Paul|Weiss

The Dodd-Frank Wall Street Reform and Consumer Protection Act:

Summary and Analysis

AUGUST 2010

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

Paul | Weiss

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Obama on July 21, 2010. 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. This compilation includes our summary of the key provisions of the Act and a series of memoranda addressing areas of regulation under the Act that have been of particular interest to our clients.

Paul | Weiss

Table of Contents

Summary of Key Provisions of the Dodd-Frank Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). 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. The key provisions of the Act are summarized below.

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 permitting the use by a shareholder of company proxy materials to nominate director candidates and requiring companies to follow certain procedures in relation to such solicitation. The Act does not require the SEC to adopt proxy access rules and it explicitly authorizes the SEC to exempt certain companies from any requirements that it does adopt. On August 25, 2010, the SEC approved final rules that establish a federally mandated proxy access procedure. The rules include requirements that any shareholder or group of shareholders wishing to use the procedures must hold at least 3% of the voting power of the shares entitled to vote (regardless of the size of the issuer) and that the requisite shares have been held continuously for at least three years.

- *No majority voting for director elections.* The Act does not include a requirement that all U.S. public companies adopt majority voting. Under the Senate version of the bill, companies would have been required to implement majority voting for all uncontested director elections.

- *Chairman and CEO disclosures.* The Act directs the SEC to issue 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.

Contents

- *Broker discretionary voting*. The Act requires the national securities 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 was eliminated by the New York Stock Exchange for director elections starting this past proxy season, and this new provision will extend the prohibition to say-on-pay votes, say-on-golden parachute votes, other executive compensation votes and other matters determined by the SEC to be significant. The NYSE has sent a notice to its member organizations and listed companies that brokers will no longer be able to exercise discretion with respect to votes related to executive compensation matters at meetings occurring after July 21, 2010.

Executive Compensation

The Act provides for the following executive compensation reforms:

- *Say-on-pay*. Any proxy statement, consent or authorization for any shareholder meeting 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 those materials. In a change from the proposed legislation, the Act permits 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 changing or creating any additional fiduciary duties for the company or board.

- *Say-on-golden parachutes*. Any proxy or consent solicitation statement for which the SEC mandates compensation disclosure and that seeks shareholder approval of an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the assets of a company 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*. The Act requires institutional investment managers subject to Section 13(f) of the Securities Exchange Act of 1934 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. Controlled companies, foreign private issuers that are not otherwise subject to similar rules and certain other issuers are not subject to these independence requirements.

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. Controlled companies are not subject to these requirements.

- *Pay-for-performance and pay-parity disclosures*. The Act requires U.S. public companies to disclose in their annual proxy or consent solicitation 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 can include a graphic representation of the required information. It is unclear what additional disclosure is required as a result of this provision since similar disclosure is already required under current SEC rules. Companies are also 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*. U.S. listed companies will be required, through new rules adopted by the stock exchanges, 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 due to material non-compliance by the company with financial reporting requirements. 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 of 2002, 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 are 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.

- *Covered financial institution compensation restrictions*. Bank holding companies and certain other financial institutions are 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 by the applicable regulators.

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 statistical rating organizations ("NRSROs") will be required to establish, maintain, enforce and document an effective internal control structure and submit annual internal control reports to the SEC. The Office of Credit Ratings will be required to conduct at least annual examinations of all NRSROs and make reports of its findings publicly available. NRSROs 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 NRSROs for failing to consistently produce accurate ratings and establishes a private right of action against rating agencies.

The Act does not include a provision contained 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.

The Act nullifies Rule 436(g) under the Securities Act of 1933, which had exempted credit rating agencies from being treated as "experts" for purposes of liability under the securities laws in respect of ratings information contained in registration statements. Going forward, as a general matter, issuers that include their credit ratings in their registration statements or other documents incorporated therein by reference must either obtain the consent of the relevant rating agencies (which may not be possible because a number of rating agencies have indicated their unwillingness to provide such consents) or remove the ratings information from their registration statements and such other documents. Because of the significant impact this change will have on the use of credit ratings in registered securities offerings, the SEC staff has issued guidance for corporate issuers and no-action relief for asset-backed issuers to assist in managing the transition. For additional information, see our separate client memorandum of July 26, 2010 titled "SEC Staff Issues Guidance on Use of Credit Ratings in Securities Offerings."

In addition, the Act requires the SEC, within 90 days after the enactment of the Act (*i.e.*, by October 19, 2010), to revise Regulation FD to remove the exemption for disclosures made to credit rating agencies. Thereafter, an issuer that provides material non-public information to a credit rating agency will need to rely on another exemption from Regulation FD (if available) or ensure that the information is publicly disseminated.

Securitization Reform

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 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. 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 offerings*. The Act directs the SEC to issue rules that will disqualify certain "bad actors" from the private offering safe harbor in Rule 506 of Regulation D under the Securities Act. The SEC is required to adopt rules substantially similar to Rule 262, which currently applies to Rule 505 offerings and disqualifies issuers that have, among other things, been subject to an injunction or convicted of a felony or misdemeanor in connection with the purchase or sale of a security. In addition, the SEC is required to issue rules specifically disqualifying a person that is subject to a final order by a state securities, banking or insurance authority, a federal banking agency or the National Credit Union Administration that (i) bars the person from association with any entity regulated by such authority from engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or (ii) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct.

- *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 Act does not include a proposed amendment that would have effectively overturned the Supreme Court's 1995 decision in *Gustafson v. Alloyd Co., Inc.* The proposed 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 provisions relating to actions against credit rating agencies. 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 who do not hold themselves out to the public as investment advisers and have 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 generally subject to state registration and regulation). 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 Act does not include 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 to submit a report to Congress on the feasibility of creating a self-regulatory organization to oversee private funds.

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 they determine 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 clearinghouses, 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" must be executed on such exchange or facility.

- *Commercial end-user exception.* The Act includes an exception to the clearing and exchange trading requirement for OTC derivatives where one of the counterparties to the contract is not a "financial entity," such 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. The decision whether or not to use the exception is at the discretion of the commercial end-user. If the end-user is a company with securities registered under Section 12 of the Exchange Act or required to file reports pursuant to Section 15(d) of the Exchange Act, in order to take advantage of the commercial end-user exception, the board of the company (or an appropriate committee) must first approve the decision to enter into OTC derivatives contracts that are subject to the commercial end-user exception.

- *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. Before October 19, 2010, the CFTC or the SEC, as applicable, must issue an interim final rule providing for the reporting of swaps that were entered into before July 21, 2010. Such swaps must be reported to a swap data repository or to the CFTC or the SEC, as applicable, by the later of 30 days after the issuance of the interim final rule or such other time frame specified by the CFTC or the SEC. Reported trades will be grandfathered for purposes of the clearing requirement.

- *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 with substantial positions in OTC derivatives contracts. 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.* The Act imposes capital and, for uncleared OTC derivatives, initial and variation margin requirements on swap dealers and major swap participants. Capital and margin requirements will be set by the CFTC, the SEC and the applicable prudential regulator (in the case of banking entities). In setting the standards for capital and margin requirements, the regulators must take into consideration the risks associated with trading in uncleared OTC derivatives and the need to ensure the safety and soundness of the swap dealer or major swap participant. Although the Act does not expressly give relief to those commercial end-users that are exempt from the clearing and exchange trading requirements, it does permit the use of non-cash collateral as determined by the regulators. In addition, a letter written by Senators Dodd and Lincoln to Chairmen Frank and Peterson following the enactment of the Act clarifies that the capital and margin requirements are not to be imposed on end-users, and that margin requirements are not intended to result in the imposition of greater margin transfer obligations by end-users under exempt transactions. 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 rehypothecated.

