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House-Senate Conference Committee Approves Financial Reform Legislation

On June 25, 2010, a House-Senate conference committee reached final agreement on the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The conference report must be approved by the House and Senate before the bill is presented to the President for signature. The House is expected to approve the conference report on June 29 and the Senate is expected to vote shortly thereafter.

The Act is comprehensive in scope, providing for significant changes to the structure of federal financial regulation and new substantive requirements that apply to a broad range of market participants, including public companies that are not financial institutions. Among other measures, the Act includes corporate governance and executive compensation reforms, new registration requirements for hedge fund and private equity fund advisers, heightened regulation of over-the-counter derivatives and asset-backed securities and new rules for credit rating agencies. The Act also mandates significant changes to the authority of the Federal Reserve and the Securities and Exchange Commission as well as enhanced oversight and regulation of banks and non-bank financial institutions.

This memorandum summarizes the key provisions of the Act.

Investor Protection Measures

Corporate Governance

The Act provides for the following corporate governance reforms:

- *Proxy access*. The Act gives the SEC explicit authority to promulgate rules requiring U.S. public companies to include nominees submitted by shareholders in proxy solicitation materials and to follow certain procedures in relation to such solicitation. The legislation does not require the SEC to adopt proxy access rules, nor does it prescribe any parameters for any rules that are adopted. A late proposal by some Senators to include a 5% ownership requirement and a two-year holding period was defeated in conference. Based on statements by the SEC Chairman and staff, we expect that the SEC will take final action on proxy access soon after the Act is signed into law and that the new rules will be in effect for the 2011 proxy season.

- *Chairman and CEO disclosures*. The Act directs the SEC to promulgate rules requiring U.S. public companies to disclose in their annual proxy statements the reasons why the company has chosen to combine or separate the board chairman and CEO positions. The SEC's 2009 amendments to its proxy rules already require substantially similar disclosure, so it is unclear whether this provision of the Act will result in any additional disclosure requirements.

- *Broker discretionary voting*. The Act requires stock exchanges to prohibit broker discretionary voting in connection with the election of directors, executive compensation or any other significant matter, as determined by the SEC. Broker discretionary voting has already been eliminated by the stock exchanges for director elections and this new provision will extend the prohibition to say-on-pay votes and other matters determined to be significant.

- *No majority voting for director elections*. In a compromise with the House version of the financial reform bill, the requirement for all U.S. public companies to adopt majority voting has been eliminated. Under the Senate version of the bill, companies would have been required to implement majority voting for all uncontested director elections.

- *Smaller public companies exempt from Sarbanes-Oxley internal control requirements*. In a late addition by the conference committee, the Act exempts smaller public companies that are not "accelerated filers" or "large accelerated filers" from compliance with the internal control auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act and directs the SEC to study ways of reducing the burden of Section 404(b) compliance on companies with market capitalizations between $75 million and $250 million.

Executive Compensation

The Act provides for the following executive compensation reforms:

- *Say-on-pay*. Any proxy statement required by SEC rules to include compensation disclosure must include a separate non-binding resolution subject to shareholder vote to approve the company's executive compensation as disclosed in the proxy statement. In a change from the proposed legislation, the Act would permit shareholders to elect to have a say-on-pay vote every two years or three years rather than annually. The Act specifies that the shareholder vote will not be binding on the company's board of directors and cannot be construed as overruling any company or board decision or creating any additional fiduciary duties for the company or board.

- *Say-on-golden parachutes*. The Act incorporates the House bill's requirement for "say-on-golden parachutes." Any proxy statement subject to SEC rules that seeks shareholder approval of an acquisition, merger, consolidation or proposed sale of all or substantially all of a company's assets must include (i) disclosure regarding agreements by the person soliciting proxies to make "golden parachute" payments to the named executive officers of the company or the acquiror and (ii) a separate non-binding resolution subject to shareholder vote to approve such agreements, unless the agreements have already been subject to a vote pursuant to say-on-pay requirements.

- *Disclosure of say-on-pay and say-on-golden parachute votes by institutional investors*. Institutional investment managers subject to Section 13(f) of the Securities Exchange Act of 1934 (the "Exchange Act") will be required to disclose their say-on-pay and say-on-golden-parachute voting records at least annually unless otherwise required by the SEC.

- *Compensation committees*. U.S. listed companies will be required, through new rules adopted by the stock exchanges, to have fully independent compensation committees, based on new independence standards that require consideration of the source of compensation for the director (such as consulting, advisory or other compensatory fees paid by the company) and whether the director is affiliated with the company. The Act does not require companies to have compensation committees per se, and so NASDAQ companies and other companies that do not have compensation committee structures may be able to continue that practice.

  Compensation committees will be explicitly charged with hiring and overseeing compensation consultants, legal counsel and other committee advisors. Companies will have to provide appropriate funding for the retention of such advisors. When engaging compensation consultants, legal counsel or other advisors, compensation committees will be required to consider certain independence factors to be determined by the SEC, including factors that examine the relationship between the employer of the consultant or advisor and the company. Public companies will also be subject to additional disclosure requirements regarding the use of compensation consultants.

