwide basis, as well as credit card and other limited purpose institutions.

- **Credit Card/Debit Card/Stored Value and Payments Systems.** We assist clients in the card
area with litigation, product development, and regulatory policy, and in negotiations of their
processing, co-branding, and other agreements. Our clients include representatives of all parts
of the credit and debit card industry, including one of the major credit card associations, card
issuers, diversified financial services companies offering card products, merchant processors,
merchants, and ATM and POS operators. We represent clients that operate other types of
payment systems, as well. Clients in this area include funds and other money transmitting
companies, a major government-sponsored enterprise, and merchants in a variety of online
businesses. Our work for these organizations has included product development, assistance
with mergers and acquisitions, advice on compliance with a variety of regulations, development
and documentation of internal policies and procedures, documentation of system rules and
policies for users, and various commercial, litigation, and regulatory matters.

**Financial Regulatory Reform**

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer
Protection Act, HR4173/Public Law 111-203, the most sweeping overhaul of the US financial sector
since the Great Depression. The legislation will affect the manner in which many financial services
companies are supervised and, in some cases, structured. For example, the legislation contemplates
the creation of a new systemic risk council to monitor macroeconomic threats to US financial stability.
This council also will have the authority to impose heightened supervision on entities and activities
presenting such risks. The legislation also gives special attention to consumer financial products and
services, by providing for the creation of a new consumer protection authority responsible for reviewing
the terms and conditions and disclosures surrounding consumer financial products.

In addition, the legislation abolishes the Office of Thrift Supervision and moves supervision of savings
banks to the Office of the Comptroller of the Currency and their holding companies to the Federal
Reserve. New restrictions on affiliate transactions and lending limits will be imposed on all. The
legislation also contains the so-called “Volcker rule,” which will prohibit banks from engaging in
proprietary trading activities and in investing in hedge funds and private equity funds. As a result of
these changes, providers of financial services will likely face increased compliance expectations and
costs, and depository institutions and their holding companies will likely confront stricter capital
requirements, creating additional funding and profitability challenges for all.

This legislation does not just affect those in the financial industry. For example, a new regulatory
structure would be established for over-the-counter derivatives trading, moving most trading onto
exchanges and requiring new and higher capital and margin requirements. A new federal insurance
office would provide an additional layer of insurance company monitoring. Investment advisors and
hedge funds would be subject to new rules. Additionally, all public companies will face the prospect of greater shareholder participation in corporate governance matters and executive compensation practices.

Companies should be aware of these pending changes and be prepared to address them. Arnold & Porter’s attorneys are available to respond to questions raised by the new legislation and to help determine how pending regulations may affect your business and industry. Our multidisciplinary team consists of more than 30 lawyers from our financial services, corporate and securities, hedge fund, compensation and benefits, tax, government contracts, legislative, real estate, bankruptcy, and securities enforcement and litigation areas. They have assisted clients in dealing with the special issues that have arisen under the recent stimulus and bailout programs. They provide US and international clients with comprehensive regulatory, litigation, and transactional services, handling intricate issues and litigation at the administrative level and in the state and federal courts, including the US Supreme Court.

Financial Services Consumer Protection
We advise clients, including regulated financial institutions, mortgage lenders, and other specialty consumer and commercial lending companies on various consumer credit issues. For example, we counsel clients on exporting interest rates and fees on loans and on the practical implications and limitations of this exportation power; we review client compliance with federal and state consumer credit laws, including the Real Estate Settlement Practices Act, the Truth in Lending Act, the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, and the Fair Credit Reporting Act, and undertake risk assessments of these areas; we structure lending programs to be compliant with the consumer lending laws; we defend clients that are sued for alleged violations of the consumer credit and consumer protection laws; and we advise clients regarding the agencies’ published standards and statements of policy relating to lending practices in the consumer credit area.

In the fair lending area, we regularly assist clients in successfully resolving allegations of violations of the fair lending laws brought by the federal agencies in the earliest stages of the process, thereby avoiding costly and onerous settlements. We also advise clients on the rapidly changing area of subprime and “predatory” lending, and in providing affordable lending products consistent with the fair lending laws. We work with clients whose novel activities do not fit within the traditional banking model to develop innovative strategic plans to satisfy their Community Reinvestment Act (CRA) responsibilities and have advised investors in and organizers of community development-focused banks and CDCs. We are also experienced in addressing CRA protests raised against clients by parties challenging merger and acquisition transactions.

Financial Services Litigation
Financial services clients benefit from our extensive firmwide litigation resources and experience. Professionals in each of our offices regularly handle disputes on behalf of financial services clients, whether arising in a civil litigation/class action context, mediation and arbitration, or in a civil enforcement context. Our clients include financial services companies, banks, thrifts, officers and directors, law firms, accounting firms, other experts and consultants, and parties having dealings with failed institutions. Our representations have included litigation involving issues of federal preemption of state laws; litigation against the federal government for losses caused by changes in legislation that made so-called "supervisory goodwill" ineligible for treatment as regulatory capital; litigation defending financial services companies against alleged violations of consumer protection laws; litigation
concerning grants and denials of permission to engage in nonbanking activities and in administrative enforcement proceedings; litigation over commercial transactions, employment issues, and fiduciary relationships of financial services firms; and litigation defending a card association in various antitrust suits filed by merchants and rival card associations.

Our firm’s experience includes client representation in lawsuits and investigations stemming from consumer mortgage lending. The firm also has experience in lender liability litigation arising from, among other things, loan commitments and modifications, alleged untimely or improper disbursements of loan proceeds, alleged erroneous valuation of collateral and of borrower’s ability to pay, as well as usury and bad faith claims. We have substantial experience in litigations with respect to securitization issues in state, federal, and bankruptcy courts involving prime, non-prime, and subprime assets ranging from consumer loan assets to audio-video equipment, which raised a number of significant Uniform Commercial Code (UCC) and secured lending issues. The firm has also represented clients in disputes with respect to investor suitability issues and purported unfair and deceptive business practices arising in the consumer and commercial lending arenas.

Our litigators also have considerable experience in complex securities litigation, demonstrated by the lead role we played in the recent landmark case, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* 128 S. Ct. 761 (2008), in which the Supreme Court rejected the theory of “scheme liability” and held that a secondary actor cannot be liable unless it has made deceptive statements on which investors have relied.

We regularly handle SEC investigations and enforcement actions, and have represented major financial institutions in SEC investigations arising out of significant corporate governance and related party issues. We also defend financial services companies in class actions alleging securities fraud and related securities law violations.

**Financial Services Preemption Litigation**

We have played a prominent role in much of the most significant federal banking litigation of the past three decades. For a number of years, Arnold & Porter LLP has been actively involved in challenging, on grounds of federal preemption, state and local efforts to supervise and regulate activities of federally chartered financial institutions. The firm in recent years has developed considerable experience in representing national banks and federal savings banks in a series of cases involving preemption of state law by the National Bank Act (NBA) and the Home Owners’ Loan Act (HOLA). In a series of cases, the Arnold & Porter team, including lawyers from the firm’s Washington, DC, New York, and Los Angeles offices, has achieved major victories for national banks, savings and loan institutions, and credit unions threatened with overreaching state and local actions. With a growing number of states and localities seeking to control financial institutions’ activities, these issues have become increasingly important to financial institutions nationwide.

Examples of the cases in which we have recently achieved federal banking law preemption victories include:

- *State Farm Bank, F.S.B. v. Reardon*, 539 F.3d 336 (6th Cir. 2008) (obtained declaratory and injunctive relief from enforcement of Ohio’s mortgage-broker licensing laws against agents of federal savings bank)
- *Rose v. Chase Bank USA, N.A.*, 513 F. 3d 1032 (9th Cir. 2008), *aff’g* 396 F. Supp. 2d 1116 (C.D. Cal. 2005) (obtained dismissal of class action complaint alleging violation of state statutory disclosure requirements for access checks and unfair and deceptive practices)

- *Consumers Against Unfair Business Practices (Miller) v. Bank of Am., N.A.*, (USA), 170 Cal. App. 4th 980 (2009) (obtained dismissal of class action complaint alleging national bank’s collection of finance charges and late fees when credit card payment date fell on weekend or holiday violated state “holiday” statutes and constituted unlawful, unfair and deceptive practices)

- *Augustine v. FIA Card Servs., N.A.*, 485 F. Supp. 2d (E.D. Cal. 2007), *appeal docketed* (9th Cir. No. 07-16751) (obtained dismissal of class action complaint alleging violation state unfair and deceptive practices in that national bank failed to give notice to borrower before raising credit card interest rate due to borrower default)

- *Montgomery v. Bank of America Corp.*, 515 F. Supp. 2d 1106 (C.D. Cal. 2007) (obtained dismissal of class action complaint alleging unfair and deceptive trade practices based upon the amount of a national bank’s insufficient funds fees and the manner in which the fee amount was disclosed to customers)


- *Silvas v. E*Trade Mortgage Corp.*, 421 F. Supp. 2d 1315 (S.D. Cal. 2006) (obtained dismissal of complaint alleging violations of Truth in Lending Act and state unfair and deceptive practices laws), *aff’d* 514 F.3d 1001 (9th Cir. 2008)

- *Bank of Am., N.A. v. McCann*, 444 F. Supp. 2d 1227 (N.D. Fla. 2006) (obtained injunctive relief under the visitorial powers provision of the National Bank Act preventing state court lawsuit by qui tam plaintiffs alleging violation of state escheat laws)

- *Am. Bankers Ass’n v. Lockyer*, 239 F. Supp. 2d 1000 (E.D. Cal. 2002) (obtained summary judgment declaring that state disclosure statute requiring minimum payment disclosures was preempted)


- *Armanini v. Bank One, Del., N.A.*, Orange County Super. Ct., No. 03 CC 00255 (Feb. 3, 2005) (obtained summary judgment for national bank in class action alleging violation of state access check disclosure requirements and unlawful, unfair, and deceptive practices). We also recently achieved a grant of review by the New York Court of Appeals of *Spitzer v. Applied Card Systems*, 7 A.D.3d 104 (NY 2005), in order that we may appeal our Truth in Lending Act preemption defenses.

In addition, we have filed amicus briefs on behalf of the banking industry arguing federal banking law preemption in numerous cases, including:
Financial Services
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- *Am. Bankers Assn. v. Gould,* 412 F.3d 1081 (9th Cir. 2005) (Fair Credit Reporting Act preemption)

**Financing Transactions and Capital Markets**

We advise both domestic and international financial institutions on a wide variety of financing opportunities, including securities offerings, leveraged buyouts, lending activities, and debt restructuring. Our attorneys are skilled at structuring securities offerings to ensure favorable regulatory capital treatment. We represent both issuers and underwriters of hybrid capital instruments and other capital markets transactions.

**Hedge Fund and Private Equity Investment in Financial Institutions**

We have considerable breadth and depth of experience in counseling hedge and private equity funds and their investment advisors in working through the implications of the rules and policies that apply to both controlling and non-controlling investments in financial institutions and their holding companies, including the recent policy statements from the FDIC and Federal Reserve on private capital investments in banks and bank holding companies. Our experience includes structuring investment vehicles to make such investments and the forms in which such investments will be made, negotiating the relevant documentation, and working with the funds and the regulators in either obtaining the appropriate regulatory approvals for such investments, or in addressing any presumption of control by negotiating "custom tailored" passivity agreements or rebuttal of control agreements that may be required to ensure that such investment remain passive.

**International and Foreign Banking**

We actively advise foreign banks on entry into the US and the activity of their US offices, as well as regulatory requirements, including comprehensive consolidated supervision determinations, new products (in securities, asset management, derivatives, insurance, and venture capital areas), capital issuances and other expansion opportunities. We also assist US financial services firms in expanding banking activities internationally through the establishment of foreign branches, the acquisition of subsidiary banks, and the expansion of foreign investments in established and emerging markets. In addition to commercial clients, we advise foreign governments and agencies on regulatory issues involving the US. With attorneys from our international practice, we advise foreign governments with respect to their dealings with the Federal Reserve and other regulators and international organizations located in Washington, DC, as well as their commercial dealings with banks and securities firms.
Legislation and Public Policy
We also represent individual institutions and trade associations on matters relating to federal financial regulatory legislation and policy. We develop legal positions for clients on many of the major public policy issues affecting financial institutions. Working with our legislative and public policy colleagues, we monitor legislative developments that concern the financial services industry, draft legislative proposals, provide legal and technical support for institutions commenting on proposed legislation, and work closely with congressional and federal agency staffs.

Mergers, Acquisitions, and Strategic Alliances
Our firm historically has had one of the leading bank mergers and acquisitions practices in the US. Our attorneys are experienced with sophisticated merger techniques and skilled in developing related tax, antitrust, and regulatory strategies. Our work includes structuring and negotiating acquisitions of all types within the financial services industry, including cross-industry acquisitions, and strategic alliances among financial services companies and other entities. We also perform targeted due diligence to assist potential acquirors in regulatory risk assessment.

Privacy and Data Security
What financial services firms know about their customers has become a heavily regulated aspect of doing business. We have been active for two decades in representing our financial services clients on matters relating to customer privacy.

In this regard, we counsel financial institutions on the rapidly growing body of federal and state privacy laws affecting their operations, including developing privacy notices, negotiating data protection agreements with business partners, and setting up internal databases to ensure appropriate safeguards on access to, and disclosure of, personal information. We also work with clients on the privacy rules adopted pursuant to the HIPAA and on international privacy requirements, including the restrictions imposed by the Data Protection Directive of the EU. Our privacy experience includes protection of financial information, including electronic data. As a complement to this advice, we work closely with clients on the security aspects of information privacy, which involve technical considerations that are integral to any program of privacy compliance.

Regulatory and Strategic Counseling
We counsel clients on complicated issues arising under the statutes, regulations, and proposed regulations governing the financial services industry. We also counsel clients on the application of agency guidance documents and statements of policy on a wide range of issues, particularly in the areas of evolving regulatory scrutiny, in order to assist clients in identifying significant legal, supervisory, and reputational risks, and implementing systems and controls tailored to address those risks.

Based on our extensive experience, we often propose changes to agency regulations and request interpretations of existing or proposed agency rules. These efforts have led to novel legal interpretations that have enabled our clients to offer new products and services, and to expand the scope of their operations.
Tab 5: Arnold & Porter LLP’s Derivatives Practice Overview
DERIVATIVES AND COMMODITIES

Participants in the commodities and derivatives markets face the most profound regulatory changes of their history as sweeping US legislation nears completion. They may soon face a new regulatory structure for over-the-counter (OTC) derivatives trading, including requirements that most trading be moved onto exchanges or through clearinghouses with new and higher capital and margin requirements. Complying with the unprecedented new controls will present participants with complex legal and business challenges.

To meet those challenges, Arnold & Porter LLP offers a seasoned commodities and derivatives practice led by the former General Counsel of the United States Commodity Futures Trading Commission. The practice group has extensive experience representing various types of participants in the commodities and derivatives markets. We represent numerous financial entities including, banks, insurance companies, finance companies, exchanges, brokers, hedge funds, energy companies, and other major market participants. Our experience includes representing clients in regulatory, enforcement, and litigation matters involving futures, options, swaps, and other derivatives. We have also undertaken internal investigations relating to commodity trading activities.

Arnold & Porter’s derivatives practice group has also been significantly involved in advising numerous financial entities and trade associations on Congress's newly proposed OTC derivatives legislation and has helped them understand the effects of the new legislation on their business.

Our lawyers also have substantial knowledge and experience with the Commodity Exchange Act, federal and state securities laws, federal energy laws, as well as federal banking laws. We also have significant experience dealing with enforcement and rule compliance in connection with exchanges such as the Chicago Mercantile Exchange and the Intercontinental Exchange.

Our lawyers have also represented companies with regard to allegations of market manipulation or other trading abuses. We have represented several major energy traders, large broker-dealers, and various hedge funds in connection with allegations of price manipulation in the energy, securities, and futures markets.
Tab 6: Advisories By the Attorneys of Arnold & Porter
Congress Finalizes Landmark Financial Regulatory Reform Legislation

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, HR4173/Public Law 111-203, the most sweeping overhaul of the US financial sector since the Great Depression. The Act will affect the manner in which financial services companies are regulated, supervised, and in some cases structured. As a result of the Act, providers of financial services are likely to face increased compliance expectations and costs, and depository institutions and their holding companies will likely face stricter capital requirements and prudential standards, creating additional profitability and funding challenges.

The legislation will also affect companies outside of the financial services industry. For example, every public company will be affected by Title IX of the Act’s executive compensation and corporate governance reforms. Title I of the Act’s creation of a new systemic risk council to monitor macroeconomic threats to US financial stability will result in heightened supervision of entities and activities presenting such risks. Counterparties to systemically important entities will wish to take note of the new resolution process created by Title II in order to minimize potential loss in a liquidation context. Companies that trade or use derivatives are potentially affected by the new rules in Title VII, such as the significant new restrictions on certain proprietary trading activities, derivatives activities, and hedge fund and private equity fund activities, to name a few. Under Title IV, advisers to most hedge funds and private equity funds will be required to register with the SEC as investment advisers due to elimination of the “private adviser” exemption. Companies offering consumer financial products and services may be subject to the consumer financial protection changes made by Title X, including its new regulatory bureau. Residential real estate providers will face new regulatory requirements created by Title XIV. These changes are both significant and far-reaching.

This advisory provides a high level, title-by-title overview of the Act. Arnold & Porter LLP is issuing a series of advisories that will provide more detailed analyses on the major topics covered by the Act.

Financial Regulatory Reform: For Arnold & Porter’s latest resources on this topic including Advisories, upcoming events, and publications, please visit Financial Regulatory Reform. Also visit our Financial Regulatory Chart, which aggregates information on US government programs.
Title I. Financial Stability

Authority of the FSOC. Title I of the Act creates a Financial Stability Oversight Council (FSOC) to address systemic risk in the financial system, effective upon the Act’s enactment. The FSOC will be comprised of 10 voting members and 5 non-voting members, and will include the Secretary of the United States Treasury (Treasury Secretary), representatives of each of the federal financial regulators, and others.¹

The FSOC has the authority to subject certain US or foreign nonbank financial companies that it believes would pose a threat to the financial stability of the United States to the supervision of the Board of Governors of the Federal Reserve System (Federal Reserve), as well as certain large bank holding companies, to more stringent regulation by the Federal Reserve. It also may subject such “systemically significant” nonbank financial companies and large bank holding companies to stricter operating standards, including higher capital requirements, leverage limits, liquidity requirements, concentration limits, resolution plan and credit exposure requirements, enhanced public disclosures, short-term debt limits, and overall risk management requirements. The standards would not apply to any bank holding company with total consolidated assets of less than $50 billion. While there is no such floor for nonbank financial companies, only the largest such companies likely would be covered.

Title I defines “nonbank financial companies” as those companies, other than bank holding companies or their subsidiaries with either (i) revenues from activities that are financial in nature that comprise at least 85 percent of the consolidated annual gross revenues of the company; or (ii) consolidated assets that are financial in nature that comprise at least 85 percent of the consolidated assets of the company. Activities that are “financial in nature” are those listed in section 4(k) of the Bank Holding Company Act of 1956, as amended—primarily banking, insurance, securities, and passive merchant banking activities.

Additional Standards for Certain Activities or Practices. The FSOC also may make recommendations to the primary financial regulatory agencies (defined as the federal banking, securities, commodities, and housing regulators, and state insurance commissioners) to apply stricter standards to a “financial activity or practice conducted by bank holding companies or nonbank financial companies under their respective jurisdictions.” Such a recommendation could be made if the FSOC determines that the conduct of the activity or practice in question could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies; the financial markets of the United States; or low-income, minority, or underserved communities. A primary financial regulatory agency must impose the standards recommended by the FSOC or similar standards that the FSOC deems acceptable, or explain its reasons for not following the recommendation.

The Act also gives the Federal Reserve, in consultation with the FSOC, the power to terminate or impose conditions on one or more activities of a nonbank financial company determined to be subject to supervision by the Federal Reserve or a bank holding company with consolidated assets greater than or equal to $50 billion, or force such company to sell assets, if necessary to mitigate a “grave” threat to the financial stability of the United States posed by that company if less extreme actions are inadequate to mitigate the threat.

Stress Tests. Title I also requires the Federal Reserve, in coordination with the appropriate primary financial regulatory agency, to conduct annual stress tests on each nonbank financial company determined to be subject to supervision by the Federal Reserve and each bank holding company with total consolidated assets equal to or greater than $50 billion.

¹ The voting members are:
- The Treasury Secretary;
- The Chairman of the Board of Governors of the Federal Reserve System;
- The Comptroller of the Currency;
- The Director of the newly created Bureau of Consumer Financial Protection;
- The Chairman of the Securities and Exchange Commission;
- The Chairman of the Federal Deposit Insurance Corporation;
- The Chairman of the Commodity Futures Trading Commission;
- The Director of the Federal Housing Finance Agency;
- The Chairman of the National Credit Union Administration Board; and
- An independent member appointed by the President, in consultation with the Senate, having insurance expertise.

The nonvoting members will include the Director of the newly created Office of Financial Research, the Director of the newly created Federal Insurance Office, a state insurance commissioner, a state banking supervisor, and a state securities commissioner.
billion to determine if the company has the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions. Each of these companies also must conduct its own stress tests semi-annually. All other financial companies with consolidated assets of at least $10 billion that are regulated by a primary federal financial regulatory agency must conduct annual stress tests. The methodology for these self-stress tests will be determined by regulations issued by each primary federal financial regulatory agency, in coordination with the Federal Reserve and the Federal Insurance Office.

Risk Committee. The Federal Reserve is required to issue regulations requiring systemically significant nonbank financial companies supervised by it and bank holding companies that are publicly traded and have total consolidated assets of $10 billion or more to establish a risk committee to oversee the entity’s enterprise-wide risk management practices. Bank holding companies that are publicly traded and have total consolidated assets of less than $10 billion may also need to establish such a risk committee upon Federal Reserve direction, but it is not automatically required. The risk committee is to be responsible for the oversight of the enterprise-wide risk management practices of the company, and may include independent directors if the Federal Reserve determines it is appropriate, based on the nature of operations, size of assets, or other criteria related to the company. In addition, the committee will be required to have at least one member who has experience in identifying, assessing, and managing risk exposures of large complex firms.