- *Position limits.* The Act authorizes the CFTC and the SEC to establish position limits with respect to OTC derivatives traded on an exchange or a swap execution facility and 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 certain federal assistance, including access to the Federal Reserve discount window or FDIC deposit insurance, to swap dealers and non-bank 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. An exemption allows 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 to the extent of swaps involving rates or reference assets that are permissible for investment by a national bank (other than uncleared credit default swaps). Insured depository institutions that would be subject to the 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 July 21, 2010 will not be subject to central clearing and trading requirements if reported to a swap data repository within certain time periods. Similarly, trades entered into prior to July 16, 2011 will not be subject 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 have until July 16, 2011 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 "Oversight 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 Oversight 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 Oversight 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:

- *Systemically important companies.* The Oversight Council may, with a 2/3 vote of its members, 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.

- *Financial activities.* The Oversight Council may, with a 2/3 vote of its members, 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.

- *Heightened prudential standards.* The Oversight Council may 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.

- *Bank mergers.* The Oversight Council may, with a 2/3 vote of its members, 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 Oversight Council. The Office will also have the power to issue subpoenas to financial companies to collect information necessary to carry out its mandated functions.

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

The Act addresses systemic risk of financial collapse in the following ways:

- *“Living wills” and credit exposure reports.* Bank holding companies with $50 billion or more in assets and non-bank financial companies that are supervised by the Federal Reserve are required 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 non-bank financial companies and significant bank holding companies” and the nature of the credit exposure of “other significant non-bank financial companies and significant bank holding companies” to them.

- *Credit exposure limits.* 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, is required 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).

- *Short-term debt limit.* The Federal Reserve may limit 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.

- *Risk committees.* 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 are required to establish risk committees (which will be comprised of such number of independent directors as the Federal Reserve may deem appropriate).

- *Major acquisitions of financial companies.* Bank holding companies with $50 billion or more in assets and non-bank financial companies that are supervised by the Federal Reserve are required 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.

- *High capital requirements.* There will be established 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.

- *Management interlock.* A management official of a non-bank financial company that is supervised by the Federal Reserve is prohibited 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.

- *Stress tests.* The Federal Reserve, in coordination with other financial regulatory agencies and the Federal Insurance Office, is required 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).

- *Self-administered stress tests.* Bank holding companies with $50 billion or more in assets and non-bank financial companies that are supervised by the Federal Reserve are required 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.

- *Minimum debt-to-equity ratio.* The Federal Reserve is permitted 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 Oversight 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.

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

- *Early remediation.* The Federal Reserve, in consultation with the Oversight Council and the FDIC, is required 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.

- *Emergency lending.* The Federal Reserve's "lender of last resort" authority is updated 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.

- *Emergency guarantee power.* The FDIC is permitted 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 Oversight 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:

- *Vice Chairman for Supervision*. 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.

- *Interchange fees*. 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.

Orderly Liquidation Authority

The Act establishes an orderly liquidation mechanism whereby the FDIC may seize, break-up and wind down a failing non-bank 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 orderly liquidation 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 orderly liquidation authority will apply to broker-dealers that are members of the Securities Investor Protection Corporation ("SIPC") and will create a framework for providing substantially the same protections 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 borrow from the Treasury through a new-established Orderly Liquidation Fund to do so, according to a specific repayment plan) and would receive a senior claim 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:

- *Savings and loan associations.* 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.

- *State savings associations.* The FDIC will gain supervisory authority over all state savings associations.

- *Federal savings associations.* 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 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 if the following conditions, among others, are met: (i) the banking entity provides bona fide trust, fiduciary or investment advisory services to the fund, (ii) the fund does not use the banking entity's name or a variant thereof, (iii) the banking entity does not have an ownership interest in the fund other than seed investments to establish the fund and provide the fund with sufficient initial equity to attract unaffiliated investors, and (iv) the banking entity's investments do not amount to more than 3% of the total ownership of the fund and, 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 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. Banking regulators are allowed to grant up to three one-year extensions to this deadline. 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 attorneys general (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 Oversight 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 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 Oversight 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.

Pay It Back Act

In order to fund the new programs established thereunder, the Act (i) prohibits any new obligations from being incurred under TARP for a program that was not initiated thereunder prior to June 25, 2010, (ii) reduces the total authorization under TARP from $700 billion to $475 billion and (iii) increases the minimum reserve ratio for the Deposit Insurance Fund from 1.15% of estimated insured deposits to 1.35% of such deposits.

Additionally, the Act requires that proceeds from the sale of Fannie Mae, Freddie Mac and Federal Home Loan Bank debt and unused funds under the American Recovery and Reinvestment Act of 2009 must be used solely for deficit reduction.

Additional Reforms

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

- *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.

- *Exemption from Sarbanes-Oxley internal control requirements for “non-accelerated filers.”* 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. This exemption applies to smaller public companies as well as to larger companies whose only public securities are debt securities.

- *Section 13 and Section 16 amendments*. The Act amends the definition of "beneficial ownership" for the purposes of Sections 13(d) and 16 of Exchange Act to include beneficial ownership of security-based swaps. This amendment will become operative if and when the SEC adopts a rule indicating the extent to which a purchase or sale of a security-based swap constitutes beneficial ownership of the underlying security. In addition, the Act eliminates the obligation to send filed Schedule 13Ds to the issuer of the security and the obligation to submit copies of filed Schedule 13Ds and Forms 3, 4 and 5 to the exchange where the security is traded. Finally, the Act empowers (but does not require) the SEC to establish rules to shorten the Form 3 filing deadline (currently 10 days after becoming an insider) and the initial Schedule 13D filing deadline (currently 10 days after acquisition of more than 5% of registered equity).

- *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 Act does not include 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.

- *Conflict minerals*. As part of an effort to reduce the level of violence in the Democratic Republic of Congo ("DRC") and adjoining countries by targeting trade in minerals that are used to finance the conflict in the DRC, the Act directs the SEC to promulgate rules requiring annual disclosure as to whether "conflict minerals" necessary to the functionality or production of product manufactured by the company originated in the DRC or an adjoining country.

- *Mining disclosures*. The Act requires the SEC to promulgate rules requiring reporting public companies engaged in resource extraction (commercial development oil, natural gas or minerals) to disclose in an annual report to the SEC information relating to any "payments" made to foreign governments (including companies owned by foreign governments) or the federal government for the purpose of commercial development of oil, natural gas or minerals. In addition, the Act requires operators of coal or other mines to disclose certain information relating to mine safety.

- *Confidentiality of materials submitted to the SEC.* The Act provides that the SEC may not be compelled to disclose records and other information obtained from registered entities as part of the SEC's "regulatory and oversight activities," including its risk-assessment and surveillance functions. This will significantly enhance the SEC's ability to resist requests pursuant to the Freedom of Information Act.

Corporate Governance and Executive Compensation Provisions

The Act includes a number of significant corporate governance and executive compensation provisions that will apply to all U.S. public companies. These measures are discussed below.