- *Pay-for-performance and pay-parity disclosures*. U.S. public companies will be required to disclose in their annual proxy statements the relationship between executive compensation actually paid and a company's financial performance, taking into account any change in the value of the company's stock and dividends and other distributions. This disclosure could include a graphic representation of the required information. It is unclear what additional disclosure will be required as a result of this provision since similar disclosure is already required under current SEC rules. Companies will also be required to disclose (i) the median annual total compensation of all employees, other than the CEO, (ii) the annual total compensation of the CEO and (iii) the ratio of the median total annual employee compensation to that of the CEO.

- *Executive compensation clawbacks*. Listed companies will be required to develop, implement and disclose policies with respect to the clawback of incentive-based compensation paid to current or former executive officers following a restatement. These rules will apply to incentive-based compensation (including stock options) paid during the three-year period preceding the restatement. The recovery is the amount in excess of what otherwise would have been paid to the officer. This provision represents a significant expansion of the clawback provision contained in the Sarbanes-Oxley Act, which applies only to compensation received by the CEO and CFO and then only during the 12-month period following the first issuance of the restatement and only if the restatement resulted from misconduct.

- *Hedging disclosure*. U.S. public companies will be required to disclose in their annual proxy statements whether any employee or director of the company is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities of the company that are granted as compensation or otherwise held by the employee or director.

- *Financial institution compensation restrictions*. Bank holding companies and certain other financial institutions will be prohibited from providing executive officers, employees, directors or principal shareholders with compensation that is excessive or that could lead to material financial loss to the financial institution.

With the exception of the say-on-pay, say-on-golden parachute and broker discretionary voting requirements, the foregoing provisions require further action by the SEC, the stock exchanges or other regulators before they are operative. Many of the regulatory actions must be taken within one year of enactment of the Act; however, some of the provisions (such as the pay-for-performance, pay parity, hedging disclosure and clawback requirements) do not have explicit deadlines for action.

Credit Rating Agency Regulation

The Act directs the SEC to establish a new Office of Credit Ratings to oversee and examine credit rating agencies and promulgate new rules for internal controls, independence, transparency and penalties for poor performance. Nationally recognized credit rating agencies will be required to establish, maintain, enforce and document an effective internal control structure and submit an annual internal controls report to the SEC. The Office of Credit Ratings will be required to conduct at least annual examinations of all nationally recognized credit rating agencies and make reports of its findings publicly available. Credit rating agencies will be subject to new disclosure requirements that mandate public disclosure of ratings methodologies, use of third parties' due diligence and ratings track records, as well as material changes made to, or material errors identified in, ratings procedures or methodologies. The Act authorizes the SEC to penalize nationally recognized credit rating agencies for failing to consistently produce accurate ratings and establishes a new private right of action against rating agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source.

The conference committee removed a provision in the Senate version of the bill that would have required the establishment of a new self-regulatory organization charged with assigning the task of providing initial credit ratings for certain structured finance products to qualified credit rating agencies. The Act instead requires the SEC to undertake a two-year study for the purpose of determining an independent method for matching credit ratings agencies with issuers, so as to mitigate conflicts of interest in the selection process for ratings of structured finance products.

In an effort to curb reliance on credit ratings, the Act mandates that references to credit ratings be removed from certain statutes and that the SEC conduct studies on, among other things, the standardization of credit ratings.

In a late addition by the conference committee, the Act includes a provision that nullifies Rule 436(g) under the Securities Act of 1933 (the "Securities Act"), which currently exempts nationally recognized credit rating agencies from the requirements under the Securities Act that apply to experts and, importantly, exempts credit rating agencies from Section 11 liability when ratings are included in Securities Act registration statements. The rescission of Rule 436(g) will mean that the rating agencies must provide written consent before their ratings can be included in registration statements. This will have an immediate impact in the context of registered structured finance issuances, which rely directly on credit ratings, and it may take on even greater importance if the SEC promulgates rules requiring the inclusion of ratings disclosure in the registration statements of corporate debt issuers.

Securitization Retention Requirements

Federal banking agencies and the SEC are required to jointly promulgate regulations requiring issuers of asset-backed securities (and persons who organize and facilitate the sale of such securities) to retain an economic interest of not less than 5% of the credit risk in any such security that is transferred, sold or conveyed to a third party (subject to exceptions for certain residential mortgage assets and assets that meet certain prescribed reduced credit risk standards). Additionally, the Act requires enhanced reporting and disclosure by the issuer regarding the quality of the assets underlying the securities.

Regulatory Enforcement and Remedies

The Act contains a number of provisions, both procedural and substantive, that are designed to facilitate enforcement of the securities laws and expand the scope of remedies available to regulators and injured private parties. These provisions significantly modify the securities laws in the following areas:

- *Whistleblower protection*. The Act establishes monetary awards for whistleblowers in any SEC or Commodity Futures Trading Commission ("CFTC") enforcement action resulting in a sanction of over $1,000,000, with award amounts determined as a percentage of the recovery. It also creates a private right of action for whistleblowers against employers that retaliate, subjecting employers to lawsuits for reinstatement, back pay and litigation costs and attorneys' fees.

- *Collateral bars*. The Act expands the collateral bar provisions applicable to violators of Sections 15, 15E and 17A of the Exchange Act and Section 203(f) under the Investment Advisers Act of 1940 (the "Advisers Act"). Under the new collateral bar provisions, such persons could be barred from being associated with a broker-dealer, investment adviser, transfer agent or credit rating agency.