Segregation of Activities. The Federal Reserve also is given the authority to require systemically significant nonbank financial companies subject to its supervision that engage in some activities that are not deemed to be financial in nature to create an intermediate holding company to house those of its activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act. That intermediate holding company then would become the nonbank financial company supervised by the Federal Reserve. In forming an intermediate holding company, internal financial activities conducted by the company do not need to be moved to the intermediate holding company. Title I is very specific that a nonbank financial company supervised by the Federal Reserve, or a company that controls a nonbank financial company supervised by the Federal Reserve, is not required to conform its activities to those financial activities listed in section 4(k) of the Bank Holding Company Act.

“Hotel California” Provision. Title I also contains a provision that has come to be known as the “Hotel California” provision, which provides that if a bank holding company had total consolidated assets equal to or greater than $50 billion as of January 1, 2010, and received financial assistance under or participated in the Capital Purchase Program established under the Troubled Asset Relief Program authorized by the Emergency Economic Stabilization Act of 2008, then it will be treated as a nonbank financial company subject to supervision by the Federal Reserve if it ceases to be a bank holding company. A company subject to the Hotel California Provision may request a hearing before the FSOC to appeal its treatment as a nonbank financial company supervised by the Federal Reserve.

Collins Amendment. Title I also contains a revised version of the Collins Amendment, which requires the federal banking agencies to establish minimum leverage and risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies (bank holding companies and savings and loan holding companies), and nonbank financial companies supervised by the Federal Reserve. This will be the first time that savings and loan holding companies will be specifically required by statute to comply with consolidated capital requirements.2

As a result of the Collins Amendment, trust-preferred securities, which are a type of hybrid capital that has qualified for Tier 1 Capital, will no longer be eligible for such Tier 1 capital treatment going forward for large and medium-sized depository institution holding companies. Upon enactment, the requirement to exclude hybrid capital instruments such as trust-preferred securities from Tier 1 capital becomes

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2 In addition, in section 616(d) of the Act, the Federal Deposit Insurance Act is amended to require the appropriate federal banking agency for a bank holding company or savings and loan company, or insured depository institution not a subsidiary of a bank holding company or savings and loan holding company (e.g., an industrial bank) to require that such bank holding company, savings and loan holding company or parent company of an insured depository institution act as a source of strength to its insured depository institution subsidiary.
immediately effective for hybrid capital instruments issued on or after May 19, 2010, by depository institution holding companies (except small bank holding companies with less than $500 million in assets) and nonbank financial companies supervised by the Federal Reserve. For hybrid capital instruments issued before May 19, 2010, by depository institution holding companies with total consolidated assets of $15 billion or more and nonbank financial companies supervised by the Federal Reserve, the requirement to exclude pre-May 19, 2010-issued hybrid capital instruments from Tier 1 capital will be phased in incrementally over a period of three years, beginning January 1, 2013. For hybrid capital instruments issued before May 19, 2010, by depository institution companies with total consolidated assets of less than $15 billion as of December 31, 2009, and by companies that were mutual holding companies on May 19, 2010, there is no requirement to deduct pre-May 19, 2010-issued hybrid capital instruments from Tier 1 capital.

Small bank holding companies with less than $500 million in assets will continue to be subject to the Federal Reserve’s Small Bank Holding Company Policy Statement and will not be subject to the risk-based and leverage capital requirements (or the exclusion for certain hybrid instruments from Tier 1 capital) under the Collins Amendment.

In addition, the requirement to exclude hybrid capital instruments from Tier 1 capital becomes immediately effective upon enactment of the Act for hybrid capital instruments issued on or after May 19, 2010, by US bank holding company subsidiaries of foreign banking organizations that have relied on the Federal Reserve’s Supervision and Regulation Letter SR–01–1 (SR–01–1 Exemption), which relates to compliance with capital adequacy standards by certain US bank holding companies owned by foreign banks that the Federal Reserve has determined are well-capitalized and well-managed. The other risk-based and leverage capital requirements (including the deduction for certain pre-May 19, 2010-issued hybrid capital instruments from Tier 1 capital) under the Collins Amendment will become effective for such entities five years after the enactment of the Act. Depository institution holding companies not previously supervised by the Federal Reserve (e.g., savings and loan holding companies) also will have a five-year grace period for the leverage and risk-based capital requirements of the Collins Amendment other than those relating to the treatment of the deduction of hybrid capital instruments from Tier 1 capital, whether issued before or after May 19, 2010.

Additionally, subject to the recommendations of the Council, the Act requires that the federal banking agencies develop capital requirements applicable to insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the Federal Reserve that address the risks that the activities of such institutions pose to the institution engaging in the activity and other public and private stakeholders, in the event of adverse performance, disruption, or failure of the institution or the activity. At a minimum, the capital requirements must address the risks arising from:

- Significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, and repurchase and reverse repurchase agreements;
- Concentrations in assets for which the values presented in financial reports are based on models rather than historical cost or prices deriving from deep and liquid two-way markets; and
- Concentrations in market share for any activity that would substantially disrupt financial markets if the institution is unexpectedly forced to cease the activity.

**Title II. Orderly Liquidation Authority**

To prevent future taxpayer bailouts of firms deemed “too big to fail,” Title II of the Act gives the Federal Deposit Insurance Corporation (FDIC) power to unwind large failing bank holding companies and other nonbank financial companies determined to be subject to supervision by the Federal Reserve. While the Bankruptcy Code and the FDIC resolution process would continue to apply to most failing financial companies, the orderly liquidation authority established by the Act would apply when failure of a financial company would threaten the stability of the entire US financial system.

In light of its exceptional nature, liquidation of a company under Title II of the Act must be approved by the Federal Reserve, the FDIC, and the Treasury Secretary (in consultation with the President). If the failing company does
not consent to the appointment of the FDIC as receiver, the Treasury Secretary must petition the District Court for the District of Columbia for an order authorizing the appointment. The District Court’s determination is reviewable by the Court of Appeals for the DC Circuit, whose decision in turn subject to discretionary review by the US Supreme Court. Liquidation pursuant to Title II must comply with several mandatory terms:

- The FDIC must ensure that shareholders do not receive any payment until after all other claims are fully paid, that unsecured creditors bear losses in accordance with the Title’s priority provisions, and that managers responsible for the company’s failure are removed.

- The FDIC may also hold directors and officers of companies placed into receivership personally liable for damages arising from gross negligence and may recover compensation previously paid to senior executives and directors “substantially responsible” for the failure of the company.

The Act explicitly prohibits the use of taxpayer funds to rescue a failing financial firm placed into receivership. Instead, the costs of unwinding a firm would be paid with proceeds from its liquidation and an after-the-fact assessment on financial companies with at least $50 billion in total consolidated assets and on any nonbank financial companies supervised by the Federal Reserve.

Title III. Transfer of Powers to the OCC, FDIC, and Federal Reserve

Title III of the Act abolishes the Office of Thrift Supervision (OTS) and allocates its responsibilities, personnel, and assets among the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the FDIC. The Federal Reserve assumes responsibility for supervision of savings and loan holding companies and their nonbank subsidiaries, while federal savings associations and state savings associations become the responsibility of the OCC and the FDIC, respectively. Prospectively, OTS rulemaking authority is divided between the Federal Reserve and the OCC, and the new position of “Deputy Comptroller for the Supervision and Examination of Federal Savings Associations” is created at the OCC. Existing OTS regulations, orders, legal actions, guidance, and similar materials remain in force until altered or otherwise acted on by the Federal Reserve, the OCC, or the FDIC. These changes generally become effective one year from enactment of the legislation, which may be extended by the Treasury Secretary for up to six additional months (Transfer Date). The abolition of the OTS would become effective 90 days after the Transfer Date. The Director of the newly created Consumer Financial Protection Bureau would then replace the Director of the OTS on the FDIC Board of Directors.

The Act leaves intact the federal thrift charter and does not mandate the conversion of existing federal thrift charters to bank charters. However, it does facilitate such conversions by allowing a converted savings association to retain any branches it operated at the time of conversion, notwithstanding state or federal law to the contrary, and to establish additional branches in any state in which it operated a branch at the time of its conversion as if it were a bank chartered in that state.

The Act also makes important changes to the federal deposit insurance program. The temporary increase of the federal deposit insurance limit to $250,000, currently set to expire at the end of 2013, is made permanent and is retroactively applied to January 1, 2008. Additionally, noninterest-bearing transaction accounts remain fully insured through the end of 2012, at which point the program terminates. The Act also instructs the FDIC to amend the regulatory definition of “assessment base” to shift to an asset-based, rather than a liability-based, formula, and the FDIC is given authority to exclude an institution from eligibility for the lowest-risk assessment category based solely on the institution’s size.

Title IV. Regulation of Advisers to Hedge Funds and Others

Title IV of the Act amends the Investment Advisers Act of 1940 (Advisers Act) to impose Securities and Exchange Commission (SEC) registration, reporting, and record-keeping obligations on investment advisers to “private funds” that have assets under management in the United States of $150 million or more, subject to limited exemptions. Advisers to such funds (which include hedge funds, private equity funds, and other private funds not subject to an exemption) will be subject to Advisers Act regulation through elimination of the “private adviser” exemption in the Advisers Act that
applies to investment advisers who, during the course of the preceding 12 months, had fewer than 15 clients (with a fund counting as a single client) and who do not hold themselves out to the public as an investment adviser or act as an investment adviser to a registered investment company. Elimination of the “private adviser” exemption applies to investment advisers generally, not just those that act as advisers to private funds.

**Exemptions.** Although elimination of the “private adviser” exemption would subject advisers to virtually all private funds to Advisers Act registration, the Act carves out exemptions for:

- Investment advisers that act solely as an adviser to private funds with US assets under management of less than $150 million. These advisers will be subject to SEC record-keeping and reporting requirements;³
- Investment advisers who solely advise small business companies;
- “Foreign private advisers” (as defined in the Act);
- Investment advisers that act as advisers solely to “venture capital funds” (to be defined by SEC rule). These advisers will be subject to SEC record-keeping and reporting requirements; and
- Any “family office” (as defined by SEC rule, regulation, or order), effected through an amendment to the definition of “investment adviser.”

**Records and Reports.** The SEC is authorized to require advisers to private funds to maintain records and file reports with the SEC.⁴ The SEC may share this information with the FSOC, which may use it to determine whether to designate a private investment fund as “systemically significant” and therefore subject to Federal Reserve supervision, capital requirements, risk controls, pre-packaged liquidation plan requirements, the FDIC’s orderly liquidation authority, and other significant and pervasive regulatory requirements that will apply to financial companies so designated under Titles I and II of the Act.⁵

**Custody Requirement.** Registered investment advisers are required to take such steps to safeguard client assets over which the adviser has custody, including verification of such assets by an independent public accountant, as the SEC may prescribe by rule.⁶

**Accredited Investors.** The Act directs that changes be made to adjust the net-worth standard required to qualify as an “accredited investor” under the Securities Act of 1933, principally by excluding the value of a primary residence from the calculation.

**Effective Date.** The effective date for the private fund provisions is generally one year after the date of enactment of the Act. An investment adviser to a private fund is permitted to register under the Advisers Act during the one-year transition period, subject to SEC rules.

**Title V. Insurance**

Title V of the Act establishes the Federal Insurance Office (FIO) within the Department of the Treasury. Once established, the FIO will be responsible for comprehensive monitoring of the insurance industry (other than health insurance, certain long-term care insurance, and crop insurance). The FIO will be

3 Investment advisers with clients other than private funds that have less than $25 million in assets under management (or such higher amount as the SEC specifies by rule) continue to be subject to state law and are not permitted to register with the SEC. An investment adviser that has assets under management between $25 million and $100 million that is required to register as an investment adviser in the state where the adviser maintains its principal office and place of business and is subject to examination in that state must generally register under state law rather than with the SEC. However, if the effect of this provision would be to require that the investment adviser register with 15 or more states, then the adviser is permitted to register with the SEC. In addition, as has previously been the case, SEC registration is required if the adviser acts as an investment adviser to an investment company registered under the Investment Company Act or to a business development company.

4 Records and reports to be maintained by an investment adviser include the amount of assets under management; use of leverage, including off-balance sheet leverage; counterparty credit risk exposure; trading and investment positions; valuation policies and practices; types of assets held; side arrangements or side letters, whereby certain fund investors obtain more favorable rights than others; trading practices; and other information that the SEC, in consultation with the FSOC, determines is necessary or appropriate in the public interest or for the assessment of systemic risk.

5 The FSOC and any department, agency, or self-regulatory organization that receives records or other information of private funds from the SEC must keep it confidential. The Act provides enhanced protection for “proprietary information” of a private fund adviser. This information is subject to the same limitations on public disclosure as any facts ascertained during an investment adviser examination under Section 210(b) of the Advisers Act.

6 The SEC recently adopted new rules that provide additional safeguards when a registered adviser has custody of client funds or securities.
able to recommend to the FSOC that it designate an insurer, including its affiliates, as an entity subject to regulation by the Federal Reserve as a nonbank financial company. The Act does not specify a timeframe for the Treasury Secretary to issue regulations to establish the FIO.

The FIO will also coordinate federal efforts and establish federal policy on prudential aspects of international insurance matters, determine whether state insurance measures are preempted by certain international insurance agreements, and consult with the states regarding insurance matters of national importance and prudential insurance matters of international importance. The new agency also is authorized to conduct a study and submit a report to Congress on how to modernize and improve the system of insurance regulation in the United States. The Act also authorizes the Treasury Secretary and the United States Trade Representative, jointly, to negotiate and enter into international insurance agreements regarding prudential measures on behalf of the United States. The FIO may require an insurer or an affiliate to submit information reasonably required to carry out these functions, working in cooperation with the appropriate state regulatory agencies.

The Act also includes some protections for companies offering reinsurance by prohibiting non-domiciliary states from denying credit for reinsurance if the state of domicile of a ceding insurer (the insurance company that buys the reinsurance) is a state accredited by the National Association of Insurance Commissioners or has solvency requirements substantially similar to those required for accreditation. Furthermore, the Act provides that in such a case the state of domicile of the reinsurer is solely responsible for regulating the financial solvency of the reinsurer.

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

Title VI of the Act contains several new provisions affecting the regulation of insured depository institutions and their holding companies.

**Moratorium for Certain Deposit Insurance Applications.**

For example, Title VI imposes a three-year moratorium on the ability of the FDIC to approve a new application for deposit insurance for an industrial loan company, credit card bank, or trust bank that is owned or controlled by a commercial firm (an entity that derives at least 15 percent of its consolidated annual gross revenues, including all affiliates, from non-financial activities). During this period, the appropriate federal banking agency may not approve a change in control of an industrial loan company, a credit card bank, or a trust bank if the change in control would result in direct or indirect control of that bank by a commercial firm, unless the bank is in danger of default, or unless the change in control results from certain bona fide merger or acquisition transactions. The Act further provides that the Comptroller General must submit a report to Congress analyzing whether it is necessary to eliminate the exceptions in the Bank Holding Company Act for credit card banks, industrial loan companies, trust banks, thrifts, and certain other entities in order to strengthen the safety and soundness of these institutions or the stability of the financial system.

**Enhanced Regulation of Holding Company Entities.**

In order to aid a consolidated supervisor’s ability to identify and address risk throughout an organization, the Act also removes limitations under the Gramm-Leach-Bliley Act on the ability of a federal banking agency to obtain reports from, examine, and regulate all subsidiaries of a bank or savings and loan holding company it supervises. The Act also provides that the lead federal banking agency for each depository institution holding company (which would be the Federal Reserve or the OTS prior to the Transfer Date and would be the Federal Reserve in all cases after the Transfer Date) must examine the permissible activities of each non-depository institution subsidiary, other than a functionally regulated subsidiary, of that holding company to determine whether those activities present safety and soundness risks to any depository institution subsidiary. This approach is intended to ensure that the placement of an activity in a holding company structure could not be used to arbitrage between different supervisory regimes or approaches.
Volcker Rule. Title VI also contains the so-called “Volcker Rule.” Under these provisions, subject to certain exemptions, federal regulators must issue regulations to prohibit “banking entities” (i.e., insured depository institutions, their holding companies, non-US banks with branches or agency offices in the US, and any affiliate or subsidiary of such entities) from engaging in proprietary trading,7 sponsoring or investing in hedge funds and private equity funds, and having certain financial relationships with those hedge funds or private equity funds for which they serve as investment manager or investment adviser. A systemically significant non-bank financial company supervised by the Federal Reserve that engages in such activities would be subject to rules establishing enhanced capital standards and quantitative limits, but such activities would not be prohibited.

Subject to restrictions that the appropriate federal banking agencies, the SEC, and the Commodity Futures Trading Commission (CFTC) may determine, certain activities would not be subject to these limitations, including:

- The purchase, sale, acquisition, or disposition of obligations of the United States, Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution; and state or municipal obligations.
- Transactions in connection with underwriting or market-making-related activities, to the extent that any such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.
- Hedging activities designed to mitigate risks associated with individual or aggregated positions.
- Transactions on behalf of customers.

- Investments in small business investment companies; investments designed primarily to promote the public welfare; or investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure.
- The purchase, sale, acquisition, or disposition of securities and other instruments by a regulated insurance company for the general account of the company and by any affiliate of such regulated insurance company, subject to certain requirements.
- Organizing and offering a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, provided certain requirements set forth in the law are met. These requirements include that the banking entity provide bona fide trust, fiduciary, or investment advisory services; that the fund be organized and offered only in connection with the provision of such services and only to persons that are customers of such services of the banking entity; and that the banking entity not acquire or retain more than a specified de minimis ownership interest in the fund.
- Proprietary trading conducted solely outside of the United States by a banking entity pursuant to Section 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, unless the entity is controlled by a banking entity organized in the United States.
- The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund by a banking entity pursuant to Section 4(c)(9) or 4(c)(13) of the Bank Holding Company Act solely outside of the United States, provided that no ownership interest in such hedge fund or private equity fund is offered or sold to United States residents and the banking entity is not controlled by a banking entity organized in the United States.
- Other activity as permitted by regulators.

These permitted activities may be prohibited if the transaction, class of transactions, or activity:

7 “Proprietary trading,” for purposes of the Volcker Rule, means engaging as a principal for an entity’s “trading account” in purchases or sales of securities, derivatives, commodity futures, options on such instruments, and any other financial instrument that the appropriate federal banking agencies, the SEC, and the CFTC may, by rule, determine. “Trading account,” for purposes of the Volcker Rule, means any account used to take positions 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 such other accounts as the regulators may determine.
Would involve or result in a material conflict of interest (as defined by regulators) between the banking entity and its clients, customers, or counterparties;

Would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as defined by regulators); or

Would pose a threat to the safety and soundness of such banking entity or to the financial stability of the United States.

The Volcker Rule will not become effective until the earlier of one year after the issuance of final rules implementing it, or two years after the date of enactment of the Act. In addition, there is a two-year transition period, with up to three one-year extensions available for banking entities and systemically important nonbank financial companies to come into compliance. In addition, an extension may be granted, upon application, for up to a maximum of five years for a banking entity’s contractual obligation with any equity or other ownership interest in certain illiquid funds.

Concentration Limits and Other Restrictions. The Act also imposes concentration limits on large financial companies, including nonbank financial companies supervised by the Federal Reserve and foreign banks or companies that are treated as bank holding companies, with the result that these financial companies would not be permitted to merge with, or otherwise acquire control of, another company if the total US consolidated liabilities of the acquiring company upon consummation of the transaction would exceed 10 percent of the aggregate US consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction.

The Act also would, among other things:

Expand the type of transactions subject to insider lending limits to include derivatives transactions, repurchase agreements, reverse repurchase agreements, and securities lending or borrowing transactions;

Tighten national bank lending limits by treating credit exposures on derivatives, repurchase agreements, reverse repurchase agreements, and securities lending or borrowing transactions as extensions of credit for purposes of national bank lending limits; and

Require that insured state banks may engage in derivatives transactions (as defined under national bank lending limits laws) only if the law with respect to lending limits of the state in which the insured state bank is chartered takes into consideration credit exposure to derivative transactions.

Source of Strength Doctrine. The Act codifies the source of strength doctrine by amending the Federal Deposit Insurance Act to state that the appropriate federal banking agency for a bank holding company or savings and loan holding company must require the bank holding company or savings and loan holding company to serve as a source of financial strength for its depository institution subsidiaries. If an insured depository institution is not the subsidiary of a bank holding company or savings and loan holding company, the appropriate federal banking agency for the insured depository institution must require any company that directly or indirectly controls the insured depository institution to serve as a source of financial strength for such institution. Notably, this will be the first time that savings and loan holding companies are required to serve as a source of strength for their depository institution subsidiaries. Previously, only bank holding companies were required to serve as a source of strength for their depository institution subsidiaries under Regulation Y, 12 C.F.R. § 225.4(a)(1).

Title VII. Wall Street Transparency and Accountability (Over-the-Counter Derivatives)

Title VII of the Act provides for unprecedented and substantial regulation of the over-the-counter derivatives market, including swaps. In an effort to provide additional “transparency” to financial markets, the Act increases the regulatory requirements imposed on various financial entities that utilize derivatives products. More specifically, the Act
regulates "swap dealers" and "major swap participants," whose definitions would likely include banks, large hedge funds, and possibly even large insurance and some finance companies. Requirements imposed on entities that fit within the definition of swap dealers and major swap participants include registration requirements, posting of margin for trades, capital requirements, reporting and recordkeeping requirements, and business conduct standards. Certain "end-user" businesses could be exempt from many of the above requirements if their positions in derivatives are determined to be for hedging and commercial risk mitigation purposes.

Additionally, the Act amends the Commodity Exchange Act to implement mandatory clearing of swaps on clearinghouses. In general, the CFTC is assigned the responsibilities of reviewing any swap that a clearinghouse lists for clearing and of determining whether the swap or class of swaps is required to be cleared. In a broadening of the exemption contemplated in earlier versions of the legislation, the final version of the Act generally exempts an entity from the clearing requirement if one of the counterparties to the swap is not a financial entity and is using the swap to hedge or mitigate commercial risk.