Corporate Governance Reforms

- *Proxy access (Section 971).* The Act gives the SEC explicit authority to promulgate rules permitting the use by a shareholder of company proxy materials to nominate director candidates and requiring companies to follow certain procedures in relation to such solicitation. The Act does not require the SEC to adopt proxy access rules and it explicitly authorizes the SEC to exempt companies from any requirements that it does adopt after taking into account considerations such as whether the requirements would disproportionately burden small companies. On August 25, 2010, the SEC approved final rules that establish a federally mandated proxy access procedure. The rules include requirements that any shareholder or group of shareholders wishing to use the procedures must hold at least 3% of the voting power of the shares entitled to vote (regardless of the size of the issuer) and that the requisite shares have been held continuously for at least three years.

- *No mandatory majority voting for director elections.* The Act does not include a requirement that all public companies adopt majority voting. Under the Senate version of the bill, companies would have been required to accept the resignation of any director who receives less than a majority vote in an uncontested election, unless the board unanimously declined to accept the resignation. Notwithstanding the elimination of the majority voting requirements from the Act, we expect shareholder proposals requesting companies to adopt majority voting will likely continue until there is significant adoption of majority voting across all public companies. Currently, majority voting is the predominant standard at larger companies. According to ISS data, approximately 70% of the S&P 500 (as compared to approximately 37% of the S&P 1500) have a majority voting standard.

- *Chairman and CEO disclosures (Section 972).* The Act creates a new Section 14B of the Exchange Act, which directs the SEC to issue 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 will result in any additional disclosure requirements.

- *Broker discretionary voting (Section 957).* The Act amends Section 6(b) of the Exchange Act to require that the national securities exchanges prohibit proxy voting by a broker in connection with the election of directors (other than a vote with respect to the uncontested election of a member of the board of any registered investment company), executive compensation or any other significant matter, as determined by the SEC, unless the beneficial owner of the security has specifically instructed the broker to vote in such way. Broker discretionary voting was eliminated by the New York Stock Exchange for director elections starting this proxy season, and this new provision will extend the prohibition to say-on-pay and golden parachute votes, among other matters. The NYSE has sent a notice to its member organizations and listed companies that brokers will no longer be able to exercise discretion with respect to votes related to executive compensation matters at meetings occuring after July 21, 2010 (other than those meetings for which the NYSE had issued a "may vote" ruling prior to July 21), and that it intends to amend Rule 452 and related rules to reflect these requirements.

- *Risk committees at certain non-bank financial companies and bank holding companies (Section 165).* The Act requires that public non-bank financial companies supervised by the Federal Reserve and bank holding companies with assets of $10 billion or more establish a risk committee. Non-bank financial companies supervised by the Federal Reserve are those companies that have been designated by the soon-to-be-established Financial Stability Oversight Council as systemically important and that are substantially engaged in activities in the United States that are financial in nature (other than bank holding companies or their subsidiaries). The Federal Reserve may at its option extend these requirements to bank holding companies with assets of less than $10 billion.

  The Act specifies that these risk committees must be responsible for the oversight of the enterprise-wide risk management practices of the company and must include (i) such number of independent directors as the Federal Reserve determines appropriate (based on the nature of operations, size of assets and other appropriate criteria related to the company) and (ii) at least one risk management expert having experience in identifying, assessing and managing risk exposures of large, complex firms.

  This requirement represents a dilution of the proposal set forth in the Shareholder Bill of Rights Act introduced by Senators Schumer and Cantwell in 2009, which would have mandated risk committees for all U.S. listed companies. Notwithstanding the limited application of these risk committee requirements, risk management and the related processes to implement that discipline will continue to be at the top of the agenda for many companies, even those in non-financial sectors, in particular after recent events, such as the Gulf oil spill.

Executive Compensation Reforms

- *Say-on-pay (Section 951).* The Act creates a new Section 14A(a) of the Exchange Act, which requires companies to include in any proxy, consent or authorization for any shareholder meeting for which the SEC mandates compensation disclosure, a separate non-binding resolution subject to shareholder vote to approve the company's executive compensation as disclosed in those materials. In a change from the proposed legislation, the Act permits shareholders to elect to have a say-on-pay vote every two years or three years as opposed to annually, with a requirement that companies seek a shareholder vote to determine the frequency of such say-on-pay vote at least every six years. The Act further specifies that the shareholder vote will not be binding on the company's board of directors and could not be construed as overruling any company or board decision, changing or creating any additional fiduciary duties for the company or board or limiting the ability of shareholders to submit executive compensation proposals for inclusion in the company's proxy materials. The SEC has authority to exempt companies from the say-on-pay requirements after taking into account, among other considerations, whether they would disproportionately burden smaller companies.

- *Say-on-golden parachutes (Section 951).* The Act creates a new Section 14A(b) of the Exchange Act, which requires soliciting persons to include the following items in any proxy or consent solicitation for which the SEC mandates compensation disclosure and that seeks shareholder approval of an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the assets of a company:

  - "clear and simple" disclosure of any agreements that the soliciting person has with any named executive officers of the subject company or the acquirer (if the subject company is not the acquirer) concerning any compensation (present, deferred or contingent) that is based on or otherwise relates to such business combination and the aggregate total of all such compensation that may be paid to or on behalf of such executive officer (including the conditions of such payment); and

  - a separate 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.

  As with say-on-pay, the say-on-golden parachute requirements would be non-binding on the company's board of directors, have the same rules of construction as described above and be subject to SEC exemptive authority.

- *Disclosure of say-on-pay and say-on-golden parachute votes by institutional investors (Section 951).* The Act requires institutional investment managers subject to Section 13(f) of the Exchange Act to disclose their say-on-pay and say-on-golden parachute voting records at least annually unless otherwise required by the SEC.

- *Compensation committees (Section 952).* In legislation that is reminiscent of the audit committee independence and other requirements that were enacted as Section 10A of the Exchange Act pursuant to the Sarbanes-Oxley Act, the Act adds a new Section 10C of the Exchange Act, which requires the SEC to direct the national securities exchanges to require that all members of compensation committees of U.S. listed companies be independent and that compensation committees be given certain oversight responsibilities and adequate funding to carry out those responsibilities.

  In determining independence for this purpose, the Act requires the securities exchanges to consider certain factors, including the source of compensation for the director (such as any consulting, advisory or other compensatory fees paid by the company) and whether the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

The Act further provides that compensation committees will have the sole discretion to hire compensation consultants, legal counsel and other advisers and shall be directly responsible for the appointment and compensation, and oversight of the work, of these advisers. Companies will be required to provide appropriate funding for the retention of such advisers. When engaging compensation consultants, legal counsel or other advisers, compensation committees must consider certain independence factors to be determined by the SEC (which factors must be competitively neutral among categories of advisers), including (i) what other services the employer of the consultant or adviser provides to the company, (ii) the amount of fees the employer of the consultant or adviser receives from the company as a percentage of revenue for such employer, (iii) the policies and procedures related to conflicts of interest of the employer of the consultant or adviser, (iv) any business or personal relationships between the consultant or adviser and the members of the compensation committee and (v) any stock of the company owned by the consultant or adviser. The Act further specifies that the engagement of advisers under these new rules will in no way require compensation committees to act in accordance with the adviser's recommendations.

Also, in any proxy or consent solicitation for an annual meeting, companies will have to disclose (i) whether the compensation committee used any compensation consultants and (ii) whether any such compensation consultant identified any conflicts of interest and, if so, how the conflict is being addressed by the company.