- *Regulation D eligibility.* The Act disqualifies certain offerings from the protections of Regulation D under the Securities Act if the offerings are made by certain "bad actors," defined as persons who (i) have been convicted of a felony or misdemeanor in connection with the purchase or sale of any security or a false filing with the SEC, (ii) are barred from association with regulated entities or from engaging in the business of securities, insurance, banking or in savings association or credit union activities for fraud, manipulation or deception or (iii) are subject to a final order based on a violation of any law prohibiting fraud or manipulation or deceptive conduct. The Act does not include an earlier proposal that would have subjected a Regulation D offering to state regulation if the SEC failed to review the offering within 120 days.

- *Aiding and abetting liability*. The Act clarifies and extends the scope of liability for aiders and abettors of securities violations by allowing government enforcement actions against persons who "knowingly or recklessly" provide substantial assistance for such violations. Importantly, the Act does not go so far as to create a private right of action against persons who knowingly or recklessly aid or abet violations of federal securities laws.

- *Strengthening SEC enforcement*. The Act strengthens the SEC's enforcement powers in three keys respects. First, it allows the SEC to impose monetary penalties under certain circumstances against any person, rather than just regulated entities, in cease and desist proceedings. Second, it expands federal court jurisdiction by allowing the SEC to bring enforcement actions against persons (i) taking "significant steps in furtherance" of a violation, even where the securities transaction takes place outside the United States and (ii) engaging in conduct outside the United States that has a foreseeable impact within the United States. Third, it clarifies that control person liability under Section 20(a) of the Exchange Act applies in SEC enforcement actions, not only in private actions.

- *Deadlines for the SEC*. The SEC will be required to either file an action or provide notice of its intent not to file an action within 180 days of providing a Wells notification to any person. Similarly, the SEC will have a deadline of 180 days after completing an onsite compliance examination or inspection or receiving all requested records to issue a written notification providing the results of the examination or inspection.

- *Gustafson not overturned.* The final draft of the Act did not include a proposed amendment that would have effectively overturned the Supreme Court's 1995 decision in *Gustafson v. Alloyd Co., Inc.* The amendment, which received publicity due to its implications for liability in connection with private placements of securities, would have created prospectus liability under the Securities Act for offering memoranda issued in connection with private placements.

The Act contains a number of additional enforcement measures, including provisions to allow nationwide service of subpoenas and to enhance confidentiality of materials submitted to the SEC. The Act stops short of creating a private right of action against extraterritorial violators of the antifraud provisions of the Exchange Act and, as noted above, against aiders and abettors of securities fraud, opting instead to require studies and reports on the impact of such private rights.

Private Fund Adviser Regulation

The Act eliminates the "private adviser exemption" from the Advisers Act for advisers with fewer than 15 clients and, with some exceptions, requires advisers to private funds with $100 million or more in assets under management to register with the SEC as investment advisers (those below the threshold will be subject to state registration). Registered advisers will be subject to reporting and recordkeeping requirements and periodic examination by the SEC staff. Information provided by registered advisers can be shared by the SEC with the Financial Stability Oversight Council (discussed below) for assessment of systemic risk.

The Act provides exemptions for advisers who solely advise "venture capital funds" (to be defined by the SEC) and for advisers who solely advise private funds and have assets under management in the United States of less than $150 million; however, in each case, such exempted advisers will still be subject to recordkeeping and reporting requirements to be determined by the SEC. Certain advisers to family offices, foreign private advisers and advisers to small business investment companies will also be exempt from registration. The conference committee agreed to remove a provision in the Senate version of the bill that would have exempted private equity fund advisers from registration with the SEC.

The Act effectively raises the assets under management threshold for federal regulation of investment advisers from $25 million to $100 million. Any investment adviser that qualifies to register with its home state and has assets under management of between $25 million and $100 million (and that otherwise would be required to register with the SEC) must register with, and be subject to examination by, such state. If the investment adviser's home state does not perform examinations, the adviser is required to register with the SEC.

In addition, the Act directs the Government Accountability Office ("GAO") to submit a report to Congress on the feasibility of creating a self-regulatory organization to oversee private funds.

Accredited investor and qualified client standards. The Act modifies the net worth standard in the definition of "accredited investor" to provide that the value of a person's primary residence is excluded from the calculation of the $1 million net worth requirement. The SEC is directed to periodically review and modify the definition of "accredited investor," as appropriate, and the GAO is required to submit a report to Congress on the appropriate criteria for accredited investor status and eligibility to invest in private funds. In addition, within one year after the date of enactment (and periodically thereafter), the SEC is required to adjust for inflation the net worth and/or asset-based qualifications applicable to a "qualified client" under the Advisers Act.

Regulation of Over-the-Counter Derivatives

The Act introduces significant direct regulation of over-the-counter ("OTC") derivatives transactions. Among the most notable provisions affecting the OTC derivatives markets are:

- *Clearing and trading*. The Act authorizes the CFTC and the SEC to mandate central clearing of OTC derivatives that are determined to be appropriate for clearing and capable of being cleared. The CFTC and the SEC may self-initiate the review of OTC derivatives contracts or make a determination on contracts submitted for review by derivatives clearing organizations, and will take into consideration such factors as outstanding notional exposure, trading liquidity, operational clearing expertise and resources and systemic risk. An OTC derivative subject to mandatory clearing that is also accepted for trading on an exchange or "swap execution facility" would have to be executed on such exchange or facility. There is an exception to the clearing requirement for OTC derivatives involving at least one counterparty that is not a financial entity, where the counterparty is using the derivatives contract to hedge commercial risk and notifies the CFTC or the SEC how it generally meets its financial obligations under non-cleared OTC derivatives contracts.