The Act also directs the CFTC to impose position limits on swaps if it determines that the swap has a "significant price discovery function." In determining a swap's "significant price discovery function," the CFTC will consider various criteria, including the swap's price linkage to traded contracts, the potential for price arbitrage between the swap and a contract on the traded platform, and whether such contracts are sufficiently liquid. As a compromise over one of the most contentious issues in the legislation, the Act stops short of requiring banks to divest all of their swaps activities and instead permits them to maintain their derivatives business in products that are tied to hedging for the banks' own risk. Such products would likely include interest rate swaps, gold, and silver, as well as credit products. However, trades in agriculture products, energy swaps, and uncleared commodities would likely have to be spun off to the bank's affiliates, which would be required to meet significant capital requirements. Unlike many other sections of the Act which require implementation one year after enactment, the bank divestiture provision is required to be implemented two years after implementation of the Act.

Title VIII. Payment, Clearing, and Settlement Supervision

Title VIII of the Act contains a number of provisions designed to mitigate systemic risk in the financial system by giving regulators an enhanced role in the supervision of "financial market utilities" (FMUs), such as clearinghouses and other financial institutions that participate in payment, clearing, or settlement activities. The Act authorizes the FSOC to designate an FMU or certain payment, clearing, and settlement activities carried out by a financial institution as "systemically important" based on criteria such as the aggregate value of processed transactions and the aggregate exposure of a financial institution to its counterparties.

The Act directs the Federal Reserve to issue uniform risk management standards governing systemically important payment, clearing, and settlement activities. The Federal Reserve is also authorized to allow a Federal Reserve bank to grant discount and borrowing privileges to a systemically important FMU in "unusual and exigent" circumstances. The Act grants examination and enforcement authority to an institution's primary federal regulator, while reserving emergency or back-up enforcement authority for the Federal Reserve. Rulemaking authority is granted to the Federal Reserve, the FSOC, and other supervisory agencies.

Title IX. Investor Protections and Improvements to the Regulation of Securities Securitization Reforms

In order to address practices believed to have played a major role in the recent financial crisis, Title IX of the Act makes substantial changes to the processes by which asset-backed securities are created, rated, and sold. In order to promote responsible lending and securitization, the Act directs regulators to issue rules requiring lenders to retain credit risk for any asset transfer or sell, through the issuance of an asset-backed security. It also directs the SEC to adopt rules requiring disclosure of tranche-specific information as to the assets underlying such securities. Issuers of such securities are also required to conduct and disclose the results of a due diligence analysis of underlying assets.
Credit Rating Reforms

The Act reflects a compromise as to a method for addressing the conflicts raised by the traditional “issuer pays” model of securing credit ratings that had been proposed by Sen. Al Franken (D-Minn.). The Franken proposal would have created a Credit Rating Agency Board to assign rating agencies to provide initial ratings of asset-backed securities. The Act, however, requires the SEC to study conflicts of interest at rating agencies. If the SEC deems it necessary based on the study, it would be authorized to establish a system for the assignment of rating agencies to issue initial ratings for asset-backed securities such that the issuer, sponsor, or underwriter would not be able to select the rating agency.

The Act also removes references to Nationally Recognized Statistical Ratings Organizations and credit ratings from the Federal Deposit Insurance Act, the Investment Company Act, and the Exchange Act. In each of these statutes, the Act replaces references to investments that meet certain credit ratings with references to investments that meet standards of creditworthiness established by the agencies that oversee those statutes. Finally, the Act eases pleading standards in plaintiffs’ actions against credit rating agencies and applies enforcement and penalty standards to statements by rating agencies to the same extent that they apply to statements by registered public accountants and securities analysts.

Regulation of Broker-Dealers and Investment Advisers

For broker-dealers, the legislation includes several items of particular note. The Act directs the SEC to conduct a study of how broker-dealers’ and investment advisers’ relationships with retail customers are regulated. The SEC must describe any gaps or overlap in the two systems in a report to Congress within six months of enactment. The Act gives the SEC authority to adopt rules for the standard of care for broker-dealers and advisers and directs the SEC to consider the study’s findings. The SEC may adopt a “best interest” fiduciary duty standard for broker-dealers, investment advisers, and their associated persons when providing advice to retail customers.

On a more substantive basis, the Act extends the protections of the Securities Investor Protection Act by permitting both securities and related futures to be held in a single “portfolio margin account,” thereby allowing investors to hedge more effectively. It also extends the authority of the Public Company Accounting Oversight Board to allow it to write professional standards, inspect audits, and bring disciplinary proceedings for deficiencies in audits of securities broker-dealers that are not issuers. Finally, it authorizes the SEC to issue rules to prohibit or restrict mandatory pre-dispute arbitration clauses in broker-dealer and investment adviser account agreements.

Whistleblowers, Accomplice Liability, Short Sale Disclosures, and Other Reforms

The Act also effects numerous other changes to the securities laws. For example, it:

- Codifies the SEC’s whistleblower program and strengthens it by providing for substantial awards, the creation of a fund for such awards, and sanctions for retaliatory firings, including attorneys’ fees and double the amount of lost income;

- Amends the Securities Act, Exchange Act, Investment Company Act, and Advisers Act so that in an SEC enforcement action, persons may be held liable for knowingly or recklessly providing substantial assistance to a violator;

- Strengthens oversight of municipal securities markets by requiring persons who advise municipalities on bond issuances, or who otherwise participate in or solicit issuances (including guaranteed investment contract brokers, swap advisors, and finders), to register with the SEC;

- Requires the SEC to issue rules to provide for public disclosure of aggregate short sale data for individual securities at least each month; and

- Requires broker-dealers to inform customers (i) that they may elect not to allow their fully paid securities to be used in connection with short sales; and (ii) that the broker may receive compensation if they are so used.

The Act directs numerous organizational changes within the SEC. Notably, it directs the SEC’s Divisions of Trading and Markets and Investment Management to have their own...
examination staffs, streamlines and accelerates the process for rule changes by self-regulatory organizations, codifies the establishment of the SEC’s Investor Advisory Committee, and creates an Investor Advocate’s Office to assist and represent the interests of retail investors.

Executive Compensation and Governance Reforms

The Act includes governance and executive compensation provisions that will significantly affect public companies. The Act also prohibits covered financial institutions with $1 billion or more in assets from rewarding their executive officers, employees, directors, and principal shareholders with incentive-based compensation arrangements that encourage “inappropriate risks,” and requires reporting of all incentive-based compensation arrangements to the appropriate federal regulator.

Proxy Access. The Act grants the SEC authority to issue rules permitting a shareholder access to a company’s proxy solicitation materials for the purpose of nominating directors. Despite efforts to introduce language into the legislation limiting the right of shareholders to nominate directors in a company’s proxy materials to those shareholders who own at least 5 percent of the company for a minimum two-year holding period, the Act does not specify any minimum ownership threshold or holding period. The SEC has authority to grant an exemption to small issuers.

Say on Pay and Say on Golden Parachutes. Non-binding shareholder advisory votes on executive compensation must be held at least once every three years, at any annual or other meeting for which SEC proxy rules require disclosure of executive compensation. At the first annual or other meeting of shareholders that occurs six months after the date of enactment, public companies are required to include both a resolution providing shareholders with a non-binding advisory vote on executive compensation and a separate resolution to determine whether future “say-on-pay” votes should occur on an annual, biennial, or triennial basis. Public companies are also required to give shareholders a non-binding advisory vote on golden parachute compensation in connection with certain business combinations. The SEC has authority to grant an exemption to small issuers with regard to both say on pay and say on golden parachute votes.

No Majority Voting Requirement. A provision that would have required public companies to adopt a majority vote and resignation policy for uncontested elections was dropped during conference.

Executive Compensation Disclosures. The Act requires new executive compensation disclosure, including the ratio of CEO to employee compensation and any hedging activities by employees and directors with respect to equity compensation.

Compensation Committees. Compensation committee members of listed companies are required to satisfy heightened independence standards. Compensation committees of listed companies must consider specific factors identified by the SEC as affecting the independence of compensation consultants and advisers before selecting such advisers.

Clawback Provision. The Act requires the SEC, by rule, to direct national securities exchanges to prohibit the listing of any security of an issuer that does not develop and implement a policy to “clawback” compensation from executive officers who received incentive-based compensation (including stock options) during the three-year period preceding the date of an accounting restatement, in excess of what would have been paid under the accounting restatement. This provision is broader than the current Sarbanes-Oxley Act clawback provision.

Enhanced Disclosure and Reporting of Compensation Arrangements by Covered Financial Institutions with $1 Billion or More in Assets; Prohibition on Certain Compensation Arrangements. Not later than nine months after the date of enactment, appropriate federal regulators must jointly prescribe regulations or guidelines that:

- Require “covered financial institutions” to disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements sufficient to determine whether the compensation structure provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or could lead to material financial loss to the covered financial institution; and

- Prohibit any incentive-based payment arrangement that such regulators determine encourages “inappropriate
risks” by covered financial institutions, by providing an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or that could lead to material financial loss to the covered financial institution.

Reporting of the actual compensation of particular individuals is not required. “Covered financial institutions” include banks and savings associations and their respective holding companies, registered broker-dealers, credit unions, investment advisers, Fannie Mae, Freddie Mac, and any other financial institution that the appropriate federal regulators jointly determine should be treated as a covered financial institution. These requirements do not apply to covered financial institutions with assets of less than $1 billion.

**Title X. Bureau of Consumer Financial Protection**

Title X of the Act establishes a Bureau of Consumer Financial Protection (CFPB) within the Federal Reserve. The Director of the CFPB would be appointed by the President and confirmed by the Senate for a five-year term. While housed within the Federal Reserve, the CFPB would be required to operate without interference with regard to rulemaking, examinations, enforcement actions, and appointment or removal of employees, much in the same way that the OCC enjoys autonomy from the Treasury. The CFPB would be funded by the Federal Reserve in an amount determined to be “reasonably necessary” by the Director, subject to an annual funding cap.

**Rulemaking Authority.** The CFPB would be vested with the authority to promulgate regulations under certain federal consumer financial laws, including existing federal statutes for which the Federal Reserve or the US Department of Housing and Urban Development currently has rulemaking authority. These statutes include, among others:

- The Electronic Funds Transfer Act;
- The Equal Credit Opportunity Act;
- The Fair Credit Reporting Act;
- The Fair Debt Collection Practices Act;
- The Real Estate Settlement Procedures Act;
- The Truth in Lending Act; and
- The Truth in Savings Act; and
- The Interstate Land Sales Full Disclosure Act (added during conference).

Notably, the Act preserves the Federal Trade Commission’s (FTC’s) authority to enforce the Federal Trade Commission Act against nonbank entities engaged in financial activities. The Act also gives the CFPB certain specific rulemaking authority to issue regulations to restrict the use of pre-dispute mandatory arbitration agreements, to prescribe requirements for consumer disclosures, and to identify and prohibit “unfair, deceptive, or abusive acts or practices.” In addition, the Act requires the CFPB to make rules that would ensure that consumers gain access to their account information and receive timely responses to their complaints or inquiries.

There are several provisions that purport to place limitations on the CFPB. For example, the Act requires the CFPB to consult with the primary federal bank regulators before proposing a rule and during the comment process, and it must address any written objection of a primary federal bank regulator to its proposed rule in the adopting release. In addition, the FSOC may set aside a final regulation of the CFPB if two-thirds of the FSOC finds that the regulation would put the safety and soundness of the banking system or the stability of the financial system at risk. Furthermore, during the rulemaking process, the CFPB must collect advice and recommendations from small businesses about the potential impact of its regulations on small businesses, including the impact on the cost of credit to small businesses.

The regulations issued by the CFPB would apply to any “covered person,” which is defined as any person engaged in offering or providing a consumer financial product or service (generally not including otherwise-regulated securities and insurance activities) and an affiliate that acts as a service provider to such a person. However, the Act makes it clear that the CFPB does not have authority over commercial transactions or the sale of nonfinancial goods or services. For example, the CFPB generally may not exercise authority with respect to a merchant, retailer, seller, or broker of nonfinancial goods or services. At conference, payday lenders, money remitters, check cashers, and private student loan providers were explicitly added to the
supervision of the CFPB, while motor vehicle dealers were excluded. Pawn shop lenders do not appear to be subject to the supervision of the CFPB. Motor vehicle dealers and their financing operations are exempt to the extent that the source of the motor vehicle dealer’s financing is a third party; however, motor vehicle dealers continue to be subject to FTC jurisdiction, and the FTC is given Administrative Procedure Act rulemaking powers over them.

**Supervisory Authority.** The CFPB would have examination and enforcement authority over all participants in the consumer mortgage arena, including mortgage originators, brokers, servicers, and consumer mortgage modification and foreclosure relief services. The CFPB also would have supervisory authority over larger non-depository institutions that offer or provide non-mortgage consumer financial products and services. Larger non-depository institutions are to be defined by regulations issued by the CFPB, in consultation with the FTC. While earlier versions of the legislation required the CFPB to prescribe rules on the registration of these non-depository institutions, the final Act permits, but does not require, the CFPB to impose such registration obligations.

With respect to depository institutions, the CFPB would have primary supervisory authority over only those insured depository institutions and credit unions with more than $10 billion in assets and the affiliates and service providers of such institutions. Banks, savings associations, and credit unions with assets of $10 billion or less would continue to be examined for consumer compliance by their primary federal bank regulators. The CFPB would have no authority to take enforcement action against them.

The CFPB would be required to coordinate examination and enforcement activities with the appropriate federal bank regulator and with state bank regulators where appropriate. If the proposed supervisory determinations of the CFPB and the primary federal bank regulator were to conflict, the conflict would be resolved either through the coordination of the two agencies, or through a governing panel. The governing panel would be composed of one representative each from the CFPB and the primary federal bank regulator, together with a representative from a federal bank regulator not involved in the dispute.

**Preemption.** The Act does not preempt any state law that provides greater protection for consumers, nor does it change the preemption standards or preemptive effect of any of the existing federal consumer banking laws. The Act also generally preserves preemption of state law for national banks under the National Bank Act and modifies it for federal savings banks under the Home Owners’ Loan Act by codifying the standard for preempting state consumer financial law set forth in the 1996 US Supreme Court case *Barnett Bank v. Nelson*. Subsidiaries of these institutions would no longer be able to claim that federal law preemption principles that apply to their parent institutions also apply equally to them. Specifically, the Act codifies the standard for preempting state consumer financial law set forth in the 1996 US Supreme Court case *Barnett Bank v. Nelson*. Consistent with that standard, the Act provides that the National Bank Act and the Home Owners’ Loan Act preempt state consumer law:

- When the state law would have a discriminatory effect on a national bank or federal savings bank in comparison with the effect of the law on a bank chartered by that state;
- If the state law prevents or significantly interferes with a national bank or federal savings bank’s exercise of its power; or
- If the state law is preempted by another federal law.

The OCC as well as the courts are authorized to make determinations of preemption, on a “case-by-case” basis, under the above-referenced standard. If the OCC seeks to make a determination regarding preemption of a law of one state applicable to similar laws of other states, it must first consult with, and take into account the views of, the CFPB. The OCC is required to publish a list of its preemption determinations periodically. The Act does not disturb the applicability of any OCC or OTS preemption rules or opinions to contracts entered into prior to its enactment. It also does not affect the ability of a depository institution to export interest rates from any state in which the institution is located.

A state attorney general may bring a civil action in the name of the state to enforce regulations that the CFPB issues, but not the provisions of Title X itself, against a federally
chartered institution. To that end, the visitorial standard for federally chartered institutions will remain the standard set forth in the 2009 US Supreme Court case *Cuomo v. Clearing House Association, L.L.C.* Under that standard, a state attorney general may bring a judicial action against a federally chartered institution to enforce an applicable law.

**Debit Card Fee Restrictions.** In an amendment that has implications for both card issuers and card networks, the Act imposes restrictions on the interchange fees that may be assessed in connection with certain debit card transactions. Specifically, the Federal Reserve is instructed in an amendment sponsored by Sen. Richard Durbin (D-III.) to issue regulations requiring debit card interchange fees to be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." Smaller card issuers (with less than $10 billion in assets) are exempted from these regulations, and during the House-Senate conference, reloadable prepaid cards and government-administered benefit cards were also exempted.

The Act also set limits on certain restrictions that payment card networks may impose. A payment card network (or issuer) may not require that a debit transaction be processed exclusively through a single network or inhibit a merchant from using other payment card networks to process debit transactions. A payment card network also may not inhibit the ability of merchants to offer discounts to customers who make payments by a certain means or to set a minimum purchase amount for payment by credit card (not to exceed $10), or inhibit the ability of federal agencies or colleges and universities to set a maximum dollar amount for payment by credit card, all of the above to the extent that the discount, minimum, or maximum does not differentiate between issuers or payment card networks.

**Title XI. Federal Reserve System Provisions (Emergency Lending Authority and Debt Guarantee Programs)**

Title XI of the Act requires the Federal Reserve to establish by regulation policies and procedures governing emergency lending programs. The programs must be of "broad based" applicability and designed to provide liquidity and not to aid a failing financial company. The programs must also be designed to ensure that the security for emergency loans is sufficient to protect taxpayers from losses and that the programs are terminated in a timely and orderly fashion. The Federal Reserve may not establish any emergency lending programs without the prior approval of the Treasury Secretary.

The Act also allows the FDIC to guarantee the debt of solvent insured depository institutions and their holding companies under certain circumstances. However, the FDIC may set up a facility to guarantee debt only if the FDIC and the Federal Reserve determine that there is a "liquidity event," that failure to take action would have serious adverse effects on the financial stability or economic conditions in the United States, and that guarantees are needed to avoid or mitigate the adverse effects. Furthermore, the FDIC may guarantee debt only up to a maximum amount established by the Treasury Secretary (in consultation with the President) and subsequently approved by a joint resolution in Congress. The FDIC's debt guarantee programs must be funded by fees and assessments on participants in the program, and to the extent the funds collected do not cover the program's losses, the FDIC would be required to impose a special assessment solely on participants in the program.

**Title XII. Improving Access to Mainstream Financial Institutions**

Title XII of the Act contains provisions intended to help unbanked and underbanked individuals gain access to mainstream financial services by authorizing government-subsidized programs that would be aimed at providing low- and moderate-income individuals with financial products or services, such as small loans, including loans that would be more consumer-friendly alternatives to payday loans. Such programs could also provide financial education and counseling.

**Title XIV. Mortgage Reform and Anti-Predatory Lending Act**

Title XIV creates new standards and prohibitions for residential mortgage lending to be supervised by the CFPB. These standards are designed to prevent the practices that were prevalent during the subprime mortgage crisis. Mortgages will be subject to a federal standard that would require the loans to reasonably reflect a borrower's ability
to repay. A consumer may assert a lender’s violation of this “ability to repay” standard as a defense to a foreclosure. A mortgage that fits certain qualifications will be presumed to meet this standard. These qualifications include:

- Mortgage payments do not result in an increase of the principal balance;
- No balloon payment;
- Borrower income and financial resources are verified;
- Underwriting is based upon the full amortization of the loan;
- Ratio of the borrower’s total monthly debt to monthly income are within guidelines to be established by the federal reserve;
- Total points and fees do not exceed 3 percent of the loan amount; and
- The term of the loan does not exceed 30 years.

A mortgage that fits within these qualifications may not charge a prepayment penalty after the third year of the mortgage payment period. For variable rate mortgages, additional disclosures would be required six months prior to an interest rate reset. The disclosures must explain the calculation of the interest rate change, provide information on counseling agencies, and provide a list of alternatives for consumers prior to the interest rate reset, such as refinancing, renegotiating loan terms, or forbearing payment.

Title XIV also addresses mortgage broker practices. Specifically, the Act prohibits mortgage brokers from receiving compensation that varies based on the terms of the loan, including yield spread premiums. The Federal Reserve is required to draft regulations prohibiting mortgage brokers from steering consumers to predatory loans or loans that a borrower lacks a reasonable ability to repay. Mortgage brokers that are required to register under the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act) will be required to include their Nationwide Mortgage Licensing System and Registry number on all loan documents. Title XIV also requires the Federal Reserve to draft regulations requiring depository institutions to monitor the compliance of subsidiaries, as well as employees with the registration procedures under the S.A.F.E. Act.

Arnold & Porter is available to respond to questions raised by recent or forthcoming legislation, or to help guide your business towards legislative and regulatory solutions. We can assist in determining how pending bills and regulations may affect your business and industry. For further information, please contact your Arnold & Porter attorney or:

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Foreign Banks and Nonbank Financial Companies Also Face Challenges from Dodd-Frank

Foreign banks and nonbank financial companies (jointly, foreign financial companies) that are engaged in activities in the United States, whether or not through a direct office or subsidiary, are affected in significant ways by provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), Public Law 111-203.¹ Some provisions in the Act affect specific activities in which the foreign financial company might be engaged in the United States in the same manner and to the same extent as a US financial company. Other provisions of the Act specifically exempt foreign financial companies or treat them in a different or alternative manner than US financial companies. The Act leaves many areas unclear, including areas of importance to foreign financial companies, with details left to the regulatory agencies to sort out in the hundreds of regulations, studies and regulatory guidance that either are required or made necessary by the Act. These regulations, studies and guidance will be issued or conducted by the US Department of the Treasury, the new Consumer Financial Protection Bureau, and federal banking, housing, and securities regulators.² This Advisory will discuss some of the important provisions in the Act that may directly or indirectly affect foreign banks and foreign financial companies.

Title I—Financial Stability

Financial Services Oversight Council

The Act establishes the Financial Stability Oversight Council (Council), chaired by the Secretary of the Treasury, as an overseer of US financial system stability. The Council’s 10 voting members are representatives from the various federal government agencies.


responsible for regulation of financial services and an individual who is experienced in the insurance industry. Among its many functions, the Council is required to monitor the financial markets for trends affecting systemic risk. In addition, the Council has the authority to identify US or foreign nonbank financial companies that are considered to pose a threat to the stability of the US financial system and require those companies to be subject to supervision and regulation by the Board of Governors of the Federal Reserve System (Federal Reserve) and be subject to heightened prudential requirements, such as more stringent capital, liquidity, leverage, and risk management requirements.\(^3\) Large bank holding companies (those with total consolidated assets of more than US$50 billion as of January 1, 2010), including foreign banks that are treated as bank holding companies under the Bank Holding Company Act, also will be subject to these heightened prudential requirements.