Controlled companies are exempted from all of the foregoing requirements. Also, limited partnerships, companies in bankruptcy proceedings, registered investment companies and foreign private issuers that provide annual disclosures of the reasons why they do not have an independent compensation committee are explicitly exempted from the compensation committee independence requirements. In addition, the SEC has authority to exempt companies from any of these requirements based on relevant factors, such as the size of the company. The SEC is also directed to provide for appropriate cure periods for any failure to meet these requirements.

Finally, the Act requires the SEC to conduct a study of the use of compensation consultants and the effects of such use and to report the results of the study to Congress no later than two years after the Act's enactment.

- *Pay-for-performance and pay-parity disclosures (Section 953).* The Act amends Section 14 of the Exchange Act to direct the SEC to issue rules that require companies to disclose in any proxy or consent solicitation material for an annual shareholder meeting a "clear description" of any executive compensation arrangement required to be disclosed by Item 402 of Regulation S-K, including 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 is required as a result of this provision since similar disclosure is already currently required under SEC rules.

The Act also directs the SEC to issue rules that require companies 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. This pay-parity disclosure will be required not just for annual proxy statements but also for registration statements under the Securities Act and periodic reports filed pursuant to Section 13 or 15(d) of the Exchange Act to the extent that Item 402 disclosure is required.

- *Executive compensation clawbacks (Section 954).* The Act adds a new Section 10D of the Exchange Act, which requires the SEC to direct the national securities exchanges to require listed companies to develop and implement policies providing for (i) the disclosure of company policies on incentive-based compensation based on financial information required to be reported under the securities laws and (ii) the clawback of incentive-based compensation paid to current or former executive officers following a restatement due to material non-compliance of the company with financial reporting requirements under securities laws. These policies must apply to incentive-based compensation (including stock options) paid during the three-year period preceding the restatement, and the recovery would be the amount in excess of what otherwise would have been paid to the officer. The Act expands 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 (Section 955).* The Act amends Section 14 of the Exchange Act to require the SEC to issue rules requiring companies to disclose in any proxy or consent solicitation material for an annual shareholder meeting whether any employee or director of the company or any of their designees 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 (including prepaid variable forward contracts, equity swaps, collars and exchange funds) that are granted as compensation or otherwise held by the employee or director.

- *Covered financial institution compensation restrictions (Section 956).* The Act directs the "appropriate federal regulators" of "covered financial institutions" to require each institution to disclose to the appropriate regulator the structures of its incentive-based compensation arrangements so that a determination can be made as to whether that structure provides the institution's executive officers, employees, directors or principal shareholders with excessive compensation, fees or benefits or could lead to material financial loss to the bank holding company. No reporting of the actual compensation of particular individuals would be required. "Covered financial institutions" includes bank holding companies, registered broker-dealers, insured credit unions, investment advisers and any other financial institution that the appropriate federal regulators jointly by rule determine should be treated as a covered financial institution for these purposes. "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.

Further, the appropriate regulators must jointly issue rules to prohibit any incentive-based payment arrangement that they determine will encourage inappropriate risks by the covered financial insitutions by providing their executive officers, employees, directors or principal shareholders with excessive compensation, fees or benefits or that could lead to material financial loss to the institution.

Other Reforms

- *Exemption from Sarbanes-Oxley internal control requirements for "non-accelerated filers" (Section 989G).* The Act exempts 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. This exemption applies to smaller public companies as well as to larger companies whose only public securities are debt securities.
- *Amendments to Section 13 and Section 16 (Section 766).* The Act amends the definition of "beneficial ownership" for the purposes of Sections 13(d) and 16 of the Exchange Act to include beneficial ownership of security-based swaps. This amendment will become operative if and when the SEC adopts a rule indicating the extent to which a purchase or sale of a security-based swap constitutes beneficial ownership of the underlying security. In addition, the Act eliminates the obligation to send filed Schedule 13Ds to the issuer of the security and the obligation to submit copies of filed Schedule 13Ds and Forms 3, 4 and 5 to the exchange where the security is traded. Finally, the Act empowers (but does not require) the SEC to establish rules to shorten the Form 3 filing deadline (currently 10 days after becoming an insider) and the initial Schedule 13D filing deadline (currently 10 days after acquisition of more than 5% of registered equity).

Timing/Applicability

Most of the Act's executive compensation and corporate governance provisions require further regulatory action for implementation. While some provisions include a specified deadline for regulatory action, many provisions do not have explicit deadlines, leaving it open to interpretation as to when the respective regulators must act. We set forth below more detail as to the regulatory actions necessary, if any, to implement the particular provision and any applicable deadlines to such action. Unless otherwise specified, these provisions of the Act generally apply to all U.S. public companies, subject to any exemptive authority that the SEC might have in the rule making process. The Act will generally not apply to foreign private issuers, however, the exact scope of many of these provisions will be known only after rulemaking.

Corporate Governance	Action Required	Deadline for Action/Effect
Proxy access	SEC may establish rules	The SEC adopted final proxy access rules at an open meeting on August 25, 2010.
Chairman/CEO disclosures	SEC to establish rules	SEC to act no later than 180 days after enactment
Broker discretionary voting	None specified	None specified; however, the NYSE has notified its member organizations and listed companies that brokers will no longer have discretion with respect to votes related to executive compensation matters at meetings occurring after July 21, 2010 (other than those meetings for which the NYSE has issued a "may vote" ruling prior to July 21st).
Risk committees at financial institutions	Federal Reserve to establish rules	Two years after enactment, with rules to take effect no later than two years and three months after enactment

Executive Compensation	Action Required	Deadline for Action/Effect
Say-on-pay vote and frequency of say-on-pay vote	None specified	Both votes are required for the first applicable shareholder meeting occurring six months after enactment
Say-on-golden parachutes	None specified	Required for the first applicable shareholder meeting occurring six months after enactment
Disclosure of say-on-pay and say-on-golden parachute votes by institutional investors	None specified	None specified
Compensation committees	SEC to direct stock exchanges to develop listing standards	SEC to act no later than 360 days after enactment, except that compensation consultant disclosure must be included in proxy materials for an annual meeting occurring on or after the date that is one year after enactment, suggesting that the SEC must act in time for such disclosures to be effective one year after enactment
Pay-for-performance and pay-parity disclosures	SEC to establish rules	None specified
Executive compensation clawbacks	SEC to direct stock exchanges to develop listing standards	None specified
Hedging disclosures	SEC to establish rules	None specified
Covered financial institution compensation requirements	Federal regulators jointly to establish rules	Regulators to act no later than nine months after enactment

Other Reforms	Action Required	Deadline for Action/Effect
Exemption from Sarbanes-Oxley internal control requirements for "non-accelerated filers"	SEC to study the effects of Section 404(b) on mid-size companies	Exemption is effective for non-accelerated filers upon enactment. The SEC must report the results of its study to Congress no later than nine months after enactment
Section 13 and 16 amendments to include in beneficial ownership security-based swaps	SEC to establish rules	None specified

Private Fund Investment Advisers Registration Act

Included in Title IV of the Act is the Private Fund Investment Advisers Registration Act of 2010, which eliminates the "private adviser exemption" from SEC registration currently contained in Section 203(b)(3) of the Advisers Act for investment advisers who do not hold themselves out to the public as investment advisers and have fewer than 15 clients. As a result, many investment advisers to private funds (with some exceptions) will be required to register with the SEC. Registered advisers to private funds will be subject to substantial regulatory reporting and recordkeeping requirements regarding the private funds they advise. In addition, the Act effectively raises the assets under management ("AUM") threshold for federal registration of investment advisers to $100 million, with those advisers falling below such threshold becoming subject to state registration and regulation. Title IV becomes effective on July 21, 2011, prior to which time the SEC is required to adopt rules and regulations providing procedures for registration and reporting. Investment advisers to private funds may voluntarily register with the SEC during the period prior to the effective date.