- *Reporting*. OTC derivatives that are subject to mandatory clearing or are otherwise cleared also will be subject to real-time public reporting, resulting in public access to trade data including volume and pricing as soon as technologically possible after trade execution. Such reporting will not identify parties to the trades and may be delayed for block trades. In addition, each OTC derivatives transaction (whether cleared or uncleared, including those that were entered into prior to the enactment of the Act) must be reported to a “swap data repository.”

- *Regulation of market participants.* Market participants in the OTC derivatives market that fall within the definitions of “swap dealer” or “major swap participant” will be subject to registration, capital, margin, reporting, recordkeeping and operational requirements. The Act generally defines "swap dealer" as any person who holds itself out as a dealer in, regularly engages in, or makes a market in OTC derivatives contracts. A "major swap participant" generally is any person who is not a swap dealer but maintains substantial positions in OTC derivatives contracts other than hedging positions, whose outstanding OTC derivatives positions create substantial counterparty exposure that could threaten the stability of the United States financial markets or who is a highly leveraged non-bank financial entity. Each swap dealer and major swap participant also will be subject to heightened business conduct standards. Swap dealers and major swap participants will be required to verify counterparty eligibility standards and to disclose certain information to their counterparties, including risks, any material incentives or conflicts of interest associated with the trades and the daily marks of the transaction (in case of cleared transactions only upon request of the counterparty). The Act also raises the standard of care owed by swap dealers that act as advisor to any federal, state or municipal governmental entity or agency or a retirement plan or endowment (referred to as "special entities") by imposing a duty to act in the best interests of the special entity. In addition, swap dealers and major swap participants may only act as counterparties to such special entities if they have formed a reasonable belief that the special entity has an independent sophisticated representative that acts in its best interests.

- *Margin requirements*. For cleared OTC derivatives, any party that accepts initial and variation margin from a customer will have to be registered as a futures commission merchant or broker-dealer and maintain such margin segregated from its proprietary assets. For OTC derivatives that are not cleared, a swap dealer or major swap participant will be obligated to segregate initial margin with an independent third-party custodian if so requested by the counterparty. Segregated assets may not be re-hypothecated.

- *Position limits.* The Act authorizes the CFTC and the SEC to establish aggregate position limits with respect to OTC derivatives traded on an exchange and non-exchange traded OTC derivatives that perform significant price discovery functions.

The position limits restrict the number or size of positions in OTC derivatives that any person can hold.

- *Swap dealer spin-off.* The Act provides for a modified version of the "spin-off clause" that was included in the Senate bill. The provision prohibits the extension of any federal assistance, including access to the Federal Reserve discount window or FDIC deposit insurance, to swap dealers and major swap participants. The Act clarifies that FDIC-insured institutions that fall under the definition of "swap dealer" in the new regime are permitted to spin out their OTC derivatives activities to an affiliate that is controlled by the same bank holding company as long as such affiliate is independently capitalized and its liabilities are not guaranteed by the FDIC-insured institution. In a compromise worked out in the conference committee, the modified version of the spin-off clause in the Act includes an exemption that will allow insured depository institutions to retain their OTC derivatives activities to the extent they are limited to hedging activities directly related to the business of the institution or swaps involving rates or reference assets that are permissible for investment by a national bank (excluding uncleared credit default swaps). Insured depository institutions that would be subject to Federal assistance prohibition due to their existing OTC derivatives activities are granted a transition period of up to 24 months to divest or limit their OTC derivatives activities accordingly.

- *Market manipulation.* The Act creates a private right of action against any person who employs manipulative devices in violation of CFTC rules and regulations relating to OTC derivatives contracts.

- *Grandfathering of existing trades.* OTC derivatives trades entered into prior to the enactment of the Act will not be subject to central clearing and trading requirements or to position limits. The Act also provides that, unless specifically provided for in their bilateral trading agreements, counterparties may not treat the enactment or the requirements of the Act as a termination event or similar event that would permit the early termination or modification of any grandfathered transaction.

Many provisions of the Act, including many of the defined terms, position limits and margin requirements, will have to be clarified by regulations to be issued by the CFTC and the SEC. These agencies will have one year from the date of the enactment of the Act to jointly implement the provisions of the Act.

Financial Stability

Financial Stability Oversight Council

The Act seeks to mitigate the systemic risk of financial collapse through several legislative and regulatory initiatives, the most substantial of which is the creation of a 10 voting member Financial Stability Oversight Council (the "Council"), which will be chaired by the Secretary of the Treasury and will also include the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the newly created Consumer Financial Protection Bureau, the Chairman of the SEC, the Chairman of the FDIC, the

Chairman of the CFTC, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board and an independent member having insurance expertise appointed by the President to a term of six years with the advice and consent of the Senate. The Council will also include, as non-voting members, the Director of the newly created Office of Financial Research, the Director of the Federal Insurance Office and certain state insurance, banking and securities regulators.