As defined in the Act, a “foreign nonbank financial company” is any company that is organized under the laws of a country other than the United States (other than a foreign bank that is treated as a bank holding company under the Bank Holding Company Act, (BHC Act)), and derives 85 percent or more of its annual gross revenues from, or has 85 percent of its consolidated assets related to, financial activities as defined in section 4(k) of the BHC Act (primarily banking, insurance, securities, and merchant banking activities).

Generally, it is expected that only the US activities of the foreign nonbank financial company, whether through a direct office or a subsidiary, would become subject to the heightened prudential requirements under Title I. This is because the Act provides that references to a “company” or a “subsidiary” when referring to a foreign nonbank financial company (except with respect to its designation as systemically significant) include only the US activities and subsidiaries of such foreign nonbank financial company, except as otherwise provided.

The Council is required to consult with both the home country regulator of a foreign nonbank financial company, if any, in making a systemically significant determination regarding that company, and, with “appropriate foreign regulatory authorities” in generally exercising its duties with respect to foreign nonbank financial companies.

The definition of a foreign nonbank financial company excludes a foreign company that is, or is treated in the United States as, a bank holding company under the BHC Act. Under the International Banking Act (IBA), a foreign bank that maintains a branch, agency, or commercial lending company in the United States, and any company controlling that bank, is treated as if it were a bank holding company with respect to its US activities. However, as noted above, large foreign banks (that is, those with total consolidated assets of more than US$50 billion as of January 1, 2010), also will be subject to Title I’s heightened prudential requirements to the same extent as a U.S. bank holding company. It should be noted that the Act is silent on whether only US assets will be considered when calculating this US$50 billion asset threshold.

In imposing Title I’s heightened prudential requirements on foreign companies, the Council and the Federal Reserve are to take a number of factors into consideration, including the amount and nature of the US activities of the company, particularly whether it owns an insured depository institution; whether the particular company is subject to comprehensive supervision on a consolidated basis in its home country at a level similar to that provided to US financial companies; and whether “due regard” has been given to “the principle of national treatment and equality of competitive opportunity” in developing the Prudential Requirements. Exactly what will constitute “due regard” and how the various factors will be weighed by the Council are unclear at this point, pending the issuance of key regulations and additional guidance from the Council and the regulatory agencies. Foreign financial companies are encouraged to monitor the regulatory rulemaking process and participate by submitting comments to the regulatory agencies on these areas of importance to non-US financial companies.

Establishment or Termination of US Offices of Foreign Banks

Title I of the Act also amends the IBA to require the Federal Reserve to take into account additional factors relating to systemic risk when either reviewing the application of a foreign bank to establish a US branch, agency or commercial lending company in the United States, or when it is considering terminating a foreign bank’s authority to maintain a branch, agency or commercial lending company in the United States.

The additional factor for consideration when reviewing an application by a foreign bank that has been determined to be a risk to the stability of the US financial system for approval to establish the branch, agency, or commercial lending company is whether the home country of a foreign bank has adopted, or is making demonstrable progress towards adopting, an appropriate system of financial regulation for the financial system of such home country to mitigate such risk.

The Federal Reserve also will be able to terminate the authority of such a bank to operate a branch, agency or commercial lending company in the United States if it determines that the bank’s home country has not in fact adopted an appropriate system of financial regulation or made demonstrable progress towards doing so.

Enhanced Capital Requirements

The so-called “Collins Amendment” (named after Senator Susan Collins of Maine) of Title I requires the federal banking agencies to establish minimum leverage capital and risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies (that is, bank holding companies and savings and loan holding companies), and nonbank financial companies supervised by the Federal Reserve. In addition, the Collins Amendment terminates the ability of holding companies to use hybrid capital instruments such as trust-preferred securities as part of Tier 1 capital for all such securities issued on or after May 19, 2010. For those securities issued prior to that date, use of these securities is phased out over a period of time for depository institution holding companies that maintained total assets of at least US$15 billion as of December 31, 2009.

These new capital requirements will be applicable to any US-based depository institution or depository institution holding company owned by a foreign bank, but not to the parent foreign bank itself. Under Federal Reserve Supervisory Letter 01-1, issued January 5, 2001, current US bank holding company capital standards are not applicable to US bank holding companies that are owned by foreign banks that qualify as financial holding companies under section 4 of the BHC Act. Under the Collins Amendment, intermediate US holding companies will no longer be able to rely on Supervisory Letter 01-1 and will have to meet the new minimum capital requirements, effective five years after the date of enactment of the Act (i.e., July 2015).

Title II—Resolution Authority

Title II of the Act gives the Secretary of the Treasury, upon the recommendation of the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC), the authority under certain extraordinary circumstances to circumvent the US bankruptcy process and place any bank holding company or nonbank financial company that is in default or in danger of default into receivership to be liquidated by the FDIC under a new expedited resolution process being developed by the FDIC. The Act provides for special rules for dealing with liquidating insurance companies and broker dealers pursuant to the new Title II resolution authority. The provisions of Title II, however, are only applicable to US companies. Thus, the US bank holding company or savings and loan holding company subsidiary of a foreign financial company potentially could be subject to Title II’s resolution provisions. The FDIC will continue to use the provisions of the Federal Deposit Insurance Act with respect to the receivership of insured depository institutions.


Title III—Transfer of OTS Authority

Regulatory Redistribution

Title III of the Act will be of particular interest to those foreign financial companies that own a US savings institution and thus are savings and loan holding companies under the Home Owners Loan Act (HOLA). The Treasury Department’s Office of Thrift Supervision (OTS) regulates savings and loan holding companies and charters and regulates federal savings associations. Title III abolishes the OTS within a year to 18 months of the date of enactment of the Act and redistributes its supervisory authorities. Chartering and supervision of federal savings associations is given to the Treasury Department’s Office of the Comptroller of the Currency (OCC), and the Federal Reserve will take over the supervision of savings and loan holding companies, using HOLA instead of the BHC Act. HOLA has enough flexibility to allow the Federal Reserve to tighten up supervision of savings and loan holding companies to a level that is more similar to its supervisory reach under the BHC Act. In general, the Federal Reserve’s supervision and regulation of bank holding companies is viewed as being more rigorous and pervasive than OTS supervision and regulation of savings and loan holding companies. Foreign financial companies that are savings and loan holding companies may need to make significant adjustments as the regulation of holding companies is shifted from the OTS to the Federal Reserve.

Increase in Minimum Deposits at US Branches of Foreign Banks

A provision in Title III also makes permanent the change from US$100,000 to US$250,000 in the federal standard maximum deposit insurance amount (SMDIA) that had originally been instituted in 2009 as a temporary measure and would have expired on December 31, 2013. Why should this matter to a foreign bank that has an uninsured branch in the United States and does not own a US bank that carries federal deposit insurance? Subject to certain exceptions, an uninsured state-licensed US branch of a foreign bank now may only establish accounts for customers who make an initial deposit of at least US$250,000. The initial deposit amount had been set at US $100,000 for many years until the FDIC issued regulations in 2009 pegging the initial deposit amount to the SMDIA, thus temporarily raising it to US$250,000. When the US$250,000 SMDIA was scheduled to go back to the US$100,000 SMDIA on January 1, 2014, the minimum deposit required to open an account at an uninsured state-licensed US branch of a foreign bank also would have gone back to US$100,000. The permanent increase in the SMDIA under the Act thus results in a permanent increase in the initial minimum deposit amount required to open a deposit account at an uninsured state-licensed US branch of a foreign bank.

To complicate the matter, this required minimum deposit is not applicable to the few foreign banks that maintain US-insured branches (the authority of a US branch of a foreign bank to obtain federal deposit insurance ended in December 1991). It also is not applicable to US branches of foreign banks that have licenses issued by the OCC (federal branches). When the FDIC amended its regulations in 2009, the OCC did not follow suit and thus OCC regulations still require only a minimum deposit of at least US$100,000 for federal branches.

Title IV—Increased Regulation of Investment Advisers

Title IV of the Act contains amendments to the US securities laws that would increase regulation of investment advisers by eliminating certain exceptions from the required registration with the Securities & Exchange Commission (SEC) for certain investment advisers to private funds. For example, the Act repeals the exemption from registration for investment advisers with fewer than 15 clients. However, certain currently exempt foreign-based investment advisers will continue to remain exempt provided that they meet certain conditions.


Title VI—Regulatory Enhancements

Moratorium on Certain New Charters

Many foreign financial companies have established banking subsidiaries in the United States that have not caused the foreign financial company to be required to register as a bank holding company with the Federal Reserve and as a result become subject to the restrictions on bank holding companies under the BHC Act. As noted above, neither savings and loan holding companies nor owners of certain other specified categories of banking institutions such as industrial banks, credit card banks, and limited purpose trust banks, subject to the provisions of the BHC Act. The Act imposes a three-year moratorium on applications by commercial firms for deposit insurance for, and most acquisitions of, industrial banks, credit card banks, and limited purpose trust banks. A firm is a “commercial firm” if its annual gross revenues, and those of its affiliates, derived from financial activities and, if applicable, from the ownership or control of one or more insured depository institutions, represent less than 15 percent of the consolidated annual gross revenues of the particular company.

Title VI also requires the General Accountability Office (GAO) to conduct a study to determine if most of the BHC Act exemptions, including those for savings associations, industrial banks, credit card banks, and limited-purpose trust banks, should be eliminated completely. Foreign financial companies that own or control banking organizations currently exempt from having to register as bank holding companies need to remain cognizant of future developments regarding these BHC Act exemptions. If the exemptions are abolished, senior management at foreign financial companies owning a now non-exempt banking organization will have to analyze the increased costs and compliance burdens resulting from the loss of such exemptions and assess whether maintaining the banking charter can continue to be justified in light of such regulatory changes.

Merchant Banking Activities

Since the enactment of the Gramm-Leach-Bliley Act of 1999, many foreign banks have qualified under the BHC Act to be treated as if they are financial holding companies. Prior to the Act, aside from needing prior approval to purchase a savings association, financial holding companies did not need prior approval to engage in most nonbanking financial activities, including merchant banking activities (which are passive investments of limited duration in nonfinancial companies). The Act amends the BHC Act to require that a financial holding company obtain prior Federal Reserve approval to make a merchant banking acquisition if the total consolidated assets of the target exceed US$10 billion.

Lending Limits and Affiliate Transactions

The Act also amends the limitations on loans that a national bank may make to one borrower. This change in national bank lending limits is relevant to foreign banks with US branches and agencies because the IBA makes the lending limits for national banks applicable to both state-licensed and federally licensed branches and agencies of foreign banks. Among other provisions, the definition of “loan” for purposes of the lending limit restrictions has been broadened to include credit exposure to a person arising from a derivative transaction, repurchase (or reverse repurchase) agreement, or securities lending or borrowing transaction between the bank and the borrower.

The Act also expands the restrictions on transactions between affiliates in Section 23A of the Federal Reserve Act to include credit exposure arising from derivative transactions and securities borrowing or lending transactions with affiliates, thus subjecting those transactions to the quantitative and qualitative restrictions on affiliates required by Section 23A. Foreign banks should remember that the restrictions of Section 23A apply to transactions by a US insured depository institution subsidiary of a foreign bank with the head office of its foreign parent. In addition, Section 23A is applicable to transactions by the US branch, agency or commercial lending company of a foreign bank with an affiliate engaged in certain activities in the United States, such as securities and insurance underwriting. 8

**Volcker Rule**

Under the so-called “Volcker Rule,” named for former Federal Reserve Chairman Paul Volcker, pursuant to regulations to be issued by the federal banking, securities and commodities regulators and subject to certain exceptions, a “banking entity” is prohibited from engaging in proprietary trading in most securities and financial instruments or sponsoring or investing in hedge funds or private equity funds. The term “banking entity” is defined for purposes of the Volcker Rule as an insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of the IBA, and any subsidiary or affiliate of the foregoing. As defined, the term would capture foreign banks that maintain branches and agencies in the United States because, as noted above, such foreign banks are treated as bank holding companies pursuant to the IBA. The definition also captures foreign nonbank financial companies that own or control an insured depository institution such as an industrial bank that does not otherwise cause the owner thereof to become a bank holding company or savings and loan holding company. Even if it does not own an insured depository institution, a systemically significant nonbank financial company that engages in proprietary trading or sponsors or invests in hedge funds or private equity funds will be subject, by regulation, to additional capital requirements for, and additional quantitative limits with regards to, such proprietary trading and hedge fund/private equity fund sponsorship or investment.

Permitted proprietary trading and fund-related activities include activities conducted solely outside the United States under Sections 4(c)(9) and 4(c)(13) of the BHC Act by a banking entity that is not directly or indirectly controlled by a US-organized banking entity. However, offering interests in the funds held under this exemption to US residents is prohibited. What will be required in order to meet the “solely outside the United States” requirement for these exemptions is not yet known. Sections 4(c)(9) and 4(c)(13) of the BHC Act do not require that the foreign bank’s activities take place wholly outside the United States, and the Federal Reserve has implemented and interpreted these BHC Act provisions to allow for some incidental activities in the United States. In contrast, the Volcker Rule exception tied to these two sections of the BHC Act requires that the transaction be conducted solely outside the United States. The Federal Reserve and the other regulatory agencies with responsibility to draft regulations to implement the Volcker Rule will have to clarify the applicability of these exemptions through such regulations. Foreign companies that are not subject to the BHC Act but are covered by the Volcker Rule due to their ownership of insured depository institutions such as industrial banks do not appear to be covered by the exemptions, and the ability of the regulators to expand the exemption to include such companies is not clear.9

The Volcker Rule has a protracted implementation period. It must be implemented in accordance with joint regulations issued by the US federal banking, securities and commodities regulators. Prior to the rulemaking, however, the Council must undertake a study (to be completed within six months after the Act’s enactment) regarding, among other things, limitations on an insured depository institution’s activities that pose a risk of undue losses, and provide recommendations to the regulators issuing the regulations. Regulations must be adopted within nine months of the completion of the Council’s study. The effective date of the Volcker Rule is the earlier of 12 months after the date of the issuance of the regulations or two years after the date of enactment of this section (i.e., July 21, 2012). Even then, there is a two-year conformance/divestiture period, with three one-year extensions possible, and a special extended transition period for illiquid funds.

**Title VII—Over the Counter Derivatives**

The Act also creates a comprehensive new regulatory regime for most derivative transactions that were previously deregulated by the Commodities Futures Modernization Act of 2000. Among the most significant challenges that foreign banks and nonbank financial companies face under the Dodd-Frank Act is the newly implemented requirement that most over-the-counter derivative transactions be subject to clearing by a regulated clearing organization. The Act also requires that most transactions be executed on regulated exchanges or electronic trading platforms. The Act further imposes a requirement that most swaps and security-based swaps be subject to mandatory reporting by market participants to a swap data repository. Foreign banks and nonbank financial companies also face challenges from Dodd-Frank.

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aspects of Title VII’s provisions regarding regulation of derivatives are (i) new categories of regulated market participants (including “swaps dealers” and “major swaps participants”); (ii) mandatory clearing through regulated clearing organizations and mandatory trading through regulated exchanges or execution facilities; and (iii) the requirement that banks push out many swaps activities to affiliates. In order to foster global uniformity in the swaps area, US regulators are required to consult and coordinate with foreign regulatory authorities on the establishment of “consistent international standards” regarding the regulation (including fees) of swaps, entities engaging in swaps activities, and futures and options contracts.10

Under the Act, “swaps entities,” which could include banks and US branches and agencies of foreign banks, will be prohibited from receiving any “federal assistance” with respect to their activities. “Federal assistance” includes access to the Federal Reserve Bank discount window for purposes of obtaining a loan. US banks and US branches and agencies of foreign banks maintain accounts at Federal Reserve Banks, and may from time to time borrow money from the Federal Reserve Bank backed by collateral in its collateral account at the Federal Reserve Bank.

The Act exempts insured depository institutions from this prohibition if their hedging and other similar risk-mitigating activities are directly related to the insured depository institution’s activities or they are engaging in swaps related to assets that are permissible investments for a national bank, such as loans and other extensions of credit, foreign currency, bullion (including gold, silver, and certain other precious metals), and US government and agency securities. However, as the Act is written, US branches and agencies of foreign banks, most of which are uninsured, will not be able to take advantage of that exemption. This gap in equitable treatment for US branches and agencies of foreign banks was acknowledged as inadvertent in a colloquy on the floor of the United States Senate during the debate on the Act, so action at some point to correct this gap is expected.

Foreign banks are typically involved in foreign exchange activities, often through their US offices, so it is important to note the Act’s significant provisions regarding the regulatory treatment of foreign exchange swaps and forwards. The Act provides that foreign exchange swaps and forwards will be considered to be swaps (and thus subject to jurisdiction of the Commodities Futures Trading Commission) unless the Treasury Secretary grants an exemption by making a written determination that either or both types of foreign exchange derivatives (i) should not be regulated as swaps; and (ii) are not structured in a manner so as to evade application of the Act. On October 29, 2010, the Treasury Department published a request for public comment on questions relating to the determination as to whether foreign exchange swaps and forwards should be exempted from the new regulations contemplated under Title VII of the Act. Treasury will accept written comments through November 29, 2010.

Title IX—Investor Protection and Securities Regulation11

Title IX of the Act is aimed at, among other issues, improvements for investors in securities and commodities, executive compensation, and Securities and Exchange Commission (SEC) governance.

In addition, pursuant to an amendment to the Securities Exchange Act of 1934, under regulations jointly issued by federal regulators (including the federal banking agencies and the SEC), persons who securitize assets, and those who originate assets to be used in a securitization, will be required to retain an economic interest in a portion of any asset that the securitizer transfers, sells, or conveys to a third party through the issuance of an asset-backed security. The term “securitizer” means an issuer of an asset-backed security


or a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer; the term “originator” means a person who through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and sells an asset directly or indirectly to a securitizer. Foreign financial companies, including US branches and agencies of foreign banks, could fall within the definition of either originator or securitizer depending upon their particular activities in connection with securitization transactions.

The Act requires that the regulations include certain mandatory requirements that will:

- Prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset;
- Prescribe a general credit retention requirement of 5 percent of the value of the asset in question, with the percentage being greater or lesser under certain circumstances;
- Specify the permissible forms and minimum duration of the required risk retention;
- Be applicable regardless of whether the securitizer is an insured depository institution;
- Provide specified criteria for risk retention with respect to securitization of commercial mortgages and collateralized debt obligations; and
- Provide for certain exemptions, such as with respect to securities issued or guaranteed by the United States (Fannie Mae and Freddie Mac are ineligible for this exemption).

Title IX also provides for increased information sharing by the SEC with US and foreign authorities and extends the jurisdiction of US courts in actions or proceedings brought or instituted by the SEC or the United States alleging a violation of the anti-fraud provisions of the US federal securities laws to cover securities transactions outside the United States where conduct inside the United States constituted “significant steps in furtherance of the violation” or conduct occurring outside the United States that has a “foreseeable substantial effect” within the United States.

Conclusion

The Act imposes significant new regulatory requirements and obligations on foreign banks and nonbank financial companies operating in the United States. The full scope of the new challenges faced by foreign financial companies under the Act ultimately will be determined over the coming months by the regulatory agencies through the regulatory rulemaking process. Foreign financial companies should actively engage in the rulemaking process in order to ensure that the regulatory agencies fully consider their concerns as the regulations to implement these and other important provisions of the Act are written.

Arnold & Porter LLP has long represented large financial companies and their subsidiaries in resolving their regulatory and supervisory issues, including many foreign banks. We have been assisting such companies during the legislative process in understanding the implications of the Act and in various changes that were made or attempted to be made to the legislation during the last several months. We are available to respond to questions raised by the Act, or to help guide your business in responding to it. For further information, please contact your Arnold & Porter attorney or:

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The Corporate Governance and Executive Compensation Provisions in the Dodd-Frank Act—What to Do Now

Will Rogers once quipped, “Be thankful we're not getting all the government we're paying for.” Now that the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) has been enacted into law, that is about to change. The Act and related rulemaking by the US Securities and Exchange Commission (SEC) will profoundly affect executive compensation and governance at public companies, making it essential that companies start preparing for these changes now and closely monitor SEC rulemaking.

The Act requires the SEC to issue more than 90 rules and 15 studies, many of them relating to corporate governance and executive compensation. In some cases there is no deadline set for when the SEC must issue rules, while in other cases the SEC must adopt rules not later than a certain number of days or months after enactment of the legislation. Several provisions in the Act require the SEC to issue rules directing the national securities exchanges to adopt listing standards to effectuate the rules. Listed companies that do not comply with the new requirements could be subject to delisting (although in some cases the rules adopted by the SEC must provide issuers with a reasonable opportunity to cure any defects that would be the basis for a delisting).

In this advisory, we discuss the executive compensation and governance provisions in the Act, together with practical suggestions that companies might consider to be ready for the new requirements. Separate sections discuss executive compensation and governance provisions that relate solely to financial institutions or “nonbank financial companies” supervised by the Board of Governors of the Federal Reserve System (Federal Reserve).

Say on Pay. New “say on pay” provisions give shareholders a vote on executive pay. The Act does not mandate that a “say-on-pay” vote be held annually as was originally proposed in both the Senate and House bills. Rather, public companies, at the first annual or other meeting of shareholders that occurs six months after the date of enactment, will be required to include a resolution providing shareholders with a non-binding, advisory vote on the compensation of their company’s executive officers.

Financial Regulatory Reform: For Arnold & Porter’s latest resources on this topic including Advisories, upcoming events, and publications, please visit Financial Regulatory Reform. Also visit our Financial Regulatory Chart, which aggregates information on US government programs.
vote on the compensation of executive officers (as disclosed under Item 402 of Regulation S-K), as well as a separate resolution to determine whether future “say-on-pay” votes should occur on an annual, biennial, or triennial basis. Companies must hold a shareholder vote no less than every six years to reconsider whether to hold the say-on-pay vote annually, biennially, or triennially. Presumably, companies may try to match shareholder votes with the objectives of their compensation programs. If, for example, a company’s pay programs emphasize multiyear performance, as is generally the case, a staggered “say-on-pay” vote may be easier to justify.