SEC Registration Requirement

The Act eliminates both the "private adviser exemption" described above, as well as the intrastate exemption from SEC registration, which is applicable to advisers with clients that are all residents of the state in which the adviser maintains its principal place of business. As a result of the foregoing, many investment advisers to private funds will be required to register with the SEC, unless they fall within one of the specified exemptions. Additionally, the Act defines a "private fund" as any issuer that would be an investment company under Section 3 of the Investment Company Act of 1940, but for the exception provided by either Section 3(c)(1) or Section 3(c)(7) thereunder. Most private investment funds commonly rely on these provisions of the Investment Company Act to avoid regulation as an investment company.

Exemptions from SEC Registration

The Act provides the following exemptions from SEC registration as an investment adviser:

- an adviser that solely advises private funds and has aggregate AUM in the United States of less than $150 million (such an adviser is nevertheless subject to certain recordkeeping and reporting requirements described below);

- an adviser that solely advises "venture capital funds" (to be defined by the SEC) (such an adviser is nevertheless subject to certain recordkeeping and reporting requirements described below);

- an adviser that is a "foreign private adviser," which is defined as an adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser; (iii) has aggregate AUM attributable to clients and investors in the United States in private funds advised by such adviser of less than $25 million; and (iv) neither holds itself out generally to the public in the United States as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act or any business development company;

- an adviser that is registered with the CFTC as a commodity trading advisor and advises a private fund (however, if the "business of the advisor should become predominately the provision of securities-related advice," then such adviser must register with the SEC);

- an adviser to small business investment companies, which are regulated by the Small Business Administration; and

- family offices (to be defined by the SEC in a manner consistent with the SEC's prior exemptive orders and certain grandfathering provisions); the Act excludes family offices from the definition of "investment adviser" under Section 202(a)(11) of the Advisers Act, effectively placing such entities outside the purview of the Advisers Act (except that family offices that rely on the grandfathering provisions are subject to the antifraud provisions of Sections 206(1), (2) and (4)).

In addition, with respect to "mid-sized private funds" (as yet not defined), the SEC must provide for registration and examination procedures that reflect the level of systemic risk posed by such funds taking into account the size, governance and investment strategy of such funds.

Records; Reports; Examinations

The SEC is given general authority to require recordkeeping and reporting by registered investment advisers and to conduct periodic examinations of such advisers. The records of any private fund advised by an SEC-registered adviser are "deemed to be the records and reports of the investment adviser." SEC-registered advisers to private funds are required to maintain records regarding each private fund they advise, including a description of the following: amount of AUM; use of leverage; counterparty credit risk exposures; trading and investment positions; valuation policies and practices of the fund; types of assets held; side arrangements or side letters; trading practices; and other information relevant to determining potential systemic risk. Such records are subject to periodic, special or other examinations by the SEC. Registered advisers will also be subject to ongoing periodic reporting requirements, which could be expanded beyond the current requirements under Form ADV.

Importantly, advisers that are exempt from registration with the SEC because they either solely advise venture capital funds or solely advise private funds and have AUM in the United States of less than $150 million are subject to such recordkeeping and reporting requirements as the SEC "determines necessary or appropriate in the public interest or for the protection of investors."

Information Sharing; Disclosures

Reports filed with the SEC by such advisers are not subject to disclosure pursuant to Freedom of Information Act requests. The SEC will report annually to Congress on how the SEC uses the data collected to monitor the markets for the protection of investors and the integrity of the markets. The SEC will share with the Financial Stability Oversight Council such reports and other documents provided to it by registered advisers as the Oversight Council considers necessary for the purposes of assessing the systemic risk of private funds. Confidentiality protection is provided for any proprietary information submitted to the government, including sensitive, non-public information regarding the investment adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property. Regarding disclosure, Section 210(c) of the Advisers Act is amended to permit the SEC to require an investment adviser to disclose the identity, investments or affairs of any client "for purposes of assessment of potential systemic risk."

Limitation on SEC Rulemaking Authority

For purposes of the first two subparagraphs of the antifraud provisions of Section 206 of the Advisers Act, the Act prohibits the SEC from defining the term "client" to include an investor in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser. As a result, it will continue to be the case that an investment adviser will owe a fiduciary duty to a private fund.

Asset Threshold for Federal Registration of Investment Advisers

The Act effectively raises the AUM threshold for federal registration of investment advisers from $25 million to $100 million. The Act prohibits an investment adviser from registering with the SEC if the adviser: (i) has AUM between $25 million and $100 million (or such higher amount as the SEC may, by rule, determine) and (ii) is required to be registered as an investment adviser with the securities regulator of the state in which it maintains its principal office and place of business and, if registered, would be subject to examination as an investment adviser by any such state regulator, unless the investment adviser is an adviser to a registered investment company or business development company. If any investment adviser would be required to register with 15 or more states, it may register with the SEC. As a result, some advisers that are currently registered with the SEC must "de-register" with the SEC and, instead, register with their home state(s).

Custody

The Act requires a registered adviser to take steps to safeguard client assets over which it has custody as the SEC may prescribe, including, verification of such assets by an independent public accountant. Within three years after the enactment of the Act, the GAO must submit a report to Congress on the compliance costs associated with the current SEC custody rule applicable to registered investment advisers.

Accredited Investor Standard

Immediately upon enactment of the Act, the net worth standard for an "accredited investor" who is a natural person, as set forth in Rules 215 and 501(a)(5) of the Securities Act, is adjusted to exclude from the calculation of net worth the "value of the primary residence" of the investor. Pending implementation of the changes to the SEC's rules required by the Act, the SEC has issued Compliance and Disclosure Interpretations clarifying that the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth. The SEC is required to review and modify the definition of "accredited investor" periodically for the protection of investors, in the public interest and in light of the economy. Within three years after the enactment of the Act, the GAO must submit a report to Congress on the appropriate criteria for accredited investor status and eligibility to invest in private funds.

Qualified Client Standard

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. Under current law, an SEC-registered adviser may only charge incentive or performance based fees to investors in a fund if they meet the qualified client standard set forth in Rule 205-3 of the Advisers Act.

SRO for Private Funds

Within one year after the enactment of the Act, the GAO must submit a report to Congress on the feasibility of forming a self-regulatory organization ("SRO") to oversee private funds.

Other Relevant Provisions

- *Enhancing investment adviser examinations (Section 914).* The Act requires the SEC to review and analyze the need for enhanced examination and enforcement resources for investment advisers, including consideration as to whether designating one or more SROs to augment the SEC's efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers.

- *Investor access to information on registered investment advisers (Section 919B).* The Act requires the SEC to complete a study on ways to improve the access of investors to registration information about registered investment advisers, including disciplinary actions, regulatory, judicial and arbitration proceedings.

- *Regulation D offerings (Section 926).* The Act directs the SEC to issue rules that will disqualify certain "bad actors" from the private offering safe harbor in Rule 506 of Regulation D under the Securities Act. The SEC is required to adopt rules substantially similar to Rule 262, which currently applies to Rule 505 offerings and disqualifies issuers that have, among other things, been subject to an injunction or convicted of a felony or misdemeanor in connection with the purchase or sale of a security. In addition, the SEC is required to issue rules specifically disqualifying a person that is subject to a final order by a state securities, banking or insurance authority, a federal banking agency or the National Credit Union Administration that (i) bars the person from association with any entity regulated by such authority from engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or (ii) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct.