The Council will be required to meet at least once each quarter and will monitor the U.S. financial markets in order to identify systemic financial risks, promote market discipline and respond to emerging threats. Among other things, the Council will be authorized to:

- with a 2/3 vote of the Council, including the affirmative vote of the Treasury Secretary, identify systemically important domestic or foreign non-bank financial companies whose material financial distress, or whose nature, scope, size, scale, concentration, interconnectedness or mix of the activities, could pose a risk to the financial stability of the United States and require the regulation of such companies by the Federal Reserve;

- with a 2/3 vote of the Council, including the affirmative vote of the Treasury Secretary, determine that material financial distress related to, or the nature, scope, size, scale, concentration, interconnectedness or mix of, financial activities by any domestic or foreign company would pose a risk to the financial stability of the United States and require the regulation of such financial activities by the Federal Reserve;

- make recommendations, on an individual basis or by category, to the Federal Reserve for more stringent prudential standards (including risk-based capital requirements, leverage limits and concentration limits) and reporting and disclosure requirements applicable to certain higher risk domestic or foreign non-bank financial companies that are supervised by the Federal Reserve and certain higher risk large, interconnected domestic or foreign bank holding companies; and

- with a 2/3 vote of the Council, with or without the affirmative vote of the Treasury Secretary, approve a decision by the Federal Reserve to require a bank holding company with $50 billion or more in assets or a non-bank financial company that is supervised by the Federal Reserve to limit the ability of such company to merge with, acquire, consolidate with or otherwise become affiliated with another company, limit or terminate certain activities or, in extreme cases, to divest certain of its holdings if such company poses a grave threat to the financial stability of the United States.

Office of Financial Research

The Act authorizes the creation of an Office of Financial Research, which will be charged with collecting financial data and delivering to Congress annual assessments of systemic financial risk. Although the Office of Financial Research will be located within the Department of the Treasury, its director will be appointed by the President, with the advice and consent of the Senate, to six-year terms. The Office will have the authority to issue regulations supporting its own data collection and will issue regulations standardizing the scope and format of data collected by the agencies represented on the Council. The Office will also have the power to issue subpoenas to financial companies to collect information necessary to carry out its mandated functions.

The expense of the Office of Financial Research and the Council will be funded by special assessments collected for a Financial Crisis Special Assessment Fund. Such special assessments will be imposed by the Council and will be collected on an annual basis by the FDIC from financial companies with at least $50 billion in assets and hedge funds with at least $10 billion in assets under management. The amounts to be collected from any financial company or hedge fund will be based on the case-by-case risk-based determinations of the Council and certain other enumerated factors.

Treatment of Certain Former Bank Holding Companies (the so-called "Hotel California" rule)

Any company that was a bank holding company having total consolidated assets of $50 billion or more as of January 1, 2010 and received financial assistance under or participated in the Capital Purchase Program established under the Troubled Asset Relief Program ("TARP") will be treated as a non-bank financial company supervised by the Federal Reserve if such company ceases to be a bank holding company at any time after January 1, 2010.

Systemic Regulation and Emergency Powers

In addition to steps described elsewhere in this memorandum, the Act addresses systemic risk of financial collapse by:

- requiring bank holding companies with $50 billion or more in assets and non-bank financial companies that are supervised by the Federal Reserve to submit (i) plans for their rapid and orderly shutdown in the event of material financial distress or failure (so-called "living wills") and (ii) periodic reports on the nature of their credit exposure to "other significant nonbank financial companies and significant bank holding companies" and the nature of the credit exposure of "other significant nonbank financial companies and significant bank holding companies" to them;

- requiring each bank holding company with $50 billion or more in assets and each non-bank financial company that is supervised by the Federal Reserve, not earlier than three years after the enactment of the Act, to limit its aggregate credit exposure to any unaffiliated company to 25% of its capital stock and surplus (or such lower amount as the Federal Reserve may determine by regulation to be necessary to mitigate risks to the financial stability of the United States);

- limiting the amount of short-term debt, including off-balance sheet exposures, that may be accumulated by any bank holding company with $50 billion or more in assets or any non-bank financial company that is supervised by the Federal Reserve;

- requiring publicly traded bank holding companies with $10 billion or more in assets and publicly traded non-bank financial companies that are supervised by the Federal Reserve to establish risk committees (which will be comprised of such number of independent directors as the Federal Reserve may deem appropriate);

- requiring bank holding companies with $50 billion or more in assets and non-bank financial companies that are supervised by the Federal Reserve to provide advance notice to the Federal Reserve of any acquisition of direct or indirect ownership or control of any voting shares of any company (other than an insured depository institution) that is engaged in activities described in Section 4(k) of the Bank Holding Company Act of 1956 (*i.e.*, activities that are financial in nature) having total consolidated assets of $10 billion or more;

- requiring the establishment of higher minimum leverage capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies and non-bank financial companies that are supervised by the Federal Reserve;

- prohibiting a management official of a non-bank financial company that is supervised by the Federal Reserve from serving as a management official of any bank holding company with $50 billion or more in assets or any other non-bank financial company that is supervised by the Federal Reserve;

- requiring the Federal Reserve, in coordination with other financial regulatory agencies and the Federal Insurance Office, to conduct annual analyses ("stress tests") in which bank holding companies with $50 billion or more in assets and non-bank financial companies that are supervised by the Federal Reserve are subject to evaluation of whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions (to be specified by the Federal Reserve);