A say-on-pay vote is nonbinding and does not overrule any decision made by the company or the board or otherwise change the fiduciary duties of the board. The SEC has authority to exempt small issuers from say-on-pay and say-on-golden-parachute provisions to the extent it determines that these requirements disproportionately burden small issuers, but it is not clear whether the SEC will exercise its authority to do so.

Recent say-on-pay votes demonstrate that shareholders are willing to “just say no” when voting on executive compensation. During the 2010 proxy season, Motorola, Occidental Petroleum, and Keycorp became the first three companies that failed to garner majority support for a management-sponsored “say on pay” vote. Although the say-on-pay vote is non-binding and advisory, RiskMetrics Group, a proxy advisory firm that provides voting recommendations to institutional shareholders and often receives delegated authority to vote their shares, is advising its institutional clients to vote against directors who ignore the outcome of shareholder say-on-pay votes. Thus, “say-on-pay” votes have an “in terrorem” effect on companies and their boards of directors.

Companies should consider undertaking a comprehensive review of executive compensation with a view toward gaining shareholder support. This review should include the new executive compensation requirements added by the Act (discussed below), as well as a fresh look at the executive compensation disclosures included in last year’s proxy statement. Companies also should strive to make their presentation of executive compensation clearer and more persuasive, providing compelling reasons for compensation decisions and analysis in the Compensation Disclosure & Analysis (CD&A) section of the proxy statement.

Companies may also benefit from reviewing the factors that institutional shareholders and proxy advisory firms are likely to examine in conjunction with say-on-pay votes. RiskMetrics Group, which is likely to wield even more influence as a result of the new say-on-pay requirements, adopted a policy for management “say on pay” proposals in 2008 and included detailed guidance in a 2009 white paper on evaluating management say-on-pay proposals.\(^1\) The Council of Institutional Investors issued a paper on the top ten red flags that shareholders should watch for when casting advisory say-on-pay votes.\(^2\) Reviewing the issues discussed in these papers and the recommendations of compensation consultants, and staying abreast of evolving best practices and the experience of other companies with say-on-pay votes, can help companies reduce the risk of a negative outcome. Anticipating the concerns of institutional investors and learning to communicate effectively with them can head off difficulty, both as to say-on-pay votes and with regard to other areas as well. In addition, companies should communicate effectively with retail shareholders and take steps to increase retail vote participation.

**Say on Golden Parachutes.** The Act also requires that, in any proxy statement in which shareholders are asked to approve an acquisition, merger, consolidation, or sale of substantially all the assets of a company, the soliciting person (generally the target company or the acquiring company) disclose any agreements or understandings that such person has with any named executive officers concerning any type of compensation (present, deferred, or contingent) that is based

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on or relates to the business combination. The aggregate total of all such compensation that may be paid or become payable to named executive officers (including the conditions of such payments) must be disclosed. In addition, a separate non-binding shareholder resolution to approve such agreements or understandings and the compensation disclosed is required (a so-called “say on golden parachute” vote). This provision is effective for shareholder meetings occurring six months after enactment of the Act.

The Act does not require a shareholder vote on parachute agreements or understandings if they have previously been the subject of a general “say-on-pay” vote. The scope of this exception is not entirely clear, for example, in situations where a general say-on-pay vote approves potential payments to named executive officers (as seems to be contemplated by the use of the phrase “agreements or understandings”) but the final arrangements or amounts that are paid in the context of a particular transaction are different. Despite this ambiguity, companies should review existing parachutes with named executive officers in employment agreements or plans to determine if they should be revised or should be put in a more definitive form so that a general say-on-pay vote is more likely to preempt the need for a later resolution in connection with a future transaction.

The new say-on-golden parachute requirements may affect future negotiations on parachute payments both generally and in the context of specific transactions.

**Clawback of Incentive-Based Compensation.** The Act requires the SEC, by rule, to direct national securities exchanges to prohibit the listing of any security of an issuer that does not develop and implement a policy to “clawback” compensation from current or former executive officers who received incentive-based compensation (including stock options) during the three-year period preceding the date of an accounting restatement. The Act operates differently than the provision in the Sarbanes-Oxley Act. Under the Sarbanes-Oxley Act, the CEO and CFO must reimburse the company for all incentive-based compensation that is paid during the twelve-month period following the restatement, as well as any profits realized from the sale of securities of the company during that 12-month period. In addition, the Sarbanes-Oxley provision requires an issuer to recover compensation due to the material noncompliance of the issuer “as a result of misconduct.” The clawback provision in the Act operates differently than the provision in the Sarbanes-Oxley Act. The Act clawbacks incentive-based compensation from any former or current executive officer “in excess of what would have been paid to the executive officer under the accounting restatement” during the three-year period preceding the restatement.

This provision is broader than the clawback provision in the Sarbanes-Oxley Act. In addition, the Act’s clawback provision applies irrespective of whether any misconduct occurred. Even though accounting restatements do not necessarily involve wrongdoing, the Act’s clawback provision can reach to executive officers who are not even aware of a problem.

Listed companies will need to adopt clawback policies that comply with any listing standards that are adopted. Many companies have existing clawback provisions but often these provisions only seek to recover compensation from CEOs and CFOs who are involved in misconduct. While consistent with Sarbanes-Oxley requirements, these policies are inconsistent with the Act’s “no fault” provision. Companies also will need to consider whether existing employment agreements, compensation plans, and award agreements need to be modified. If no attempt is made to modify existing contracts and policies, a company could potentially be criticized for failing to take measures to enforce its clawback policy. A further issue to consider is whether the company’s clawback policy can be enforced retroactively against employees who have contractual rights, especially in the case of former employees who do not consent to a modification.

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3 Section 304 of the Sarbanes-Oxley Act requires a company to clawback compensation only from the company’s CEO and CFO and only covers the twelve-month period following the restatement. Under the Sarbanes-Oxley Act, the CEO and CFO must reimburse the company for all incentive-based compensation that is paid during the twelve-month period following the restatement, as well as any profits realized from the sale of securities of the company during that 12-month period. In addition, the Sarbanes-Oxley provision requires an issuer to recover compensation due to the material noncompliance of the issuer “as a result of misconduct.” The clawback provision in the Act operates differently than the provision in the Sarbanes-Oxley Act. The Act clawbacks incentive-based compensation from any former or current executive officer “in excess of what would have been paid to the executive officer under the accounting restatement” during the three-year period preceding the restatement.

4 In a recent decision, the Arizona district court denied a motion to dismiss the SEC’s complaint in an action against the former CEO of CSK Auto Corp. under the Sarbanes-Oxley Act even though the SEC had not alleged that the CEO was involved in the securities fraud or knew that the company’s financial statements were misleading. The court stated that the Sarbanes-Oxley Act requires only misconduct of the issuer, and does not require specific misconduct, or even personal awareness of financial misconduct, of the issuer’s CEO or CFO. See SEC v. Jenkins, No. CV 09-1510-PHX-GMS, 2010 WL 2347020 (D. Ariz. June 9, 2010). This case is not binding in other jurisdictions and could be appealed.
Listed companies may wish to consider whether protective steps, such as indemnifying executives (to the extent permitted by state law) and modifying directors and officers (D&O) liability insurance that would otherwise exclude clawback claims from coverage, can be taken to protect executives from unfair application of the provision. Companies also may decide to evaluate whether a greater proportion of executive compensation should be in the form of salary and guaranteed payments and less as incentive or equity-based compensation.

At the same time, companies should review clawback policies, agreements with executives, and plans to make sure that they protect the company and its shareholders against wrongdoing by executives. Companies should also keep an eye on evolving best practices, which could potentially go beyond the Act’s requirements. It is possible that industry groups will disapprove of attempts to indemnify or insure executives from application of the Act’s clawback policy on the theory that it is inconsistent with the Act or may cause an executive to be less vigilant in monitoring misconduct, or that the SEC could require additional disclosure regarding indemnification or insurance in this context.

**Disclosure of the Relationship Between Pay and Performance.** The SEC is required to adopt rules requiring companies to disclose in the annual proxy statement the relationship between compensation paid to executive officers and the company’s financial performance, taking into account any change in the value of stock and dividends and distributions. Companies may include a graphic representation of the information required to be disclosed. No deadline is specified for adoption of SEC rules.

The “new” requirement in the Act that companies disclose in their proxy statement the relationship between executive compensation paid and the company’s financial performance taking into account any change in its stock price takes us back to an “old” SEC rule that required companies to include a stock performance graph in their proxy statements. The SEC repealed this requirement in 2006, noting that stock performance information is widely available and that the executive compensation disclosure contained in CD&A is intended to encourage broader discussion than just the relationship of compensation to company performance as reflected in its stock price. Currently, a performance graph is required only in the company’s annual report to shareholders.

**Disclosure of Ratio of Median Employee Compensation to CEO Compensation.** The SEC is required to amend Item 402 of Regulation S-K to require companies to disclose: (1) the median annual total compensation of all employees, except the CEO; (2) the annual total compensation of the CEO; and (3) the ratio of the compensation of employees determined under (1) to the compensation of the CEO determined under (2). The annual total compensation of an employee is determined in accordance with Item 402 of Regulation S-K. This disclosure will be required in registration statements, annual reports to shareholders, proxy statements, and Exchange Act reports to the extent required in the forms and rules. No deadline is specified for adoption of SEC rules.

Patrick McGurn, Special Counsel to RiskMertics’ Governance Services unit, stated in May 2010 that if pay equity disclosure were enacted into law, the result could be “the most inflammatory number that’s ever been in the proxy statement.” Companies should focus in advance on the calculation and consider the impression that pay equity disclosure will make on both employees and shareholders (particularly in light of the new say-on-pay requirement). Consideration should be given to factors that affect internal pay equity. For example, a company that outsources a higher proportion of jobs to lower paying jurisdictions may appear to have relatively better internal pay equity statistics than peers providing lower paying jobs. Companies also may wish to think about conducting a more meaningful internal pay equity analysis than that required by the Act. Additional internal pay equity calculations (such as comparing CEO pay to the pay of...
other named executive officers and other groups) may provide additional context for the required disclosure.

**Disclosure of Employee and Director Hedging Activities.** The SEC is required to adopt rules requiring companies to disclose in their annual proxy statement whether any employee or director is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset a decline in the market value of equity securities granted as part of the employee’s or director’s compensation or held, directly or indirectly, by the employee or director. No deadline for SEC rulemaking is specified.

Companies should review their existing policies or agreements to determine whether to include restrictions on employee and director hedging activities. Many companies already prohibit some hedging activities in insider trading policies or contractual agreements, in part because Section 16 of the Exchange Act prohibits certain activities. However, such policies may not prohibit or restrict all activities as to which a company will be required to make disclosure, and they may not cover all employees. Therefore, companies should review their policies to determine whether they wish to prohibit or further restrict hedging activities or cover additional persons. In some cases, companies and employees or directors also may want to consider undoing outstanding hedging transactions before making the required disclosure.

**Compensation Committees.** The Act requires the SEC, by rule, to direct national securities exchanges to prohibit the listing of any security of an issuer that does not comply with requirements relating to compensation committee independence, the independence of compensation consultants and other advisers to the compensation committee, disclosure of the compensation committee’s use of compensation consultants, and the authority of compensation committees to retain and fund compensation consultants and other advisers.

The SEC must issue rules not later than 360 days after enactment. The rules of the SEC must provide for appropriate procedures for an issuer to cure any defect that would be the basis for a listing prohibition. The SEC rules must permit a national securities exchange to exempt a category of issuers. In determining appropriate exemptions, the exchanges must take into account the potential impact of the requirements on smaller reporting issuers.

The provisions in the Act relating to compensation committees of listed companies and their use of consultants and advisers are discussed below.

- **Compensation Committee Independence.** Compensation committee members of listed companies will be required to satisfy heightened independence standards to be established by the national securities exchanges. The definition of the term “independence” is consistent with that required of audit committee members under Rule 10A-3 of the Exchange Act. Listed companies should start reviewing whether the current members of the compensation committee meet the general provisions in the Act, and review the SEC’s rules and listing standards once they are issued. To the extent that changes to the composition of the compensation committee are required, companies may need to recruit new members if they are unable to fill compensation committee positions with existing directors. Compensation committees will also need to update their charters when the final rules become available.

- **Independence of Compensation Committee Consultants and Advisers.** Compensation committees of listed companies must consider specific factors that the SEC identifies as affecting the independence of a compensation consultant, legal counsel or other adviser before selecting such person. The SEC is required to issue rules identifying the factors that affect the independence of a compensation consultant, legal counsel, or other adviser to a compensation committee of an issuer. Such factors must

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8 The SEC must by rule direct the national securities exchanges to prohibit the listing of any equity security of an issuer (other than an issuer that is a controlled company, limited partnership, company in bankruptcy proceedings, open-ended management investment company that is registered under the Investment Company Act of 1940, or a foreign private issuer that provides annual disclosures to shareholders) if the foreign private issuer does not have an independent compensation committee that does not comply with the requirements for compensation committee independence.
be competitively neutral among categories of consultants, legal counsel, or other advisers, and preserve the ability of compensation committees to retain the services of members of any such category.9

The new requirements add to existing proxy disclosure requirements that were adopted in December 16, 2009, which require companies to disclose in the proxy statement whether the compensation consultant retained by the board’s compensation committee or its affiliates performs other work for the company that could create a conflict of interest and related fee disclosures in certain circumstances.10 Compensation committees should consider whether there is a need to retain new compensation consultants, legal counsel, or other advisers, and consider adopting policies that ensure that they are satisfying the new requirements.

Disclosure Regarding Use of Compensation Consultants. A listed company will be required to disclose in the proxy statement for an annual meeting occurring one year or more after enactment of the Act whether (1) the compensation committee retained or obtained the advice of a compensation consultant; and (2) any conflicts of interest arise from the consultant’s work and, if so, the nature of the conflict and how it is being addressed.

Authority to Engage and Oversee Independent Compensation Consultants, Counsel and Other Advisers. The compensation committee of a listed company must be granted authority, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel, and other advisers and be directly responsible for their oversight.

Funding of Compensation Consultants and Other Advisers. Listed companies must provide for appropriate funding, as determined by the compensation committee, for payment of “reasonable compensation” to compensation consultants, independent legal counsel, or other advisers to the committee.

Proxy Access. Despite efforts to introduce language into the legislation limiting the right of shareholders to nominate directors in a company’s proxy materials to those shareholders who own at least 5 percent of the company for a minimum two-year holding period, the Act does not specify any minimum ownership threshold or holding period. The SEC is authorized to exempt issuers or classes of issuers (such as small public companies) from proxy access rules.

The Act’s proxy access provision resolves the issue of whether the SEC has authority to issue proxy access rules, in anticipation of a lawsuit on the issue. With this issue out of the way, we anticipate that the SEC will adopt proxy access rules relatively quickly so that they will be in effect for the 2011 proxy season.11

Exemption From Sarbanes-Oxley Independent Auditors Attestation Requirement For Small Issuers. The Act amends the Sarbanes-Oxley Act to exempt small SEC reporting issuers that are non-accelerated filers under Rule 12b-2 of the Exchange Act from the requirement in Section 404(b) of the Sarbanes-Oxley Act for independent auditor attestation of internal control over financial reporting. Thus, small SEC reporting companies with a public float (market value of equity securities held by non-affiliates) of less than US$75 million will not be subject to this requirement.12

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9 The factors that the SEC identifies in its rulemaking as affecting the independence of a compensation consultant, legal counsel or other adviser to a compensation committee must include: “(A) the provision of other services to the issuer by the person that employs the compensation consultant, legal counsel, or other adviser; (B) the amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel, or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel, or other adviser; (C) the policies and procedures of the person that employs the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest; (D) any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee; and (E) any stock of the issuer owned by the compensation consultant, legal counsel, or other adviser.”


12 The SEC had previously granted relief to smaller public companies from compliance with the independent auditor attestation requirement in Section 404(b). The most recent extension of the original exemption expired on June 15, 2010. The Act makes this exemption for smaller reporting companies permanent.
exemption does not in any way affect a smaller issuer’s obligations under Section 404(a), which requires an annual assessment of internal controls over financial reporting.

The SEC is required to conduct a study to determine how it could reduce the burden of complying with Section 404(b) for companies whose market capitalization is between US$75 million and US$250 million for the relevant reporting period. The SEC must deliver a report to Congress not later than nine months after enactment.

**Discretionary Voting by Brokers.** The Act requires national securities exchanges to adopt rules prohibiting broker discretionary voting in connection with elections of directors, executive compensation, and any other significant matter as determined by SEC rule, unless the beneficial owner has provided voting instructions to the broker. No time period for adoption of these rules is specified.

This requirement is similar to New York Stock Exchange Rule 452, but adds voting on all executive compensation matters to the list of non-routine matters as to which a broker may not vote without instructions. It also gives the SEC authority to add to the list of items as to which a broker may not exercise discretionary voting. This could significantly affect the outcome of say-on-pay and say-on-golden parachute votes by giving institutional investors proportionately greater voting power.

**Disclosure Regarding Chairman and CEO Structure.** The SEC is required to adopt rules, not later than 180 days after enactment, requiring a company to disclose in its annual proxy statement the reasons it has chosen the same person to serve as chairman of the board and CEO or different individuals to serve in these positions. Under SEC disclosure rules adopted on December 16, 2009, companies are already required to include disclosure in the proxy statement about a company’s board leadership structure, including whether the company has combined or separated the chief executive officer and chairman position, and why the company believes its structure is the most appropriate for the company.¹³

**Adjustment to the “Accredited Investor” Standard.** During the four-year period that begins on the date of enactment of the Act, the net worth standard for a natural person to qualify as an “accredited investor”¹⁴ under the Securities Act of 1933 (Securities Act) is US$1 million, excluding the value of the primary residence of the natural person.¹⁵ Prior to enactment of the Act, individual investors could include their primary residence in the net worth calculation. This change, which is effective immediately, will make it harder for many individual investors to qualify as an accredited investor. Four years after enactment of the Act, the SEC must increase the net worth standard for individual investors to more than US$1 million. The SEC must conduct periodic reviews of the definition.¹⁶

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¹⁴ The term “accredited investor,” as defined in Rule 501(a) of Regulation D under the Securities Act for purposes of certain exempt offerings, includes:

- Individuals who have a net worth, or joint worth with their spouse, above US$1 million or have income above US$200,000 in each of the last two years (or joint income with their spouse above US$300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, executive officers or general partners of the issuer of the securities or its general partner; and

- Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than US$5 million in assets; and qualified employee benefit plans and trusts with more than US$5 million in assets.

¹⁵ The SEC has issued an interpretation that the amount of any associated mortgage or other indebtedness secured by the primary residence up to its fair market value may be excluded in determining an individual’s net worth.

¹⁶ The SEC may undertake an initial review of the definition of an “accredited investor,” as the term applies to natural persons, to determine whether the definition, excluding the requirement relating to the net worth standard described above, should be adjusted or modified, and following completion of the review, may make adjustments to the definition (except as to the net worth standard requirement) after notice and comment rulemaking. The SEC is required to conduct a review, not earlier than four years after enactment and not less frequently than every four years thereafter, of the definition of “accredited investor” in its entirety as defined in Rule 210 of the Securities Act. Upon completion of this review, the SEC may make adjustments to the definition of “accredited investor” as defined in Rule 215 after notice and comment rulemaking. (The Act does not require a review of the definition of an “accredited investor” in Rule 501(a) of Regulation D every four years. Rather, this review is only required with respect to the definition of an “accredited investor” for purposes of Rule 215, which affects the Section 4(6)
Changes to Section 13 and 16 Reporting. The Act gives the SEC authority to shorten the due date for filing beneficial ownership reports under Section 13(d) of the Exchange Act. Currently, the due date is within 10 days after the acquisition. It also eliminates requirements to send related notices to the issuer and exchanges. A similar accelerated time frame would be allowed for “short swing” reporting under Exchange Act Section 16.

The Act amends Sections 13(d) and 13(g) of the Exchange Act so that they apply to beneficial owners of any covered equity security upon the purchase or sale of a “security-based swap” (as defined by SEC rule).17

Institutional investment managers that are subject to Section 13(f) of the Exchange Act must report at least annually how they voted with regard to a shareholder vote on executive compensation or “golden parachute” compensation unless such vote is otherwise reported publicly under SEC rules.

Enhanced Disclosure and Reporting of Compensation Arrangements by Covered Financial Institutions with US$1 Billion or More in Assets; Prohibition on Certain Compensation Arrangements. Not later than nine months after the date of enactment, appropriate federal regulators18 must jointly prescribe regulations or guidelines that:

1) Require “covered financial institutions” to disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements sufficient to determine whether the compensation structure provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or could lead to material financial loss to the covered financial institution; and

2) Prohibit any incentive-based payment arrangement that such regulators determine encourages “inappropriate risks” by covered financial institutions, by providing an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or that could lead to material financial loss to the covered financial institution.

Reporting of the actual compensation of particular individuals is not required. “Covered financial institutions” include banks and savings associations and their respective holding companies, registered broker-dealers, credit unions, investment advisers, Fannie Mae, Freddie Mac, and any other financial institution that the appropriate federal regulators jointly determine should be treated as a covered financial institution. These requirements do not apply to covered financial institutions with assets of less than US$1 billion.

Risk Committee Requirements for Nonbank Financial Companies Supervised by the Federal Reserve and Certain Bank Holding Companies. The Federal Reserve must require each “nonbank financial company” supervised by the Federal Reserve that is a publicly traded company, and publicly traded bank holding companies with US$10 billion or more in assets, to establish a risk committee (in the case of a nonbank financial company supervised by the Federal Reserve, not later than one year after the date of receipt of a notice of final determination with respect to such nonbank financial company).19 In addition, the Federal Reserve may require each publicly traded bank holding company that has total consolidated assets of less than US$10 billion to establish a risk committee as determined by the Federal Reserve to promote sound risk management.