The Volcker Rule

The so-called "Volcker rule" (named after former Federal Reserve Chairman Paul Volcker) prohibits any "banking entity" from engaging in proprietary trading or sponsoring or investing in hedge funds or private equity funds, subject to limited exceptions. "Banking entity" is defined to include any insured depository institution, any company that controls an insured depository institution or that is regulated as a bank holding company, and any affiliate or subsidiary of any such entity. The Act also requires the Federal Reserve to adopt rules imposing additional capital requirements and quantitative limits on systemically important non-bank financial companies that engage in proprietary trading or sponsor or invest in hedge funds or private equity funds.

Prohibition on Proprietary Trading

The prohibition on proprietary trading extends to any transaction in the trading account of the banking entity where the entity acts as a principal. "Trading account" is defined as any account used for acquiring or taking positions in securities or other instruments principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any other account that the appropriate regulators, by rule, determine should be covered by the prohibition.

The Act provides exceptions to the prohibition on proprietary trading for the following permitted activities:

- transactions in obligations of the United States government, government-sponsored enterprises or state or municipal governments;
- transactions in connection with market making or underwriting activities, to the extent such transactions are designed "not to exceed the reasonably expected near term demands of clients, customers or counterparties;"
- risk-mitigating hedging activities related to individual or aggregated positions, contracts or other holdings of the banking entity that are designed to reduce specific risks;
- transactions in securities or other instruments "on behalf of customers;"
- investments in small business investment companies or certain other investments that are designed to promote the "public welfare" or that are qualified rehabilitation expenditures;
- transactions conducted by regulated insurance companies, provided that the appropriate banking regulators have not determined to prohibit such transactions;
- proprietary trading conducted by a banking entity solely outside of the United States, provided that the banking entity is not directly or indirectly controlled by a banking entity organized in the United States; and

- such other activities as the appropriate federal banking agencies, the SEC and the CFTC determine, by rule, would "promote and protect" the safety and soundness of the banking entity and the financial stability of the United States.

The Act further provides that no transaction may be deemed a permitted activity under the exceptions described above if it would (i) give rise to a material conflict of interest between the banking entity and its clients, customers or counterparties; (ii) result in a material exposure to "high-risk assets" or "high-risk trading strategies," as such terms are defined by rulemaking; (iii) pose a threat to the safety and soundness of the banking entity; or (iv) pose a threat to the financial stability of the United States.

Prohibition on Sponsoring or Investing in Hedge Funds or Private Equity Funds

The Volcker rule generally prohibits a banking entity from acquiring or retaining any equity, partnership or other ownership interest in or sponsoring any hedge fund or private equity fund. "Sponsoring" is defined broadly as (i) serving as a general partner, managing member or trustee of a fund; (ii) selecting or controlling a majority of the directors, trustees or management of the fund; or (iii) sharing with a fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name. "Hedge fund" and "private equity fund" are defined to include any issuer that would be an investment company subject to registration under the Investment Company Act but for an exemption provided by Section 3(c)(1) or Section 3(c)(7) thereunder, and any other issuer that the regulators determine, by rule, should be subject to the Volcker rule.

The Act provides exceptions for the following permitted activities:

- organizing and offering a hedge fund or private equity fund, including sponsoring such a fund, as long as all of the following conditions are met:

  (i) the banking entity provides bona fide trust, fiduciary or investment advisory services;

  (ii) the fund is organized and offered only in connection with the provision of such services and is only offered to customers of such services of the banking entity;

  (iii) the banking entity does not have an equity or other ownership interest in the fund except for the following de minimis investments:

    - seed investments to establish the fund and provide the fund with sufficient initial equity to attract unaffiliated investors; and

    - other de minimis investments;

  provided that, in making either of the above investments, (x) the banking entity must actively seek unaffiliated investors to reduce its ownership interest to not more than 3% of the total ownership interest of the fund within one year of the establishment of the fund (which period of time may be extended for up to two additional years upon application to the Federal Reserve); and (y) the banking entity's aggregate interests in all funds in which it is permitted to invest may not exceed 3% of its Tier 1 capital;[1]

(iv) the banking entity does not enter into covered transactions (as defined in Section 23A of the Federal Reserve Act, these transactions generally include providing loans or guarantees to funds and purchasing fund assets or securities) with the funds it organizes and offers and complies with the requirements of Section 23B of the Federal Reserve Act, which imposes restrictions on transactions between banks and their affiliates;

(v) the banking entity does not guarantee, assume or otherwise insure the obligations or performance of the fund or any other hedge fund or private equity fund in which the fund invests;

(vi) the banking entity does not share the same name or a variation of the same name with the fund;

(vii) no director or employee of the banking entity takes or retains an equity or other ownership interest in the fund, except for any director or employee who is directly engaged in providing investment advisory or other services to the fund; and

(viii) the banking entity discloses to prospective and actual investors that the fund's losses are borne by the fund's investors and not by the banking entity;

- investing in small business investment companies or certain other investments that are designed to promote the "public welfare" or that are qualified rehabilitation expenditures;

- investing in or sponsoring a hedge fund or private equity fund solely outside the United States, provided that the banking entity is not directly or indirectly controlled by a banking entity organized in the United States and the interests in the fund are not offered or sold to a resident of the United States; and

- engaging in such other activities as the appropriate federal banking agencies, the SEC and the CFTC determine, by rule, would "promote and protect" the safety and soundness of the banking entity and the financial stability of the United States.

These exceptions for permitted activities are subject to the same limitations described above with respect to proprietary trading, *i.e.*, such transactions must not give rise to material conflicts of interest, involve high-risk assets or strategies or pose a threat to the banking entity or the U.S. financial system.

[1] Tier 1 capital, as defined in the Bank Holding Company Act, generally is the sum of core capital elements less any amounts of goodwill, other intangible assets, interest-only strips receivables, deferred tax assets, nonfinancial equity investments and other items that are required to be deducted under certain requirements.

Limitations on Relationships with Hedge Funds and Private Equity Funds

The Volcker rule generally prohibits any banking entity that serves, directly or indirectly, as the investment manager, investment adviser or sponsor to a hedge fund or private equity fund, and any affiliate of such banking entity, from entering into a covered transaction (as defined in Section 23A of the Federal Reserve Act) with the fund or any other hedge fund or private equity fund that is controlled by the fund. This means that banking entities will generally be restricted in their ability to make loans or provide guarantees on behalf of their funds or to purchase fund assets or securities. Any such banking entity will also be subject to Section 23B of the Federal Reserve Act, which imposes other restrictions on transactions between banks and their affiliates. However, the Act does include an exception for prime brokerage transactions, pursuant to which the Federal Reserve is authorized to permit a banking entity to serve as prime broker for its own funds, subject to specified conditions.

Additional Capital Requirements and Quantitative Limitations for Permitted Activities

The Act authorizes the appropriate regulators to adopt rules imposing additional capital requirements and quantitative limitations, including diversification requirements, with respect to banking entities engaging in permitted activities under the exceptions to the Volcker rule. For purposes of complying with such additional capital requirements, the aggregate amount of de minimis investments of a banking entity in a hedge funds and private equity funds will be deducted from the assets and tangible equity of the banking entity, and the amount of the deduction will increase commensurate with the leverage of the hedge fund or private equity fund.