- requiring bank holding companies with $50 billion or more in assets and non-bank financial companies that are supervised by the Federal Reserve to conduct self-administered semi-annual stress tests and requiring bank holding companies with $10 billion or more (but less than $50 billion) in assets to conduct self-administered annual stress tests;

- permitting the Federal Reserve to require any bank holding company with $50 billion or more in assets or any non-bank financial company that is supervised by the Federal Reserve to maintain a debt-to-equity ratio of no more than 15 to 1, upon a determination by the Council that such company poses a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States;

- requiring any bank holding company with $50 billion or more in assets or any non-bank financial company that is supervised by the Federal Reserve to take off balance sheet activities into account when computing capital for purposes of determining whether capital requirements are met;

- requiring the Federal Reserve, in consultation with the Council and the FDIC, to prescribe regulations for the early remediation of financial distress by any bank holding company with $50 billion or more in assets or any non-bank financial company that is supervised by the Federal Reserve;

- updating the Federal Reserve's "lender of last resort" authority to permit emergency lending programs or facilities for the purpose of providing liquidity to the financial system for institutions with sufficient collateral and not to aid a failing financial company; and

- permitting the FDIC to establish a broad program to guarantee obligations of solvent insured depository institutions or solvent depository institution holding companies (including any affiliates thereof) upon a determination by the Federal Reserve and the Council that there is a "liquidity event" and that failure to take action would have serious adverse effects on financial stability or economic conditions in the United States.

Federal Reserve Oversight

In addition to the Consumer Financial Protection Bureau described below, the Act also makes the following changes to the Board of Governors of the Federal Reserve System:

- a new Vice Chairman for Supervision will develop policy recommendations for the Federal Reserve regarding supervision and regulation of depository institution holding companies and other financial companies supervised by the Federal Reserve, and will oversee the supervision and regulation of such companies; and

- the Federal Reserve will have the authority to prescribe regulations to ensure that interchange fees (*i.e.*, the fees that merchants are charged for accepting debit cards) are "reasonable and proportional" to the costs incurred by the issuers of debit cards with respect to debit card transaction.

Special Assessment

The Act mandates the newly created Financial Stability Oversight Council to impose special assessments on the nation's largest financial firms to raise up to $19 billion to offset the cost of the Act. The assessments will be imposed on financial institutions with more than $50 billion in assets and hedge funds with more than $10 billion in assets under management, with high-risk institutions paying a larger portion of the assessment than less risky institutions. The fees will be collected by the FDIC over five years, with the funds placed in a separate Financial Crisis Special Assessment Fund within the Treasury and earmarked for this specific purpose for 25 years, after which any left-over funds would go to pay down the national debt. The first payment in respect of the special assessments will be due not later than September 30, 2012.

Resolution Authority

The Act establishes an orderly liquidation mechanism whereby the FDIC may seize, break-up and wind down a failing financial company whose failure threatens financial stability in the United States. The new authority is modeled on the FDIC's resolution authority for insured depository institutions in the Federal Deposit Insurance Act. For purposes of the resolution authority, the term "financial company" is defined broadly to include any U.S. company (other than a Farm Credit System institution) that is (i) a bank holding company, (ii) a non-bank financial company that is supervised by the Federal Reserve, (iii) a company that is predominantly engaged in activities that the Federal Reserve has determined are financial in nature or incidental thereto and (iv) certain subsidiaries of the foregoing. The resolution authority will apply to broker-dealers that are members of the Securities Investor Protection Corporation ("SIPC") and attempts to create a framework for providing the same protection for customer property as would be provided in normal SIPC proceedings.

The appointment of the FDIC as receiver requires that the Treasury Secretary, upon recommendation by a 2/3 vote of each of the board of governors of the Federal Reserve and the board of directors of the FDIC (or the commissioners of the SEC, in the case of a broker or dealer or a company whose largest U.S. subsidiary is a broker or dealer, or the director of the newly created Federal Insurance Office, in the case of an insurance company or a company whose largest U.S. subsidiary is an insurance company), (i) makes a determination that, among other things, the financial company is in default or danger of default, the failure of the financial company and its resolution under otherwise applicable federal or state law would have serious adverse effects on financial stability in the United States and no viable private sector alternative is available to prevent the financial company's default and (ii) obtains either the consent of the financial company's board of directors or an order from the U.S. District Court for the District of Columbia.

As receiver, the FDIC will have the power, among other things, to take over and manage the assets of the financial company, merge the financial company with another company, organize a "bridge financial company" and transfer any asset or liability of the financial company without any approval, assignment or consent with respect to such transfer. The FDIC will also have the authority to provide financial assistance to the company (and could access an Orderly Liquidation Fund to be established by the Treasury to do so, according to a specific repayment plan) and would receive a senior claim (after payment of administrative expenses, but prior to other unsecured claims) to recoup such assistance. If necessary to repay the Orderly Liquidation Fund within 60 months, the FDIC may seek assessments from bank holding companies with assets of $50 billion or more, non-bank financial companies that are supervised by the Federal Reserve and other financial companies with total consolidated assets of $50 billion or more. Such assessments will not be pre-funded.

In acting as receiver, the FDIC is mandated to ensure at all times, among other things, that the shareholders of a covered financial company do not receive payment until all other claims and the Orderly Liquidation Fund are fully paid, and that management and the directors responsible for the failed condition of the covered financial company are removed (if management and the directors have not already been removed at the time at which the FDIC is appointed receiver).