17 A new subsection (o) to Section 13 states that for purposes of Section 13 and Section 16, a person will be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap, only to the extent that the SEC, by rule, determines that the purchase or sale of the security-based swap provides incidents of ownership comparable to direct ownership of the equity security, and that it is necessary to achieve the purposes of the section that the purchase or sale of the security-based swap be deemed the acquisition of beneficial ownership of the equity security. No deadline is specified for SEC rulemaking.

18 “Appropriate Federal regulators” include the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC, and the Federal Housing Finance Agency.

19 The term “nonbank financial company” includes companies that are “predominantly engaged in financial activities” (as defined in the bill). The Financial Stability Oversight Council can subject certain nonbank financial companies that it determines would pose a threat to US financial stability in the event of their material financial distress to the supervision of the Federal Reserve. Such companies can be subject to stricter standards, such as the risk committee requirement. For further information, see Congress Finalizes Landmark Financial Regulatory Reform Legislation, available at: http://www.arnoldporter.com/public_document.cfm?id=16134&key=2E2.
practices. The risk committee will be responsible for the oversight of enterprise-wide risk management practices and must include such number of independent directors as the Federal Reserve may determine appropriate, and at least one risk management expert with experience in identifying, assessing and managing risk exposures of large, complex firms. The Federal Reserve must issue rules not later than one year after the “transfer date,” to take effect not later than 15 months after the “transfer date.” The “transfer date” means a date that is one year after enactment of the Act, but is subject to an additional six-month extension.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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Dodd-Frank Wall Street Reform and Consumer Protection Act to Significantly Impact Derivatives Trading of Banks

The United States Congress has passed new financial reform legislation entitled the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act). Title VII of the Act provides for sweeping reforms that include substantial regulation of the over-the-counter (OTC) derivatives market. These new regulations could have a significant impact on banks that participate in derivatives trading as part of their business. Banks that fit within the Act’s definition of “swap dealer” or “major swap participant” (MSP) would be subject to new requirements that could include: registration, capital and margin, reporting and record-keeping, as well as new business conduct standards. Participants in derivatives trades could also be required to clear many or all of their swaps through a central clearing house. As a result of such changes, financial costs of derivatives transactions could increase substantially. One study estimates that the increased capital and liquidity requirements in the derivatives market could increase derivatives participants’ collateral needs by hundreds of billions of dollars.¹

Banks must, therefore, be aware of these new requirements and determine whether they would be subject to the new requirements as either a swap dealer or major swap participant or if they would be exempted pursuant to one of the definitional exclusions. The current definitions and exclusions in the Act are far from a model of clarity. Through the upcoming rulemaking process, the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and federal banking agencies will have to determine if

the definitions of swap dealers and MSPs should be interpreted in a broad or narrow fashion. It would be prudent for banks to participate in the rulemaking process to help ensure that these definitions are not unnecessarily expansive.

Another issue banks must consider is the “push out” provision of the Act. As discussed in more detail below, the push out provision would force banks to remove certain types of derivatives activities from the bank and divest them to their affiliates in order to maintain eligibility for federal assistance including access to the federal discount window and Federal Deposit Insurance Corporation insurance. This requirement would likely increase the overall costs and regulatory burdens associated with derivatives transactions. The push out provision does provide for an exemption for those products that are related to hedging the bank’s own commercial risks. The CFTC and SEC will make the final determination as to which products will be considered legitimate hedging instruments and thus eligible to be traded within the bank.

Swap Dealer Definition and its Potential Implications for Banks

The Act defines a swap dealer as an entity that: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties; or (iv) is commonly known in the trade as a dealer or market maker in swaps. The CFTC and the SEC determination of the meaning of “holding oneself out as a dealer in swaps” or “regularly entering into swaps with counterparties,” will be critical in deciding whether banks engaged in certain swaps business with customers may be excluded. As noted above, the implications of being considered a “swaps dealer” are significant. A dealer will be subject to registration with the CFTC and possibly the SEC, capital, and margin requirements on their swaps activities, reporting, recordkeeping, and business conduct standards. A dealer will also be subject to mandatory clearing and exchange trading requirements.

The swap dealer definition provides a carve out for banks that enter into a swap with a customer in connection with originating a loan with the same customer. This carve out, depending on how it is interpreted by the agencies, may provide certain banks and thrifts an exclusion from the swap dealer definition for some of their traditional swap activities. The exclusion from the swap dealer definition could then in turn provide such banks and thrifts an exclusion from the divestiture requirement discussed in more detail below. How broadly this carve out will be interpreted, however, remains very much in doubt.

Major Swap Participant Definition and its Potential Implications for Banks

The Act defines an MSP as an entity, that is not a swap dealer, and that: (i) maintains a “substantial position in swaps” for any of the major swaps categories; (ii) whose swaps create substantial counterparty exposure that could have “serious adverse effects on the financial stability of the United States banking system or financial markets;” or (iii) is “highly leveraged relative to the amount of capital it holds.” These terms and criteria are exceedingly vague and leave room for much interpretation.

The CFTC and the SEC are also tasked with the responsibility of determining which types of entities are “highly leveraged” in the MSP context. Specifically, the agencies will likely have to consider factors such as: the types of positions the entities hold; the amount of leverage the entities maintain in such positions; and the liquidity and volatility of the entities positions.

The MSP definition in the Act provides for an exclusion for positions that are held for hedging or mitigating commercial risk. It is possible, to the extent a bank’s swaps activities are solely for the purpose of hedging banking risk (e.g., interest rate swaps, credit swaps, etc.), that a bank may be permitted to claim an exclusion from the definition of MSP. Again, the rulemaking process by the agencies will be essential in determining what types of banking activities will lead to MSP requirements and whether potential exclusions may be available.

Banks Divesting Certain Swaps Activities

One of the most contentious and important sections of the
Act forces banks to move certain types of swaps activity out of the bank and to their affiliates. Specifically, the Act provides that banks would have to push out trading in any products that are not related to “hedging and other similar mitigating activities directly related to the insured depository institution activities.” As a result, banks will most likely be able retain operations in products such as interest rate swaps and foreign exchange swaps, related to the bank’s lending activities. By contrast, it is also likely that banks would have to cease trading in products such as un-cleared commodities, most metals, energy swaps, and agricultural products. Title VII permits depository institutions up to 24 months after the Title’s enactment to comply with the push out provisions and move their swaps activities to their affiliates if necessary. Again, the CFTC and SEC will be tasked with determining what types of activities and products will be considered legitimate hedging and which ones will be required to be divested. The bank affiliates that house the non-hedging swaps activities will likely be required to maintain their own capital and adhere to the various regulatory requirements of the Act applicable to swap dealers and MSPs.

Also of note, the swap push out section provides that banks are not subject to the divestiture requirement if they are simply MSPs and not swap dealers. This is further evidence that the breadth of both the MSP and swap dealer definition will have a significant impact on how banks will need to structure their derivatives trading.

**Banks Must be Proactive in the Rulemaking Process**

The new legislation of the OTC markets will substantially change the costs associated with trading derivatives products as well as regulatory requirements for participants in OTC transactions. As discussed, the extent to which costs and regulatory requirements will increase will depend on how the CFTC, SEC and federal banking regulators decide to interpret the new legislation. Rulemakings on most of the provisions of Title VII are required to be released by the agencies no later than 360 days after Title VII’s enactment. If the agencies determine to take an expansive approach in drafting the rules many participants, including banks, may be required to register with the CFTC or SEC to participate actively in the derivatives market. The costs and ongoing regulatory compliance associated with OTC trades will also likely increase substantially for banks. Therefore, banks would be advised to consider participating in the rulemaking process to help ensure that agencies adopt a reasonable and balanced approach to implementing these new regulatory requirements.

Arnold & Porter is available to respond to questions raised by recent or forthcoming legislation, or to help guide your business towards legislative and regulatory solutions. We can assist in determining how pending bills and regulations may affect your business and industry. For further information, please contact your Arnold & Porter attorney or:

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Dodd-Frank Act Addresses Systemic Risk

One of the most-cited impetuses behind the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) efforts has been the need to curtail the systemic risk potentially posed by large, interconnected firms—both those traditionally subject to financial regulation, such as bank holding companies, as well as certain nonbank financial companies. These types of firms, due to their influence and impact on the nation’s financial stability, may be considered “too big to fail.” In response to these concerns, Title I of the Act, entitled the “Financial Stability Act of 2010,” creates a framework to identify, monitor, and address potential risks to financial stability and to regulate complex companies engaged in activities and practices determined to pose systemic threats to the US economy. Nonbank financial companies deemed systemically significant may be brought under the regulatory oversight of the Federal Reserve Board (Federal Reserve), and, along with large bank holding companies already subject to Federal Reserve supervision under the Bank Holding Company Act of 1956, as amended (Bank Holding Company Act), be required to meet heightened prudential standards, refrain from engaging in certain financial activities, restrict their ability to merge with or acquire other entities, or even sell or transfer specific assets, all in order to prevent or remove “grave threat[s] to the financial stability of the United States.”

The Financial Stability Oversight Council
At the core of Dodd-Frank’s systemic risk monitoring and mitigation framework lies the Financial Stability Oversight Council (FSOC), chaired by the Secretary of the Treasury (Treasury Secretary) and consisting of 15 members: 10 voting and 5 nonvoting. The voting members, in addition to the Treasury Secretary and an independent member with insurance expertise appointed by the President, are the heads of:

- The Federal Reserve;
- The Office of the Comptroller of the Currency;
- The Securities and Exchange Commission;
The Federal Deposit Insurance Corporation (FDIC);
The Commodity Futures Trading Commission;
The Federal Housing Finance Agency;
The National Credit Union Administration Board; and
The newly created Consumer Financial Protection Bureau.

In addition to the 10 voting members, the nonvoting members are the Director of the Federal Insurance Office established under Title V of the Act, a state insurance commissioner, a state banking supervisor, a state securities commissioner, and the Director of the Department of the Treasury’s newly established Office of Financial Research.

The FSOC is charged with identifying systemic risks and gaps in regulation, making recommendations to regulators to address threats to financial stability, and promoting market discipline by eliminating the expectation that the US federal government will come to the assistance of firms in financial distress. The FSOC will be supported by the newly established Office of Financial Research, whose accountants, economists, lawyers, former supervisors, and specialists will gather and analyze data critical to the FSOC’s mission. While the FSOC holds no independent enforcement powers, given the breadth of the scope of its authority, its impact on all who engage in or with the financial services sector could be significant.

Defining Systemic Risk
Under the standards set forth in section 113 of the Act, a US or foreign “nonbank financial company” poses a potential systemic risk if “material financial distress at the [company], or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the [company], could pose a threat to the financial stability of the United States.” A US nonbank financial company is a company formed in the United States (except for a bank holding company and certain other exempt entities such as a national securities exchange) that is “predominantly engaged in financial activities.” A foreign nonbank financial company is a company formed outside the United States (except for a foreign bank that is treated as a bank holding company) that is predominantly engaged in financial activities in the United States, including through a US branch.

A company is “predominantly engaged in financial activities” if 85 percent or more of the consolidated gross revenues or assets of all the company’s constituent entities are “financial in nature” as defined in Section 4(k) of the Bank Holding Company Act. Financial activities include banking, securities, insurance, and passive merchant banking activities.

The task of designating a particular nonbank financial company as systemically significant falls to the FSOC, which must make this determination by a two-thirds vote, including the affirmative vote of the Treasury Secretary. In making this determination of systemic risk, the FSOC is directed to consider:

- The extent of the company’s leverage;
- The extent and nature of the company’s off-balance-sheet exposures;
- The extent and nature of the company’s relationships and transactions with other significant nonbank financial companies and significant bank holding companies;
- The importance of the company as a source of credit to households, businesses, and state and local governments, and as a source of liquidity for the US financial system;
- The company’s importance as a source of credit for low-income, minority, or underserved communities and the effect that failure of such a company would have on the availability of credit in such communities;
- The proportion of assets that are managed rather than owned by the company as well as the composition and diversity of those managed assets;
- The nature, scope, size, scale, concentration, interconnectedness, and mix of the company’s activities;
- The existing regulation of the company by one or more of the primary financial regulatory agencies;
- The amount and nature of the company’s financial assets and liabilities, including the degree of its reliance on short-term funds; and
Any other risk-related factors the FSOC deems appropriate.\(^1\)

The determination that a nonbank financial company is of systemic risk, and thus should be supervised by the Federal Reserve, must be made by the FSOC on a company-by-company basis. It is expected that the FSOC will issue regulatory guidance on how these factors will be weighted in a systemic risk determination.

In order to prevent evasion of the requirements of Title I, if the FSOC, on its own initiative or at the request of the Federal Reserve, determines, with a two-thirds vote, including the affirmative vote of the Treasury Secretary, that material financial distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of (i) the financial activities conducted directly or indirectly by any US company (even one that does not meet the definition of a “financial company” noted above); or (ii) the financial activities conducted in the United States by a non-US company, would pose a threat to the financial stability of the United States, based on consideration of the same factors discussed above, and that the company is organized or operates in such a manner so as to “evade” the application of Title I, then the financial activities of that company also will be supervised by the Federal Reserve in the same manner as the nonbank financial companies deemed by the FSOC to be of systemic risk.

If the FSOC makes such an “anti-evasion” determination, the company in question may elect to establish an intermediate holding company through which to conduct the financial activities that would otherwise subject the entire company to Federal Reserve supervision.

In addition, the Federal Reserve may require a company determined to be of systemic risk to establish such an intermediate holding company to segregate its financial activities. Moreover, the Federal Reserve must require that such a company establish an intermediate holding company if the Federal Reserve determines that such action is necessary to monitor appropriately the company’s financial activities and to ensure that Federal Reserve supervision does not extend to the company’s nonfinancial commercial activities. This intermediate holding company would be supervised by the Federal Reserve and be subject to the prudential standards applicable to nonbank financial companies under Federal Reserve oversight. The Federal Reserve also may promulgate regulations establishing restrictions or limitations on transactions between the intermediate holding company and its affiliates in order to prevent unsafe and unsound practices.

The FSOC must provide a company that is under review for a systemic risk determination (whether for a nonbank financial company or another company under the anti-evasion provision) with written notice of the proposed determination. The notice must describe the basis for the designation and the effect of such designation, including the possibility of heightened prudential requirements. Within 30 days of receipt of such notice, the nonbank financial company may request a written or oral hearing before the FSOC to protest the designation. This hearing must be scheduled within 30 days of receipt of the request, and, within 60 days of the hearing, the FSOC must issue its final determination with an explanation of its decision. If the nonbank financial company does not contest the designation, the FSOC must issue a final decision within 40 days of receipt of the initial notice.

These administrative notice-and-hearing procedures may be modified or waived if the FSOC, by a two-thirds vote, including the affirmative vote of the Treasury Secretary, concludes that such modification or waiver is “necessary or appropriate to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the United States.” Under these conditions, the FSOC must alert the nonbank financial company within 24 hours of the emergency exception, after which the company will have 10 days to request a hearing; the hearing will then be scheduled within 15 days of receipt of the request, with final determination to be issued by the FSOC within 30 days of the hearing.

All determinations that a nonbank financial company is of systemic risk must be reevaluated at least annually, and the

\(^1\) With respect to a foreign nonbank financial company, the FSOC will consider the same factors as for a US nonbank financial company, and also the extent to which the company is subject to prudential standards in its home country. In addition, the Council also will evaluate the specific impact of the company’s activities on the US economy, including the amount and nature of the company’s US financial assets and liabilities, and any other factors the FSOC deems appropriate.
FSOC may, by a two-thirds vote, including the affirmative vote of the Treasury Secretary, decide to rescind any such determinations. In addition, a nonbank financial company may appeal any final determination in the district court of its home office, or in the District Court of the District of Columbia, requesting an order requiring that the final determination be rescinded. The district court will review the FSOC’s decision under the “arbitrary and capricious” standard.

In addition, the Act requires the Federal Reserve, in consultation with the FSOC, to issue regulations establishing “safe harbor” criteria for exempting certain types or classes of US or foreign nonbank financial companies from Federal Reserve supervision. These safe harbor rules are to be reexamined at least every five years.

In addition to the extensive latitude granted to the FSOC in making firm-by-firm systemic risk decisions, the Act authorizes the FSOC to recommend that the primary financial regulatory agencies (defined as the federal banking, securities, commodities, and housing regulators and state insurance commissioners) impose new or more stringent standards or restrictions on certain classes and types of financial activities engaged in by bank holding companies (with no limitation on size) and nonbank financial companies under their respective jurisdictions. Thus, if the FSOC determines that “the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities,” the FSOC may recommend that the primary financial regulatory agency issue rules or standards to restrain and control such practices. Any company subject to the jurisdiction of a primary financial regulatory agency potentially could become subject to the FSOC’s recommendations regarding this particular type of financial activity (even if the company itself is not determined to be of systemic risk).

As noted above, the Act appears to presume that “large bank holding companies”—defined as bank holding companies with more than $50 billion in total consolidated assets as of January 1, 2010—pose potential systemic risks to the country’s financial stability and thus should be regulated by the Federal Reserve under a framework similar to that used for nonbank financial companies determined to be of systemic risk, rather than under the usual supervisory and regulatory system for a bank holding company under the Bank Holding Company Act. According to data compiled from bank holding company reports to the Federal Reserve, there were approximately 36 bank holding companies that held assets in excess of $50 billion as of January 1, 2010, and therefore would be subject to such treatment, including the possibility of heightened regulatory requirements and activity restrictions.

The Act also includes the so-called “Hotel California” provision: if a large bank holding company (i.e., a bank holding company having total consolidated assets equal to or greater than $50 billion as of January 1, 2010) that received Troubled Asset Relief Program (TARP) assistance through the Capital Purchase Plan ceases to be a bank holding company by shedding its banking subsidiaries and reverting to nonbank status, it (and any successor entity) still will be subject to Federal Reserve regulation as a nonbank financial company determined to be of systemic risk.

Impact of Systemic Risk Designation

**Heightened Prudential Standards.** Once an institution has been deemed to present a potential systemic risk to the US’s financial stability, the Federal Reserve may, with or without the recommendation of the FSOC, subject it to heightened prudential standards. These heightened prudential standards include more stringent risk-based and contingent capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure report requirements, concentration limits, disclosure rules, short-term debt limits, and overall risk management requirements. These enhanced standards may differ among institutions on an individual basis or by category of company or activity depending upon the level of risk the Federal Reserve determines an institution poses to US financial stability.

In formulating the new stringent liquidity and capital requirements for large bank holding companies and systemically significant nonbank financial companies, members of the FSOC and...
the Federal Reserve are likely to track the global capital and liquidity standards being negotiated and established for banks through the so-called “Basel III” process and use those standards as the base from which to develop these new standards. While these Basel III proposals will not be finalized by the Basel Committee on Banking Supervision of the Bank for International Settlements until the end of the year, the negotiations are expected to result in an international harmonization of banking rules around more stringent capital requirements and definitions and liquidity levels.

Restrictions on Activities. Moreover, if the Federal Reserve determines that a large bank holding company or nonbank financial firm determined to be of systemic risk presents a “grave” threat to US financial stability, the FSOC, by a two-thirds vote, may approve the Federal Reserve’s decision to:

- Restrict the company’s ability to merge with, acquire, consolidate with, or otherwise become affiliated with another company;
- Limit the company’s ability to offer certain financial products;
- Require that the company cease engaging in certain activities; or
- Impose restrictions on the manner in which the company engages in certain activities.

In addition, if the aforementioned actions are considered inadequate to address the threat presented, the Federal Reserve may, with the FSOC’s approval, require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities.

Early Remediation. In order to minimize the possibility that financial distress at a systemically significant company will lead to insolvency and eventually undermine the country’s financial stability, large bank holding companies and nonbank financial companies determined to be of systemic risk may be subject to regulations, promulgated by the Federal Reserve in consultation with the FSOC and the FDIC, that provide for early remediation in the event that such financial distress occurs. Similar to prompt corrective action regulations in place for banking organizations, these remediation regulations must define specific prudential measures for the company to take, such as increasing capital and liquidity, that grow increasingly stringent as the company’s financial condition declines. However, the US government is prohibited from providing financial assistance to the company.

Stress Tests. Title I also requires the Federal Reserve, in coordination with the appropriate primary financial regulatory agency, to conduct annual stress tests on each nonbank financial company determined to be of systemic risk and each large bank holding company to determine if the company has the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions. Each of these companies also must conduct a stress test of its own semi-annually.

All other financial companies with consolidated assets of at least $10 billion that are regulated by a primary federal financial regulatory agency must conduct annual stress tests. The methodology for these self-stress tests will be determined by regulations issued by each primary federal financial regulatory agency, in coordination with the Federal Reserve and the Federal Insurance Office.

Living Wills. Nonbank financial companies determined to be of systemic risk and large bank holding companies must develop and submit to regulators a resolution plan that has been referred to as a “living will.” The purpose of the resolution plan is to provide for the rapid and orderly resolution of the company in the event of material financial distress or failure and must include:

- Information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company;
- Full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company;
- Identification of any cross-guarantees tied to different securities, identification of major counterparties, and a process for determining to whom the collateral of the company is pledged; and
- Any other information that the Federal Reserve and the FDIC may jointly require by rule or order.
The Federal Reserve is to require each nonbank financial company determined to be of systemic risk and each large bank holding company periodically to submit a copy of its resolution plan to the Federal Reserve, the FSOC, and the FDIC. The FSOC may make recommendations to the Federal Reserve concerning implementation of this requirement.

The Federal Reserve and the FDIC are required to review each plan, and if, after review, the two agencies jointly determine that a particular plan is either not credible or would not facilitate an orderly resolution of the company under the US Bankruptcy Code, the agencies must notify the company of the deficiencies of the plan and require the company to resubmit a revised plan by a specified date that will demonstrate to the agencies that its plan indeed is credible and would result in an orderly resolution under the US Bankruptcy Code, including details of any proposed changes in business operations and corporate structure to facilitate implementation of the plan.

If the company fails to meet that deadline or again submits an insufficient plan, the Federal Reserve and the FDIC may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until the company submits a plan that meets the approval of the agencies. If after two years of these more stringent requirements, the company still has not provided a resolution plan satisfactory to the Federal Reserve and the FDIC, the two agencies jointly, and in consultation with the FSOC, may impose their own resolution plan on the company by jointly requiring the company to divest assets or operations identified by the two agencies in order to facilitate an orderly resolution of the company.