Non-bank Financial Companies Supervised by the Board

As noted above, the Federal Reserve is mandated to adopt rules imposing additional capital requirements and quantitative limits on systemically important non-bank financial companies regulated by the Federal Reserve that engage in proprietary trading or sponsor or acquire interests in private equity and hedge funds.

Anti-Evasion

In order to insure compliance with the Volcker rule, the appropriate federal banking agencies, the SEC and the CFTC must issue rules regarding internal controls and recordkeeping. In addition, whenever the appropriate federal regulator has reasonable cause to believe that a banking entity or systemically important non-bank financial company has made an investment or engaged in an activity “in a manner that functions as an evasion of the requirements” of the Volcker rule, such regulator must order termination of such activity and, as relevant, disposal of such investment.

Implementation

The Act requires that the Oversight Council conduct a study and make recommendations with respect to implementation of the Volcker rule within six months after enactment of the Act. Then within nine months after completion of the study, the appropriate federal banking regulators, the SEC and the CFTC are required to adopt coordinated final rules implementing the Volcker rule provisions of the Act. The Volcker rule provisions will formally take effect on the earlier of 12 months after the adoption of final regulations and two years after the date of enactment of the Act. Financial institutions covered by the rule will then have up to an additional two years to bring their activities and investments into compliance. Banking regulators are allowed to grant up to three one-year extensions to this deadline. In addition, the Federal Reserve is authorized to grant an extended exemption of up to five years for certain "illiquid funds," which are defined as funds that are principally invested in illiquid assets, such as portfolio companies, real estate investments and venture capital investments, to the extent necessary to fulfill contractual obligations that were in effect on May 1, 2010.

The federal banking agencies are directed jointly to review and prepare a report on the types of activities that a banking entity should be permitted to engage in under federal law. Separately, the GAO is directed to study the risks and conflicts associated with proprietary trading and report back to Congress within 15 months of the enactment of the Act.

Key Open Questions

- *Trading account and scope of market making exception*. For purposes of the prohibition on proprietary trading, the Act provides only a very general description of the term "trading account" and the accompanying exception for permitted market making activities. The scope of both the rule and the exception are likely to be the subject of debate during the implementation period, and the final rules can be expected to contain considerably more detail as to prohibited and permitted activities.

- *Application to employees' securities companies*. The Volcker rule's prohibition on sponsoring and investing applies to hedge funds and private equity funds that are exempt from registration under the Investment Company Act pursuant to either Section 3(c)(1) or Section 3(c)(7) thereunder, and to "such similar funds as the regulators may, by rule, determine." Sections 3(c)(1) and 3(c)(7) focus on the number of investors in a fund and the amount of investments held by an investor, respectively, rather than the specific relationship between the banking entity and the beneficial owners. Employees' securities companies (within the meaning of Section 2(a)(13) of the Investment Company Act) are exempted from the registration (and certain other) requirements of the Investment Company Act upon application pursuant to Section 6(b). Since employees' securities companies are exempted under a different section due to the specific relationship between the investors (employees) and the employer banking entity, investing in, and sponsoring funds organized as employees' securities companies should be exempted from the prohibitions of the Volcker rule. Making it clear that these funds will not be considered "similar funds" will be vital to their continued existence for banking entities. Regulations should also address situations in which these funds invest in parallel with funds sponsored by the bank employer.

- *The extent of the de minimis investment exemption*. The Volcker rule indicates that the de minimis investment exemption only applies to funds that are organized and offered by the banking entity and not to third party sponsored funds in which the banking entity might otherwise make an investment, other than through a bank sponsored fund of funds. It is not apparent that any other exemption would allow such direct investment in third party funds. If the de minimis exemption were intended to have any application to third party funds, it would need to be clarified in regulations.

- *Parallel funds and alternative investment vehicles*. Funds often set up parallel funds or alternative investment vehicles, commonly referred to as AIVs, to meet the needs of different groups of investors for a variety of specialized tax or regulatory reasons. An investor, such as a banking entity, may choose to invest its entire capital contribution in the main fund and not any of the parallel funds or AIVs. In maintaining its investment in the fund to not more than 3% of the total ownership interest of the fund, a banking entity needs to be certain if the amount of capital held by parallel funds and AIVs are considered as part of the total ownership interest of an overall fund and the 3% limit applies based on the capital of the overall fund. Regulations should provide that the parallel funds and AIVs will be treated as one entity with the main fund and the 3% capital holding requirement should be applied based on the capital of the overall fund.

- *Conversion to non-bank financial institution status*. The Act may create an incentive for bank holding companies to sell their insured depository arms and convert to non-bank financial institutions. However, entities that received TARP funds and have over $50 billion in assets will continue to be regulated by the Federal Reserve as non-bank financial institutions. The profitability of the conversion will depend on how harsh the Federal Reserve regulations on non-bank financial institutions are relative to the prohibitions on banking entities in the Act.

- *Regulation of non-bank financial institutions*. It remains to be seen the extent to which the Federal Reserve will seek to impose the Volcker rule principles on systemically important non-bank financial institutions. Minimum capital requirements and quantitative restrictions may make certain hedge fund strategies unprofitable.

- *Scope of exception for foreign entities*. The Act provides exceptions for proprietary trading and investing in and sponsoring hedge funds and private equity funds solely outside the United States by financial institutions that are not controlled by a banking entity organized in the United States. It is unclear whether the regulators will provide additional exceptions for foreign entities that would permit, among other things, foreign banks to conduct proprietary trading with U.S. counterparties on U.S. exchanges.

- *Conformance period for divestiture*. The Act provides that a banking entity must bring its activities and investments into compliance with the Volcker rule within two years of the effectiveness of the Volcker rule provisions. During this so-called "conformance period for divestiture," it is unclear whether and the extent to which banking entities will be permitted to continue proprietary trading and making new investments in funds, or whether they will only be permitted to wind-down such activities.

- *Impact on certain securitization entities*. As noted above, the Volcker rule defines "hedge fund" and "private equity fund" both to mean an issuer that would be an investment company, but for the exemptions found in Section 3(c)(1) and 3(c)(7) of the Investment Company Act. A large number of banking entity-sponsored securitization entities—including, for example, revolving securitization trusts and asset-backed commercial paper conduits—rely on either a Section 3(c)(1) or a Section 3(c)(7) exemption. Strictly read, the Volcker rule, as enacted, would apply to each of these entities as well. However, Section 619(g)(2) of the Act provides a broad exemption that nothing in the Volcker rule "shall be construed to limit or restrict the ability of a banking entity or non-bank financial company . . . to sell or securitize loans in a manner otherwise permitted by law." As such, most securitization trusts collateralized by loan assets should be exempt from the Volcker rule as written, but greater clarity will be required through rulemaking for banking entity-sponsored vehicles such as collateralized debt obligations and asset-backed commercial paper conduits, which can have more active investment policies and may hold a variety of securitized assets, such as trade receivables and other asset-backed securities.

Regulation of Over-the-Counter Derivatives

Title VII of the Act, known as the Wall Street Transparency and Accountability Act of 2010, introduces significant direct regulation of the market for OTC derivatives and the market participants that use them.

New Regulatory Structure

The Act brings the OTC derivatives markets within the scope of the federal securities and commodities laws and divides the jurisdiction over them between the SEC and the CFTC.