Reorganization of Financial Regulators

In order to increase the accountability of individual federal regulators and eliminate the ability of financial institutions to "shop" for the least burdensome of overlapping regulatory regimes, the Act will (i) eliminate the Office of Thrift Supervision (the "OTS"), which currently oversees savings and loan associations, credit unions and savings banks (collectively referred to as "thrifts"), and (ii) transfer the responsibilities of the OTS to the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency. As a result of these changes:

- the Federal Reserve will gain supervisory authority over all savings and loan holding companies and their subsidiaries (other than depositary institutions) and rulemaking authority relating to savings and loan holding companies; the Federal Reserve will also gain the rulemaking authority of the OTS relating to affiliate transactions and tying arrangements;

- the FDIC will gain supervisory authority over all state savings associations; and

- the Office of the Comptroller of the Currency will gain supervisory authority over all federal savings associations.

Unless an extension is issued, the transfer of the responsibilities of the OTS will occur one year after the enactment of the Act, and the OTS will be formally abolished 90 days after such transfer.

The Volcker Rule

The Act incorporates the so-called Volcker rule (initially proposed by former Federal Reserve Chairman Paul Volcker), which, with some important exceptions, will generally prohibit insured depository institutions, bank holding companies and certain of their affiliates from engaging in proprietary trading or sponsoring or investing in hedge funds or private equity funds.

Proprietary trading is defined broadly to encompass principal transactions effected through the "trading account" of a banking entity. It excludes underwriting and market-making activities (to the extent such activities "are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties"), bona fide hedging activities and certain other permitted activities.

Sponsoring private funds is defined to include serving as a general partner or managing member, selecting or controlling the directors, trustees or management of a fund or sharing the same name as the fund for marketing purposes. The Act includes a significant exception that permits a banking entity to sponsor a private equity fund or hedge fund as long as the bank provides bona fide trust, fiduciary or investment advisory services to the fund and the fund does not use the bank's name or a variant thereof. The Act also includes exceptions that permit (i) seed investments to establish a private fund and to provide the fund with sufficient initial equity to attract unaffiliated investors, and (ii) investments that amount to no more than 3% of the total ownership of the fund and that, in the aggregate, do not exceed 3% of the banking entity's Tier 1 capital.

Importantly, the Volcker rule is not self-executing. The Act requires banking regulators to implement the rule only after a six-month period of study by the Financial Stability Oversight Council (regulators will have nine months thereafter to adopt final rules). The Volcker rule will become effective only at the earlier of (i) 12 months after the adoption of final regulations and (ii) two years after the date of enactment of the Act. Financial institutions covered by the rule will then have an additional two years to cease or divest their relevant businesses to comply with the rule. The Federal Reserve is also permitted to grant an extended exemption of five years for certain “illiquid funds.”

The Act also requires the Federal Reserve to impose additional capital requirements and quantitative limits on non-bank financial companies that engage in proprietary trading or sponsor or invest in private equity funds or hedge funds.

Consumer Financial Protection Bureau

The Act establishes a new Consumer Financial Protection Bureau (the “CFPB”) within the Federal Reserve with a director appointed by the President and confirmed by the Senate. The CFPB will function as a consumer “watchdog” and will be authorized to autonomously write rules for consumer protections governing all financial institutions offering consumer financial services or products, including most banks, mortgage lenders, credit-card and private student loan companies, as well as payday lenders. The CFPB will also have the authority to examine and enforce regulations for banks and credit unions with assets of over $10 billion and all mortgage-related businesses (including, among other things, lenders, servicers and mortgage brokers), payday lenders, student lenders and other non-bank financial companies that are large, such as debt collectors and consumer reporting agencies, with carve-outs for certain regulated entities, such as broker-dealers, insurance companies and auto dealers. Banks and credit unions with $10 billion in assets or less will also have to comply with the CFPB’s rules, but the smaller institutions’ enforcement and supervision will remain with their current regulators. State attorney generals (or the equivalent thereof) are given explicit authority to bring actions in federal or state court to enforce the rules of the CFPB. By creating the CFPB, the Act consolidates consumer protection responsibilities currently handled by the Office of the Comptroller of the Currency, the OTS (which will be eliminated by the Act), the FDIC, the Federal Reserve, the National Credit Union Administration and the Federal Trade Commission. The CFPB will also oversee the enforcement of federal laws intended to ensure the fair, equitable and nondiscriminatory access to credit for individuals and communities.

Federal Insurance Office

The Act creates a Federal Insurance Office within the Department of the Treasury to monitor all aspects of the insurance industry (other than health insurance, long-term care insurance and crop insurance), coordinate international insurance matters, consult with the states regarding insurance matters of national importance and recommend insurers that should be treated as systemically important to the Council. The Director of the Federal Insurance Office will have subpoena power to compel the production of information with respect to major domestic and prudential international insurance policy issues. The Act requires the Federal

Insurance Office to report to Congress as to how to modernize insurance regulation and streamline the regulation of surplus lines of insurance and reinsurance through state-based reforms.