In the event of a dissolution of the company, the resolution plan is not binding on a bankruptcy court, the FDIC, or any entity that is authorized or required to liquidate or otherwise resolve the company, or any subsidiary or affiliate of the company. There also is no private right of action based on any resolution plan submitted by a company.

The Federal Reserve and the FDIC have up to 18 months after the date of the Act’s enactment to promulgate rules implementing these requirements regarding the preparation and submission of resolution plans.

In addition, based upon the results of the stress tests mentioned above, the Federal Reserve could require a nonbank financial company determined to be of systemic risk or a large bank holding company to update its resolution plan if the Federal Reserve deems it appropriate.

Implementation

Will the systemic risk determination process and the ability of the Federal Reserve and other federal regulators to intervene proactively in these nonbank companies in order to address material risks to the US financial system avert another economic crisis such as the one that started two years ago? Perhaps not completely, but the regulators now will have at their disposal more tools than the federal government has had in the past to handle a situation with a financial company that is in financial distress. As we have seen in the past two years, at times the federal government has appeared to have only two choices: either infuse massive amounts of taxpayer money into systemically significant companies (such as AIG), or stand by and let such a company file for bankruptcy protection (such as Lehman Brothers). If all the new tools provided under Title I still prove ineffective to deal with a systemically significant yet troubled financial company, Title II of the Act provides for the US government to close and liquidate the troubled company.

One comment made about the new systemic risk provisions in Title I is that many of the new authorities are not really new. With respect to nonbanking financial companies that are not otherwise subject to ongoing government oversight and supervision, the power of the Federal Reserve to supervise such an entity certainly is new. For regulated nonbank financial companies such as insurance companies and securities firms, some of the requirements could be within the current supervisory authority of insurance and securities regulators but likely not to the extent that the Act will provide to the Federal Reserve.

However, for bank holding companies and their insured depository institutions, many of these requirements are not
new. In particular, the imposition of more stringent prudential standards such as capital and liquidity, could have been imposed by the Federal Reserve and other banking regulators under their current powers, on a case-by-case basis, through enforcement orders issued to ensure the safety and the soundness of the particular bank holding company and its insured depository institution companies. Other requirements, such as the resolution plan requirements and the “Hotel California” provision, are new.

There has been criticism of the banking regulators that their failure to adequately supervise the institutions under their jurisdiction, and to make full use of their supervisory and enforcement powers, led in part to the recent crisis. These critics may be right in part. If nothing else, the Act forces the Federal Reserve to be a more effective systemic risk regulator, gives the Office of the Comptroller of the Currency and the FDIC authority over additional banking institutions, and abolishes the Office of Thrift Supervision, which had been perceived by some as the least effective federal banking regulator preceding the recent crisis.

Another issue left open in the Act is whether the definition of “predominantly engaged in financial activities” leaves outside the ambit of the Act companies that should be subject to review by the Council to determine their systemic significance. Large conglomerates with subsidiaries that engage in significant financial activities may, dollar-wise, have very significant revenues or assets from financial activities, yet still fall below the 85 percent threshold. Those companies still could pose a systemic risk, but it will not be the FSOC that will have the authority to determine it.

As much of the systemic risk determination process is required to be fleshed out in regulations, the regulatory rulemaking process is the next step for the industry to tackle. While the legislative battle is over, the regulatory battle is just beginning.

Arnold & Porter, LLP has long represented large bank holding companies, foreign banks and financial services companies in resolving their regulatory and supervisory issues. We have been assisting such companies during the legislative process in understanding the implications of the Act and in various changes that were made or attempted to be made to the legislation during the last several months. We are available to respond to questions raised by the Act, or to help guide your business in responding to it. For further information, please contact your Arnold & Porter attorney or:

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Banking Entities, Other Significant Financial Service Companies to Face Significant Restrictions Under New “Volcker Rule”

The Dodd-Frank Wall Street Reform and Consumer Protection Act features a number of significant new restrictions on financial services firms. Banking entities and other financial service companies should be especially attentive to the so-called “Volcker Rule,” which will substantially restrict their proprietary trading and investing activities, as well as their relationships with hedge funds and private equity funds.

Background
The Volcker Rule appears as Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), and, upon enactment, will become new Section 13 of the Bank Holding Company Act of 1956 (Bank Holding Company Act) and new Section 27A of the Securities Act of 1933. In brief, it would, subject to a number of limited exceptions, prohibit any “banking entity” from:

- Engaging in proprietary trading; or
- Sponsoring or investing in hedge funds and private equity funds.

For purposes of the Volcker Rule, a “banking entity” is defined as any insured depository institution, any company that controls such an institution, any company treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978 (i.e., any non-US bank with a branch or agency office in the United States), and any affiliate or subsidiary of any such entity.\(^1\)

In addition, a systemically significant nonbank financial company subject to supervision by the Federal Reserve Board (Federal Reserve)\(^2\) that engages in such activities will be subject to rules establishing enhanced capital standards and quantitative limits on these types of activities, but such activities will not be prohibited.

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1 In general, institutions that function solely in a trust or fiduciary capacity will not be deemed “banking entities.”

2 The Act provides that nonbanking financial companies meeting specified criteria can be designated as “systemically significant” and be subject to supervision by the Federal Reserve.
All of the principal financial regulators (i.e., the federal banking agencies, the Securities and Exchange Commission and the Commodity Futures Trading Commission) must adopt rules to put these restrictions into effect. In general, the Volcker Rule’s requirements will be effective on the earlier of two years from the date of enactment, or one year from the issuance of substantive regulations. An initial set of regulations, however, is required to be issued by the Federal Reserve within six months of enactment, and is to implement a phase-in schedule of at least two years for entities subject to the Volcker Rule to divest of prohibited holdings or positions. Regulators must allow such entities a reasonable time to divest themselves of illiquid assets, so under some circumstances, compliance periods may extend into 2022. This is, however, only for cases involving illiquid investments, and as permitted by the Federal Reserve. In most cases, investments and activities must be conformed within two years of the effective date of the Volcker Rule provisions, with the possibility of three one-year extensions by the Federal Reserve.

I. Proprietary Trading Restrictions
Not all proprietary transactions would be subject to the restrictions on proprietary trading. The Volcker Rule defines “proprietary trading” to mean engaging as a principal for an entity’s “trading account” in purchases or sales of securities, derivatives, commodity futures, options on such instruments, or any other instrument identified by regulators. A “trading account,” in turn, is defined as an account used to take positions “principally for the purpose of selling in the near term,” or “with the intent to resell in order to profit from short-term price movements,” or any other account defined by regulation.

The legislation also specifies certain activities that would nevertheless be permitted for banking entities, subject to limits adopted by regulators. These activities include:

- Transactions in government securities, agency securities, and state and municipal obligations;
- Transactions in connection with underwriting or market-making-related activities to the extent they are “designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties”;
- Risk-mitigating hedging activities designed to reduce specific risks of a firm’s individual or aggregated positions or holdings;
- Transactions on behalf of customers;
- Investments in small business investment companies and certain enterprises devoted to the public interest;³
- Transactions by any regulated insurance company directly engaged in the business of insurance for the general account of the company or by its affiliates (also for the general account of the company), as permitted by relevant state insurance company investment laws and regulations (subject to additional review by the appropriate Federal banking agencies, after consultation with the Act’s new systemic risk council and state insurance commissioners);

³ It appears that investments pursuant to this “public interest” exception could include those of a type that would allow banks to claim Community Reinvestment Act credits.

- Other activity as permitted by regulation.

Such activities would be permitted so long as they would not involve a material conflict of interest (as defined by regulation) between the banking entity and its clients, customers, or counterparties or result in a high degree of risk to the banking entity or US financial stability. Systemically significant nonbank financial companies supervised by the Federal Reserve would also be permitted to engage in these activities, subject to enhanced capital requirements and quantitative limitations, including diversification requirements, as regulators deem appropriate.

⁴ 12 U.S.C. § 1843(c)(9), (13).
II. Restrictions on Relationships with Hedge Funds and Private Equity Funds

The Volcker Rule will, subject to limited exceptions outlined below, prohibit banking entities from sponsoring or investing in “private equity funds” or “hedge funds.” It will also subject systemically significant nonbank financial companies supervised by the Federal Reserve to enhanced capital requirements and quantitative limits if they engage in such fund-related activities. The legislation defines “private equity funds” and “hedge funds” as those that are not “investment companies” pursuant to Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, “or such similar funds as [regulators] may, by rule…determine.” Thus, regulators could define other types of pooled investment vehicles as “private equity” or “hedge” funds in addition to those specified. “Sponsoring” a fund means to:

- Serve as a general partner, managing member, or trustee of a fund;
- Select or control (or to have employees, officers, directors, or agents who constitute) a majority of the directors, trustees or management of a fund; or
- Share a name or a variant of a name with a fund.

Again, the legislation provides exceptions, subject to limits adopted by regulators. Specifically allowed activities include:

- Organizing and offering a fund, even to the extent of sponsorship, as long as the fund and entity do not share a name or name variant, and the following conditions are met:
  - The fund is organized and offered only in connection with the provision of bona fide trust, fiduciary or investment advisory services;
  - The banking entity may not acquire or retain an equity, partnership or other ownership interest in the fund;
  - However, “de minimis investments” (as defined by regulators) would be permitted. Such investments would have to be immaterial to a banking entity, could not, in the aggregate, exceed 3 percent of a banking entity’s Tier I Capital, and could not exceed 3 percent of the total ownership interests in any one fund. Subject to similar restrictions, a banking entity would also be permitted to make “seed” investments (i.e., initial investments of up to 100 percent of a fund for the purpose of establishing it and providing it with sufficient initial equity for investment to permit it to attract unaffiliated investors). The banking entity would then be required to reduce or dilute its investment to permitted levels within one year after the fund’s establishment (with the possibility of a two-year extension).
  - The banking entity, and its affiliates, comply with restrictions on transactions with such fund under Sections 23A and 23B of the Federal Reserve Act, as described below;
  - The banking entity may not guarantee the fund, or any fund in which the fund invests, against losses or to a minimum performance;
  - The banking entity discloses to prospective and actual investors, in writing, that the fund’s losses are borne solely by investors and not by the banking entity, and otherwise complies with rules that the regulators may issue to ensure that losses are so borne;
  - No director or employee of the banking entity may have an ownership interest in the fund, unless they directly provide investment advisory or other services to the fund.
- Acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring, a hedge fund or private equity fund by a banking entity solely outside of the United States pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, provided that no ownership interest in such fund is offered for sale or sold to a US resident and that the banking entity is not directly or indirectly controlled by a banking entity organized in the United States;
Other activities that regulators have determined would promote safety and soundness of the entity and financial stability as a whole.

Again, such activities would be permitted so long as they do not involve a material conflict of interest (as defined by regulation) between the banking entity and its clients, customers or counterparties, or would result in exposure to a high degree of risk to the bank or US financial stability. Systemically significant nonbank financial companies supervised by the Federal Reserve would be permitted to engage in these activities subject to enhanced capital requirements and quantitative limitations, including diversification requirements, as regulators deem appropriate.

III. Other Limitations on Relationships with Hedge Funds and Private Equity Funds

If a banking entity serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or organizes such a fund pursuant to the exception described above, then that banking entity and its affiliates would be:

- Prohibited from entering into a “covered transaction” as defined by Section 23A of the Federal Reserve Act. Thus, the banking entity and its affiliates could not, among other things, extend credit to the fund, or enter purchase and repurchase agreements with the fund.

- Subject to Section 23B of the Federal Reserve Act. Thus, in certain other transactions between the banking entity (or its affiliate) and the fund, the terms must be not less favorable to the banking entity than those prevailing between non-affiliates, and restrictions apply to fiduciary investments in the fund.

If a nonbank financial company supervised by the Federal Reserve engages in similar activities, it will be subject to additional capital requirements and restrictions to address the same types of conflicts of interest that banking entities would face in such transactions.

IV. Loan Securitization

The Volcker Rule does not limit or restrict a banking entity’s ability (or the ability of a nonbank financial company supervised by the Federal Reserve) to sell or securitize loans. On the other hand, other portions of the Act would affect securitizations. For example, pursuant to a new Section 27B of the Securities Act of 1933, an underwriter, placement agent, initial purchaser, a sponsor, or any affiliate thereof could not engage in any activity that would result in a material conflict of interest with any investor in the securitization for a period of one year. The Act would also require lenders and loan securitizers to retain credit risk in asset-backed securities that they package or sell.

Challenges of Implementation

The Volcker Rule will have significant effects on banking entities and firms that find themselves under Federal Reserve supervision, some of which may not be intended. For example, prohibiting banking entities from investments in hedge funds is intended to reduce risks for such firms. However, many hedge fund investments are profitable for banks, and hedge funds are often designed to be counter-cyclical or to produce absolute returns. By disallowing investments in hedge funds, the Volcker Rule may actually increase banking entities’ exposure to market volatility and close them off from a source of revenue.

Implementation of the Volcker Rule will also present many challenges. The scope and impact of the Volcker Rule will ultimately be determined by how the statutory definitions and other provisions are interpreted and implemented through regulations promulgated by relevant financial regulatory agencies. Banking entities (as well as other financial firms that may anticipate Federal Reserve supervision) should be prepared to engage in the regulatory rulemaking process and interact with regulators as rulemakings begin.


6 Nonetheless, an exception would apply that would permit a banking entity, under certain conditions, and if allowed by the Federal Reserve, to enter into prime brokerage transactions with such a fund.

One of many challenges that regulators will face is determining how to implement the Volcker Rule's prohibition on short-term proprietary trading. Bank holding companies have historically had authority to make investments in equity securities under Sections 4(c)(5) and 4(c)(6) of the Bank Holding Company Act. Also, Section 4(k) of the Bank Holding Company Act permits bank holding companies that are treated as financial holding companies to make merchant banking investments. In addition, the National Bank Act (as implemented by the Office of the Comptroller of the Currency (OCC)) permits national banks to make certain types of “bank-eligible” investments. To some extent, the Volcker Rule could be read to override these existing investment authorities, because it states that, notwithstanding any other provisions of law, its prohibitions and restrictions will apply “even if such activities are authorized for a banking entity.” Given this broad language, regulators may choose to adopt rules that define short-term trading in ways that could curtail otherwise permissible long-term investing activities. On the other hand, the prohibition on short-term trading does not appear to be meant to prohibit long-term proprietary investments. Indeed, one of the exceptions to the proprietary trading restriction explicitly permits hedging for a firm’s individual or aggregated holdings, which, at least arguably, contemplates maintenance of the status quo. However, it should be noted that it is unclear how the Volcker Rule’s restrictions, including this exception for hedging activities, will interact with the provisions in Title VII of the Act known as the “Swaps Push-Out Rules,” which restrict the ability of banks and bank holding companies from engaging in certain types of derivatives activities. In any event, as regulators move to adopt regulations under the Volcker Rule, the parameters of “short-term trading” will be subject to interpretation, so banking entities and other firms must be prepared to monitor events and communicate with federal agencies on this issue.

Special considerations will also apply in the context of international banking. Under Sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act, bank holding companies (including non-US banks regulated as such) may, as permitted by the Federal Reserve, acquire ownership or control of nonbanking companies that do not do business in the United States (except as an incident to their non-US operations), or that are organized outside of the United States and that primarily conduct their business outside of the United States.

The Volcker Rule, as noted above, stipulates that activities conducted by a banking entity pursuant to these authorizations will be permitted, notwithstanding its restrictions on proprietary trading and relationships with private equity and hedge funds, as long as the activities are conducted “solely outside the United States” and the banking entity conducting these activities is not directly or indirectly controlled by a banking entity organized in the United States. At the same time, the legislation calls for regulators to issue rules, including rules covering such international activities and investments, for the preservation of financial stability. It remains to be seen how regulators will craft such rules and define new parameters of acceptable activity. For example, Sections 4(c)(9) and 4(c)(13) have been interpreted and implemented by the Federal Reserve in a manner which permits a certain amount of incidental activity in the United States. It is unclear whether the Volcker Rule’s requirement that any otherwise prohibited proprietary trading or fund-related activity conducted under these exceptions be conducted “solely outside the United States” will be interpreted by regulatory agencies as prohibiting any such previously permissible incidental US activity. On a similar note, it also remains to be seen how the regulators will apply the exemptions for proprietary trading and fund-related activities conducted outside the US under Sections 4(c)(9) and 4(c)(13), which have historically been applicable only to bank holding companies, in the cases of companies that are not bank holding companies. For example, it is unclear whether these exemptions from the Volcker Rules restrictions will be applicable to proprietary

trading or fund-related activities conducted entirely outside the United States by a foreign company that controls a US industrial loan company, thrift institution or non grandfathered savings and loan holding company.

Arnold & Porter is available to respond to questions raised by recent or forthcoming legislation, or to help guide your business towards legislative and regulatory solutions. We can assist in determining how pending bills and regulations may affect your business and industry. For further information, please contact your Arnold & Porter attorney or:

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The Rulemakings Process Has Begun: The Dodd-Frank Act Requires More Than 180 Rulemakings

This advisory provides a preliminary overview of some of the more notable agency rulemakings that are either required or permitted by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), which was signed into law on July 21, 2010. The Act requires the federal financial regulators to promulgate more than 180 new rules. The Act also permits the promulgation of more than 75 additional rules. Arnold & Porter LLP has prepared a detailed chart of the rulemakings in the Act. Arnold & Porter has also prepared an overview of the Act itself. We also have a compendium of advisories on a variety of topics. Readers can also access a current copy of the financial reform legislation, as well as other information on recent government programs, on our regularly updated Financial Regulatory Chart.

We believe the ultimate impact of the Act on the financial industry will be shaped largely by the outcome of these rulemakings. Because the rules will be issued over a period of time, the actual effect of the Act therefore will be known only in the coming months and years. In addition, entities affected by the Act will have an opportunity to comment on the new regulations as they are drafted and finalized by the regulators, making participation in the process critical. Arnold & Porter attorneys are available to assist you with assessing the impact of the legislation on your business and participating in the comment process.

Title I. Financial Stability

Title I, which became generally effective upon enactment of the Act, creates a Financial Stability Oversight Council (FSOC) to address systemic risk in the financial system and an Office of Financial Research (OFR) to support the FSOC in carrying out its duties. Title I sets forth the following required and permissive rulemakings, which, unless specified otherwise, either have no specific timeframe or must be issued within 18 months of the Transfer Date:

1 The Transfer Date refers to the date that is one year after enactment of the Act, extendable to 18 months after enactment (i.e., July 21, 2011 extendable to January 21, 2012). On the Transfer Date, pursuant to Title III of the Act, the Board of Governors of the Federal Reserve System assumes responsibility for supervision of savings and loan holding companies and their nonbank subsidiaries, while federal savings associations and state savings associations become the responsibility of the Office of the Comptroller of the Currency.
The FSOC must adopt rules necessary for the FSOC’s conduct of business, including rules of organization, procedure, or practice.

The FSOC may recommend to the federal banking agencies that they apply new or heightened standards and safeguards for a financial activity or practice, and it must provide notice to the public and an opportunity to comment on any such recommendation. In turn, the federal banking agencies must impose the recommendations or explain in writing why they will not. No timeframe is specified either for the FSOC to recommend or for the federal banking agencies to impose the recommendations, but if the federal banking agencies choose to reject the recommendations they must do so within 90 days.

The Board of Governors of the Federal Reserve System (Federal Reserve) must issue, no later than 18 months after the Transfer Date, rules establishing prudential standards applicable to nonbank financial companies supervised by the Federal Reserve and bank holding companies with total consolidated assets equal to or greater than $50 billion in order to prevent or mitigate risks to financial stability.

The Federal Reserve must promulgate, no later than 18 months after the Transfer Date, rules regarding resolution plans and credit exposure reports, leverage limitations, early remediation of financial distress, the establishment of intermediate holding companies, and exemptions from its supervision.

The Federal Reserve must prescribe limits on credit exposures of nonbank financial companies supervised by the Federal Reserve or a bank holding company with total consolidated assets of $50 billion or more. This rulemaking must occur no later than 18 months after the Transfer Date, but the regulations may not take effect until three years after the Transfer Date, which restriction is extendable an additional two years by the Federal Reserve.

The Federal Reserve must promulgate rules regarding the establishment of risk committees no later than one year after the Transfer Date, to take effect no later than three months after that.

The Federal Reserve may issue, no later than 18 months after the Transfer Date, regulations regarding contingent capital, periodic public disclosures, short-term debt limits, and transactions between an intermediate holding company or a nonbank financial company supervised by the Federal Reserve and its affiliates.

The federal banking agencies must promulgate regulations regarding stress tests and establishing leverage and risk-based capital requirements for certain financial institutions. No timeframe is specified for this rulemaking.

The OFR, in consultation with the Chairperson of the FSOC (the Treasury Secretary), must issue rules, regulations, and orders to the extent necessary to collect and provide data to the FSOC and member agencies, standardize the types and formats of data reported and collected, and assist member agencies in determining the types and formats of data authorized by the Act to be collected by member agencies.

Title II. Orderly Liquidation Authority
Title II mandates a number of rulemakings that impact financial companies and brokers or dealers who are considered to be in default or in danger of default. Title II allows the Federal Deposit Insurance Corporation (FDIC) to place such companies into receivership if, among other criteria, their failure would have “serious adverse effects” on the financial stability of the United States. Any appointment of the FDIC as receiver for a covered financial company would terminate after a baseline period of three years (subject to extension), but the FDIC may issue specific regulations governing the termination of receiverships. The provisions of Title II became effective on July 22, 2010.

The FDIC, in consultation with the FSOC, is required to issue regulations that govern the rights of creditors and counterparties of a company placed into receivership. The FDIC is also required to enact rules that:
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- Prohibit the sale of assets in liquidation to individuals who have defaulted on obligations to covered financial companies;
- Regulate compensation paid to and activities undertaken by senior executives and directors of a company placed into receivership;
- Establish interest rates for payments of post-insolvency interest to creditors of a covered financial company;
- Govern record retention by covered financial companies; and
- Charge risk-based assessments on large financial companies to recover costs incurred in connection with the liquidation of a financial company.

With few exceptions, no deadlines for the rulemakings required under this title have been specified.

Title III. Transfer of Powers to the OCC, FDIC, and Federal Reserve

Title III transfers the rulemaking authority of the Office of Thrift Supervision (OTS) to the Office of the Comptroller of the Currency (OCC) and the Federal Reserve, effective on the Transfer Date. The OCC, FDIC, and Federal Reserve must identify existing OTS regulations that will remain in effect following the transfer of power, and publish a list of the identified regulations in the Federal Register. The FDIC, however, inherits no rulemaking authority under this title and can only identify existing policies that will remain applicable to state savings associations.

Title III splits the rulemaking authority of the abolished OTS prospectively between the Federal Reserve and the OCC. The Federal Reserve is required under this title to issue regulations applicable to savings and loan holding companies and their nonbank subsidiaries, including regulations governing transactions between savings and loan holding companies and their affiliates, as well as regulations supervising tying arrangements and credit extensions to executives, directors, and principal shareholders under the Home Owners' Loan Act. The OCC is required under this title to issue regulations applicable to savings associations, and must also amend the term “assessment base” with respect to insured depository institutions under the Federal Deposit Insurance Act. No deadlines for the rulemakings required under this title have been specified.

Title IV. Regulation of Advisers to Hedge Funds and Others

Title IV amends the Investment Advisers Act of 1940 (the Advisers Act) to impose Securities and Exchange Commission (SEC) registration, reporting, and record-keeping obligations on investment advisers to “private funds” that have assets under management in the United States of $150 million or more, subject to limited exceptions. Except as otherwise provided in Title IV, the effective date of the provisions in this title is one year after enactment (but an investment adviser to a private fund is permitted to register under the Advisers Act during the one-year transition period, subject to SEC rules). Title IV sets forth the following required and permissive rulemakings, for which there are no deadlines except as indicated below:

- The SEC must issue rules requiring investment advisers to private funds to file reports with the SEC. The SEC may also require these advisers to maintain records regarding such private funds, including information that the SEC determines is necessary for assessment of systemic risk;
- The SEC must create an exemption from registration for investment advisers that act solely as an investment adviser to private funds and that have assets under management in the United States of less than $150 million. The SEC must require such advisers to maintain records and provide the SEC with annual or other reports;
- The SEC must define the term “venture capital fund” for purposes of a registration exemption by no later than July 21, 2011, and to specify records to be provided to the SEC and reports to be maintained by such advisers (with no rulemaking deadline specified);
- The SEC must define the term “family office” for purposes of excluding “family offices” from the definition of an investment adviser;
The SEC may issue rules prescribing steps that registered investment advisers must take to safeguard client assets over which they have custody;

The SEC and the Commodity Futures Trading Commission (CFTC) must jointly issue rules, no later than July 21, 2011, to establish the form and content of reports required to be filed by private fund advisers registered under both the Advisers Act and the Commodity Exchange Act;

The SEC must adjust the net-worth standard required to qualify as an “accredited investor” so that the individual net worth of any natural person (or joint net worth with spouse) is more than $1 million, excluding the value of the primary residence, except that during the four-year period that begins July 21, 2010, any net worth standard must be $1 million, excluding the value of the primary residence;

The SEC may undertake an initial review of the definition of an “accredited investor” as it applies to natural persons, and adjust the definition following notice and comment rulemaking, except as to the net worth standard described above;

The SEC must, no earlier than July 21, 2014 and at least once every four years thereafter, undertake a review of the “accredited investor” definition in its entirety for purposes of Rule 215 of the Securities Act of 1933 as the term applies to natural persons, and the SEC may make adjustments as it deems appropriate after notice and comment rulemaking; and

The SEC must make inflation adjustments to the “qualified client” standard in any SEC rule under Section 205(e) of the Advisers Act not later than July 21, 2011, and every five years thereafter.

Title V. Insurance
Title V establishes a Federal Insurance Office (FIO), and gives the Treasury Secretary the authority to issue orders, regulations, policies, and procedures to carry out the functions of the FIO, to facilitate the collection of information from insurers and affiliates, and to preempt certain state insurance measures. Title V also provides that the states adopt nationwide uniform requirements regarding the payment and allocation of premium taxes. We note that, generally, many of the provisions in Title V became effective on July 22, 2010, while some of the Title V provisions will become effective July 22, 2011.

Title V authorizes the states to enter into compacts or establish procedures to facilitate the payment and allocation of premium taxes for nonadmitted insurance paid to an insured’s home state. If such nationwide uniform requirements are not adopted by a state, then that state is prohibited from imposing eligibility requirements for nonadmitted insurers domiciled in the United States, except in conformance with the Non-Admitted Insurance Model Act. Lastly, a state is prohibited from collecting fees relating to the licensing of an individual or entity as a surplus lines broker in the state, unless the state enacts laws or regulations that provide for participation in the national insurance producer database of the National Association of Insurance Commissioners (or an equivalent database). The rulemakings under Title V have no specific timeframe, but the rulemakings may not be effective any earlier than the Transfer Date.

Title VI. Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions
Title VI establishes a number of rulemakings that impact insured depository institutions, bank holding companies, savings and loan holding companies, supervised securities holding companies, nonbank financial companies supervised by the Federal Reserve, and intermediate holding companies. We note that some of the provisions in Title VI became effective on July 22, 2010, while many of the provisions in Title VI will become effective on the Transfer Date or within one year or 18 months after the Transfer Date. With regard to the so-called “Volcker Rule” under Title VI, the provisions of the Volcker Rule will become effective no earlier than August 2011 and no later than July 21, 2012.

Title VI sets forth, for example, the following required rulemakings:
The appropriate federal banking agencies may establish capital regulations applicable to bank holding companies, savings and loan holding companies, and insured depository institutions (there is no specific timeframe for this rulemaking, but the rulemaking may not be effective any earlier than the Transfer Date);

- The Federal Reserve must prescribe capital adequacy and other risk management standards applicable to supervised securities holding companies and nonbank financial companies supervised by the Federal Reserve (there is no specific timeframe for this rulemaking);

- The Federal Reserve must enact other rules regulating supervised securities holding companies, which may include substantive areas such as registration requirements, recordkeeping and reporting requirements, and compliance with applicable provisions of law (there is no specific timeframe for this rulemaking);

- The Federal Reserve must issue rules implementing the conformance period for divestiture and for transition for illiquid funds (this rulemaking must be issued no later than January 21, 2011), and concentration limits on large financial firms (this rulemaking must be issued no later than October 21, 2011), as well as establish criteria for determining whether to require a grandfathered unitary savings and loan holding company to establish an intermediate holding company (there is no specific timeframe for this rulemaking);

- The appropriate federal banking agencies must jointly issue rules that require a bank holding company or a savings and loan holding company to serve as a source of financial strength for any subsidiary that is a depository institution (additionally, if the insured depository institution is not a subsidiary of a bank holding company or a savings and loan company, then the jointly issued rules must require that any company that directly or indirectly controls the insured depository institution serve as the source of financial strength) (this rulemaking must be issued between the Transfer Date and one year after the Transfer Date);

- The appropriate federal banking agencies, along with the SEC and the CFTC, must issue rules implementing the Volcker Rule and coordinate to ensure comparable regulations to the extent possible (this rulemaking must be issued no later than October 21, 2011; however, depending on when issued, the final rule will become effective no earlier than August 2011 and no later than July 21, 2012);

- The appropriate federal banking agencies, along with the SEC and the CFTC, must issue regulations regarding internal controls and recordkeeping in order to ensure compliance with the Volcker Rule (this rulemaking must be published for notice and comment no later than October 21, 2011; however, depending on when issued, the final rule will become effective no earlier than August 2011 and no later than July 21, 2012); and

- The SEC must issue rules prohibiting, for a designated period of time, an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security from engaging in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity (exceptions to this prohibition would include, however, certain risk-mitigating hedging activities, and purchases or sales consistent with commitments to provide liquidity for the asset-backed security or bona fide market-making in the asset-backed security) (this rulemaking must be issued no later than April 17, 2011).

In addition, Title VI sets forth, for example, the following permissive rulemakings:

- The Federal Reserve may issue regulations or interpretations concerning the manner in which a netting agreement between a member bank or a subsidiary and an affiliate may be taken into account in determining the amount of an inter-affiliate “covered transaction” under Section 23A of the Federal Reserve Act, including the extent to which a netting agreement may be taken into account in determining whether a covered transaction is fully secured under Section 23A (there is no specific timeframe for this rulemaking, but the rulemaking may not be effective any earlier than one year after the Transfer Date);
The Federal Reserve may also issue rules prohibiting an insured depository institution from purchasing or selling assets to insiders, unless certain conditions have been met (i.e., the transaction is on market terms and, if it represents more than 10 percent of the capital stock and surplus of the insured depository institution, it has been approved in advance by a majority of disinterested directors) (there is no specific timeframe for this rulemaking, but the rulemaking may not be effective any earlier than the Transfer Date); and

The Federal Reserve may issue regulations that establish restrictions or limitations on transactions between an intermediate holding company or a parent of such company (there is no specific timeframe for this rulemaking).

Title VII. Wall Street Transparency and Accountability (Over-the-Counter Derivatives)

Title VII provides for sweeping regulation of the over-the-counter derivatives markets including the regulation of swaps. Under this title, the CFTC and the SEC are required to promulgate rules related to swaps and security-based swaps, respectively. The Act requires the CFTC to promulgate regulations governing swaps, swap dealers, major swap participants, swap data repositories, swap execution facilities, and the activities of derivatives clearing organizations with regards to swaps. The SEC is required to institute regulations governing security-based swaps, dealers, participants, repositories, execution facilities, and derivatives clearing organizations. Unless otherwise provided within a section of Title VII, generally the provisions of Title VII take effect on the later of 360 days after the date of enactment of Title VII or, to the extent a provision requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provision. Moreover, as a general matter, the CFTC and the SEC, individually, and not jointly, are required to pass regulations within 360 days of the enactment date of the Act and may use emergency and expedited procedures if necessary. Title VII sets forth the following required and permissible rulemakings:

- The CFTC, SEC, and Federal Reserve are required to engage in joint rulemaking to adopt rules governing the books and records of entities regulated under this title.
- The SEC and CFTC are required to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to swaps and security-based swaps. The CFTC may require a foreign board of trade to register with the CFTC.
- The CFTC and SEC, in consultation with the Federal Reserve, are required to adopt rules to define a number of terms under the Act including “swap” and “security-based swap,” and other terms they determine necessary to define.
- The CFTC and SEC are required to adopt rules necessary to improve governance, mitigate systemic risk, promote competition, or mitigate conflicts of interest.
- The CFTC is authorized to issue rules and regulations to implement commodity whistleblower incentives and protections provisions.
- The federal banking regulators (referred to as Prudential Regulators in the Act) are required to prescribe minimum standards to permit swaps entities to conduct their activities in a safe and sound manner and to mitigate systemic risk.
- The CFTC and SEC are required to adopt rules in connection with the Act’s requirement that derivative clearing organization’s (DCO) submit for agency review any swaps or security-based swaps that the DCO seeks to accept for clearing. The agencies must also provide for permissible exemptions as well as prescribe rules necessary to prevent evasions of the clearing requirements and abuses of exemptions to the clearing requirements.
- The CFTC is required to prescribe rules governing swap execution facilities; the SEC must do the same for security-based swap execution facilities.
- The CFTC and SEC are required to adopt rules imposing
capital and margin requirements for swaps dealers and security-based swap dealers, as well as major swap participants and major security-based swap participants. The federal banking regulators, in consultation with the SEC and CFTC, are required to impose such capital and margin requirements on both swap dealers and security-based swap dealers, as well as major swap participants that are depository institutions.

- The CFTC is required to establish position limits, other than bona fide hedge positions, that may be held by any one person with respect to futures or options traded on or subject to the rules of a dedicated contract market and may also establish limits on the aggregate number of positions in contracts based on the same underlying commodity; the SEC is required to do the same for security-based swaps. The CFTC and SEC may make whatever exemptions to such limitations as each agency deems appropriate.

Soon after the Act went into law, the CFTC issued a notice detailing 30 areas of derivatives law where rules will be necessary as required by Title VII of the Act. As of the date of this advisory, the CFTC is accepting input and comments from market participants on this rule-writing process.

Title VIII. Payment, Clearing, and Settlement Supervision
Title VIII requires the Federal Reserve, in consultation with the FSOC and the federal agencies that have primary jurisdiction over financial market utilities (the Supervisory Agencies), to prescribe standards for the management of risks taken by systemically important financial market utilities and for the conduct of systemically important payment, clearing, and settlement activities carried out by other financial institutions. The CFTC and the SEC may also prescribe regulations, in consultation with the FSOC and the Federal Reserve Bank, containing risk management standards governing the operations related to payment, clearing, and settlement activities of designated clearing entities.

The Federal Reserve is authorized to prescribe rules that:
- Authorize a Federal Reserve Bank to establish an account for and provide assistance (including discount and borrowing privileges) to a designated institution similar to the assistance provided to depository institutions under the Federal Reserve Act; and
- Impose recordkeeping requirements, upon majority vote by the FSOC, on systemically important clearing entities or on financial institutions engaged in designated activities that are subject to risk management standards prescribed by the Federal Reserve pursuant to this title.

General rulemaking authority is granted to the Federal Reserve, the FSOC, and the Supervisory Agencies to carry out their respective duties under this title. No timeframe for the rulemakings required under this title has been specified, although the title itself became effective upon enactment.

Title IX. Investor Protections and Improvements to the Regulation of Securities
Rulemakings required or authorized under Title IX, which generally became effective on July 22, 2010, include various measures centered around securitizations and the protection of retail investors. New regulations issued pursuant to this title would:
- Require securitizers of mortgage-backed and other asset-backed securities to retain credit risk in such securities. The federal banking agencies must jointly prescribe these regulations by April 17, 2011.
- Create new disclosure obligations, including new requirements relating to pre-sale disclosures and disclosures relating to short sales. Broker-dealers and investment advisors could also face new rules designed to address gaps or overlaps in regulations that apply to their relationships with retail customers. Such regulations could include a new “best interests” fiduciary standard. Rules that address relationships with retail customers would be proposed after an SEC study and report to Congress, due in January 2011.
- Substantially rewrite regulations that apply to credit rating agencies, also known as nationally registered statistical rating organizations (NRSROs), enhancing...
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The SEC would even be authorized, after a study, to establish a system for the assignment of NRSROs to perform initial credit ratings of asset-backed securities such that issuers, sponsors, or underwriters would not be able to select the rating agency. The majority of the rulemakings relating to NRSROs would be required by July 21, 2011.

In addition, with regard to proxy disclosure, executive compensation, and corporate governance rulemaking, Title IX:

- Requires public companies to give shareholders a non-binding advisory vote on golden parachute compensation in connection with certain business combinations for meetings occurring on or after January 21, 2011. No deadline is specified for SEC rulemaking.
- Grants the SEC authority to issue rules permitting a shareholder access to a company’s proxy solicitation materials for the purpose of nominating directors. No deadline is specified for SEC rulemaking.
- Requires the SEC to issue rules (with no deadline specified) requiring a company to disclose:
  - Whether any employee or board member may purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities;
  - The relationship between executive compensation paid and the company’s financial performance; and
  - The ratio of median non-CEO employee compensation to CEO compensation.
- Requires the SEC to issue rules, not later than January 17, 2011, requiring a company to disclose in its annual proxy statements the reasons why it chose either the same person or different individuals to be the chairman of the board and CEO.
- Requires the SEC, by rule, to direct national securities exchanges to prohibit the listing of any security of an issuer that does not develop and implement a policy to “clawback” compensation from executive officers who received incentive-based compensation during the three-year period preceding the date of an accounting restatement in excess of what would have been paid under the accounting restatement. No deadline is specified for SEC rulemaking.
- Requires the SEC, by rule issued no later than July 16, 2011, to direct national securities exchanges to prohibit the listing of any security of an issuer that does not comply with requirements relating to compensation committee independence; the independence of compensation consultants and other advisers to the compensation committee; and other requirements relating to compensation committee consultants, legal counsel, and other advisers.
- Requires national securities exchanges to adopt rules prohibiting broker discretionary voting in connection with elections of directors, executive compensation, and any other significant matter, as determined by SEC rule. No deadline is specified for SEC rulemaking.
- Requires the appropriate federal regulators to jointly issue rules, no later than April 21, 2011, (1) prohibiting covered financial institutions with $1 billion or more in assets from rewarding their executive officers, employees, directors and principal shareholders with any incentive-based compensation arrangement that encourages “inappropriate risks,” and (2) requiring each covered financial institution to report all incentive-based compensation arrangements to the appropriate federal regulator.

Title X. Bureau of Consumer Financial Protection

Title X establishes the Bureau of Consumer Financial Protection (CFPB) within the Federal Reserve. The CFPB will regulate consumer financial products and services to ensure compliance with federal consumer financial laws and has the authority to prescribe rules to this effect, including rules supervising market participants and mandating certain disclosures to consumers. No timeframe is specified for rules issued pursuant to this general rulemaking authority. However, by September
19, 2010, the Treasury Secretary, in consultation with a number of other agencies, must determine a “Designated Transfer Date” for the transfer of specified functions and powers from the agencies to the CFPB. The Designated Transfer Date may be no earlier than January 17, 2011 nor later than July 21, 2011 (although this may be extended up to January 21, 2012).

Under this title, the CFPB must prescribe rules allowing for the supervision of persons who:

- Offer or provide origination, brokerage, or servicing of loans secured by real estate for consumers; or
- Offer loan modification or foreclosure relief services in connection with such loans.

The CFPB may prescribe rules to insure that these entities are legitimate and able to perform their obligations to consumers. The CFPB may also require reports and other information from persons and organizations operating in the market for consumer financial products or services.

However, the CFPB will not be able to exercise any rulemaking authority under this title over the following:

- Licensed real estate brokers;
- Persons involved in the retail of manufactured homes;
- Certified public accountants;
- Motor vehicle dealers (except for motor vehicle dealers who provide mortgages, or who extend retail credit directly to consumers without assigning that credit to a third party);
- Attorneys engaged in the practice of law;
- Products or services that relate to any specified employee benefit and compensation plans or arrangements; and
- Contributions to tax-exempt organizations.

Title X also amends several existing acts to reflect the CFPB’s ability to prescribe rules within the existing statutory framework, including:

- The Equal Credit Opportunity Act;
- The Fair Debt Collection Practices Act;
- The Gramm-Leach-Bliley Act;
- The Omnibus Appropriations Act 2009;
- The S.A.F.E. Mortgage Licensing Act of 2008;
- The Truth in Lending Act; and
- The Telemarketing and the Consumer Fraud and Abuse Prevention Act.

While the Act does not specify when the CFPB may issue rules pursuant to these amendments, such rules may not become effective before the amendments themselves become effective on the Designated Transfer Date.

Title X also creates new standards related to payment cards and their interchange transaction fees. The Federal Reserve must prescribe regulations requiring the amount of any interchange transaction fee with respect to a debit card transaction to be “reasonable and proportional” to the cost incurred by the issuer with respect to the transaction. The Federal Reserve must also issue regulations relating to network exclusivity.

Title XI. Federal Reserve System Provisions (Emergency Lending Authority and Debt Guarantee Programs)

Title XI, which became effective on July 22, 2010, gives additional rulemaking powers to the Federal Reserve and the FDIC. The title requires the Federal Reserve to establish policies and procedures governing emergency lending, including those that prohibit borrowing by insolvent borrowers. It also requires the FDIC to establish policies and procedures governing the issuance of guarantees for obligations of solvent insured depository institutions or solvent depository institution holding companies during times of severe economic distress. All rules required by this title are to be implemented “as soon as is practicable.”

Title XII. Improving Access to Mainstream Financial Institutions

Title XII is designed to provide access to mainstream financial institutions to Americans who are normally...
excluded from such access. The Treasury Secretary is authorized to implement regulations that will promote this objective, including authorizing grant programs and determining participant eligibility. Grant programs must focus on low-cost alternatives to small dollar loans, loan-loss reserve funds, and financial literacy. No timeframe is specified for the rulemakings required under this section.

Title XIV. Mortgage Reform and Anti-Predatory Lending Act

Title XIV implements reforms affecting the American mortgage lending industry by setting standards for mortgage origination, outlawing unfair, deceptive, and predatory practices (as to be defined by the Federal Reserve) related to mortgage lending, and imposing stringent restrictions on certain “high-cost” mortgages. Regulations issued under this title must be issued within 18 months of the Designated Transfer Date and must take effect within 12 months of their issuance. By statute, sections of this title will become effective only when their implementing regulations, if any, become effective or otherwise 18 months after the Designated Transfer Date.

The Federal Reserve is required to issue regulations that, among other things:

- Prevent originators from steering borrowers into loans that they will be unable to repay;
- Require creditors to make a good faith determination that borrowers will be able to repay loans;
- Prohibit originators from mischaracterizing borrowers’ credit history or the appraised value of property; and
- Set forth a standardized form for making detailed monthly disclosures to mortgagors.

In addition, the Federal Reserve may prohibit lenders from extending “high-cost mortgages” to borrowers without a certification from the Secretary of the US Department of Housing and Urban Development or a state housing agency that the borrower has received counseling on the advisability of the mortgage. We believe most of the mortgage-related regulations that the Federal Reserve is required to issue under this title will be issued through the CFPB.

A number of agencies—the Federal Reserve, the OCC, the FDIC, the National Credit Union Administration, the Federal Housing Finance Agency, and the CFPB—are required to issue rules relating to appraisal. For example, they must promulgate joint regulations that implement certain property appraisal standards. In addition, they may issue rules that establish minimum qualifications to be applied by a state in the registration of appraisal management companies and that specify practices which violate appraisal independence standards.

Finally, Title XIV establishes an Office of Housing Counseling and requires it to issue rules to carry out various counseling and housing assistance programs.

Arnold & Porter is available to respond to questions raised by the Act or the forthcoming rulemakings issued pursuant to the Act, or to help guide your business towards legislative and regulatory solutions. We can assist in determining how pending bills and regulations may affect your business and industry. For further information, please contact your Arnold & Porter attorney or:

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