Moratorium and Study on Treatment of Credit Card Banks, Industrial Banks and Trust Banks

The Act mandates that, for a period of up to three years after the enactment of the Act, the FDIC will not approve any application for deposit insurance that is received after November 23, 2009 for an industrial bank, credit card bank or trust bank that is owned by a commercial firm, and will disapprove, under most circumstances, any change in control of such a bank if the change in control would lead to ownership by a commercial firm. For purposes of this provision, a company is a "commercial firm" if its consolidated annual gross revenues from activities that are financial in nature and, if applicable, from the ownership or control of one or more insured depository institutions, in the aggregate, represent less than 15% of its consolidated annual gross revenues.

In addition, the Act also mandates that the Comptroller General of the United States will conduct a study to determine whether it is necessary, in order to strengthen the safety and soundness of institutions or the stability of the financial system, to eliminate certain exceptions under the Bank Holding Company Act of 1956 that allow some types of financial institutions (including industrial banks, credit card banks and trust banks) not to be subject to the supervision of the Federal Reserve.

Supervision of Bank Holding Companies

The Act expands the scope of Federal Reserve supervision of bank holding companies by allowing the Federal Reserve to take into account generally risks to the stability of the United States banking or financial system. The Act also includes some requirements that are designed to ensure consistent oversight of subsidiaries of bank holding companies by different regulatory authorities. Among other things, the Federal Reserve is required to examine non-bank subsidiaries that are engaged in activities that the subsidiary bank can do (*e.g.*, mortgage lending) on the same schedule and in the same manner as bank examinations. The Act also contains provisions that disallow banks from changing their charter to avoid regulatory enforcement by "forum shopping."

Payment, Clearing and Settlement Supervision

The Act authorizes the Council, with a 2/3 vote, including the affirmative vote of the Treasury Secretary, to designate certain financial market utilities and clearing, payment and settlement systems to be, or likely to become, systemically important. Such designation will be based on, among other things, the aggregate monetary value of transactions processed by the financial market utility or carried out through the payment, clearing or settlement system and the effect that the failure of or a disruption to the financial market utility or payment, clearing or settlement system would have on critical markets, financial institutions or the broader financial system. Any financial market utility or payment, clearing or settlement system that is determined to be systemically important will be supervised by the Federal Reserve and will be required to comply with risk management standards prescribed by the Federal Reserve, unless the financial market utility or payment, clearing or settlement system has either the CFTC or the SEC as its primary regulator.

Additional Reforms

In addition to the foregoing, the Act mandates the following noteworthy reforms:

- *Broker-dealer regulation*. The Act directs the SEC to continue to study the relative standards of care that apply to broker-dealers and investment advisers, respectively, and gives the SEC the explicit authority to impose a fiduciary duty on broker-dealers, but it stops short of mandating a fiduciary duty for broker-dealers. The Act also directs the SEC to adopt new rules on securities lending and clarifies the SEC's authority to adopt rules on portfolio margining and point of sale disclosure. In addition, the Act extends the jurisdiction of the Public Company Accounting Oversight Board to include auditors of broker-dealers, which had previously been exempt from PCAOB oversight.

- *Municipal securities market*. The Act subjects municipal advisors to SEC registration and new antifraud rules and expands the rulemaking authority of the Municipal Securities Rulemaking Board.

- *Investor Advisory Committee and Office of the Investor Advocate*. The Act requires the SEC to establish a standing Investor Advisory Committee to advise and consult with the commissioners and staff on regulatory priorities and an Office of the Investor Advocate within the SEC to advocate regulatory changes on behalf of retail investors.

- *SEC funding*. The conference committee removed a provision in the Senate version of the bill that would have made the SEC a self-funded agency. Instead, the Act provides for "match funding," which allows the SEC to align its transaction fee collections with its annual budget requests. The SEC is also permitted to use fee collections to establish a reserve fund of up to $100 million, which can be used to fund special projects. In addition, the Act allows the SEC to submit its annual budget directly to Congress without requiring the prior approval of the White House.

- *Conflicts of interest in the sale of asset-backed securities*. Within 270 days after the enactment of the Act, the SEC is required to issue rules that will prohibit underwriters, placement agents, initial purchasers or sponsors of asset-backed securities (or affiliates or subsidiaries of such persons), during the one-year period after any sale of such asset-backed securities, from engaging in any transaction that would involve or result in any material conflict of interest with respect to any investor in such sale. Exceptions to this prohibition will be available for certain risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase or sponsorship of asset-backed securities, and purchases or sales of asset-backed securities made pursuant to and consistent with commitments to provide liquidity or bona fide market making.

- *Mortgage broker and loan underwriter regulation*. The Act prohibits mortgage brokers and originators from being compensated based on loan yields and requires lenders to make a good faith determination of a borrower's ability to repay a loan. The Act also establishes new national underwriting standards and eliminates prepayment penalties for certain qualified and all non-qualified residential mortgages. The GAO is required to conduct a study determining the effects of the Act on the availability of consumer credit.

- *Improving access to mainstream financial institutions*. The Act authorizes the Treasury Secretary to establish a multi-year program of grants, cooperative agreements and similar contracts designed to enable low and moderate income individuals to establish accounts in federally insured depository institutions, improve access to the provision of accounts for such individuals and provide low-cost, small loans to such individuals.

- *Short sale reforms*. The Act directs the SEC to prescribe rules providing for certain public disclosures and notifications to investors relating to short sales of securities. It also specifically makes unlawful the manipulative short sale of any security.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum may be directed to:

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