CFTC Jurisdiction Over "Swaps"

The CFTC will have jurisdiction over "swaps," which are defined to include a broad range of OTC derivatives transactions based on interest rates, other rates, currencies, commodities, securities, debt instruments, indices, quantitative measures, or other financial or economic interests or property of any kind. The definition does not include futures contracts, physically-settled forward contracts, certain transactions that are subject to the federal securities laws, certain retail commodity transactions, foreign currency options that are listed on a national securities exchange, and any transaction where the Federal Reserve, the federal government or a federal agency is a counterparty. Foreign currency swaps and forwards are included in the definition, but may be exempted by the Treasury Secretary.

SEC Jurisdiction Over "Security-based Swaps"

Transactions that otherwise meet the definition of "swaps" but are based on a single security, a single loan or a narrow-based security index are referred to in the Act as "security-based swaps" and are subject to exclusive regulation by the SEC as "securities" for the purposes of the Securities Act and the Exchange Act. By contrast, the CFTC retains the jurisdiction over swaps based on multiple securities, such as a group, portfolio or basket of securities or a broad-based security index. Security-based swaps that are also based non-security reference assets—so-called "mixed swaps"—are regulated by the SEC, subject to joint rulemaking with the CFTC.[2]

Scope of the New Regulatory Regime

Most of the substantive requirements in Title VII are fundamentally the same for swaps and security-based swaps. The CFTC and the SEC must consult and coordinate with each other to

[2] For ease of presentation, the terms "swaps," "swap dealers," "major swap participants," "swap data repositories," and "swap execution facilities" include references to "security-based swaps," "security-based swap dealers," "security-based major swap participants," "security-based swap data repositories" and "security-based swap execution facilities," respectively, unless otherwise specified. The term "Commission," as used herein, refers to the CFTC or, with respect to security-based swaps, the SEC, as the context requires. The term "clearinghouse," as used herein, refers to derivatives clearing organizations or, with respect to security-based swaps, clearing agencies, as the context requires. The term "exchange," as used herein, refers to designated contract markets or, with respect to security-based swaps, national securities exchanges, as the context requires.

assure that their regulations with respect to swaps and security-based swaps are consistent and comparable. Substantively, the provisions of Title VII broadly fall into two categories:

- transaction-specific provisions that apply generally to any person that trades swaps—these provisions include clearing, trading, reporting, position limits, antifraud and market manipulation rules; and
- entity-specific provisions applicable only to particular market participants—these provisions include enhanced requirements for "swap dealers" and "major swap participants," primarily registration, margin and capital requirements, separation from deposit-taking activities and heightened business conduct standards.

Regulation of OTC Derivatives Markets

Mandatory Clearing

The Act provides that it is unlawful for any person to enter into a swap that is subject to mandatory clearing unless that person submits the swap for clearing through a clearinghouse. The Act requires the Commission to determine which swaps, or group, types or classes of swaps, should be subject to mandatory clearing, either based on a Commission initiated review or following the submission by a clearinghouse of a swap, or group, type or class of swap it plans to accept for clearing. Swap clearing involves the substitution of a clearinghouse as central counterparty to all cleared swap trades. The clearinghouse also acts as custodian of collateral posted by the parties, thereby mitigating counterparty risk among the clearinghouse members and participants. Parties to a cleared swap, including end-users, must post initial and variation margin to the clearinghouse, which is required to segregate the margin.

The Act does not require swap counterparties who intend to enter into a swap to submit the swap to the Commission for determination of whether mandatory clearing will apply. Rather, a clearinghouse that plans to accept any swap, or group, type or class of swaps for clearing must submit an application to the Commission for a determination whether such clearing should be mandatory. The Act does not require a clearinghouse to obtain the Commission's prior approval of the terms of the swaps it plans to clear, nor does the Act restrict clearinghouses from clearing a swap if the Commission subsequently determines that such clearing should not be mandatory.

The Commission is also authorized to determine on its own initiative that mandatory clearing should apply to a swap, based on a review of several factors, including the existence of significant outstanding notional exposures, mitigation of systemic risk, relative trading liquidity and the availability of adequate pricing data with respect to the swap, as well as the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract. The Act does not impose a duty on clearinghouses to accept any swap for clearing and expressly provides that nothing in the Act authorizes the Commission to require a clearinghouse to accept a swap for clearing if doing so would threaten the financial integrity of the clearinghouse.

While it is commonly understood that only swaps with standardized terms could be eligible for mandatory clearing, the Act does not expressly limit mandatory clearing to swaps with standardized terms. Rather, a clearinghouse is free to make its own determination of whether to accept a swap for clearing. That determination likely will be based on whether the clearinghouse could profitably clear the swap under its existing clearing technology as well as the existence of sufficient and reliable valuation data and valuation models, among other factors. Although it is possible that the Commission could mandate clearing of a swap that no clearinghouse is willing to accept, the structure of the Act implies that this is an unlikely scenario. The Act does not offer an exemption from the clearing requirement in such situation, but contemplates that under such circumstances the Commission would, rather than imposing mandatory clearing, investigate the reasons why no clearinghouse has accepted such swaps for clearing and take necessary actions, such as prescribing margin or capital requirements for parties to those swaps.

Commercial end-user exception. Mandatory clearing does not apply to a swap where (1) one of the counterparties is not a "financial entity," (2) uses the swaps to hedge commercial risk and (3) notifies the Commission how it generally meets its obligations under non-cleared swaps. A "financial entity" is defined to include swap dealers, major swap participants, commodity pools, private funds, employee benefit plans and other entities predominantly engaged in financial activities. The definition of "financial entity" excludes captive finance affiliates that use derivatives to hedge interest rate and foreign currency risk related to 90% or more to the financing or leasing of products, 90% or more of which are manufactured by its parent company or another subsidiary of the parent company. Mandatory clearing also does not apply to transactions of certain other affiliates of an exempt entity, including certain types of financial entities that use swaps to hedge the commercial risk of the exempt entity or the commercial risk of any of the exempt entity's other affiliates that are not financial entities. Most hedge funds and private equity funds, by contrast, likely will constitute private funds and therefore will not be able to rely on this exception.

The decision whether or not to rely on the exception is at the discretion of the commercial end-user, and the end-user may opt to have the relevant swaps cleared. If the end-user is a company with securities registered under Section 12 of the Exchange Act or required to file reports pursuant to Section 15(d) of the Exchange Act, the board of such company (or an appropriate committee) must first approve the decision to enter into OTC derivatives contracts that are subject to the commercial end-user exception.

The commercial end-user exception is aimed at providing relief from the cost of posting (additional) margin in connection with mandatory clearing. However, as discussed below, the benefits of the commercial end-user exception may be limited (at least under the current wording of the Act) since the final version of the Act does not explicitly exempt commercial end-users from having to post margin with respect to uncleared trades entered into with swap dealers and major swap participants. See further under *Regulation of Swap Dealers and Major Swap Participants—Capital and Margin Requirements* below.

Grandfathering. Swaps entered into before July 21, 2010 are exempt from the clearing requirement if reported to a swap data repository or to the Commission within 180 days of the effective date. The relevant effective date is the later of (1) July 16, 2010 and (2) 60 days after publication of the Commission's final rule or regulation implementing the clearing provisions of the Act (see further under *Regulatory Implementation* below). Swaps entered into on or after July 21, 2010 are exempt if reported within the later of 90 days of the effective date or such other time frame specified by the Commission.

Trade Execution

Swaps that are subject to mandatory clearing and that also are made available for trading on an exchange or swap execution facility must be executed on such exchange or facility. Since the Act does not actually require any swaps to be made available for trading, the trade execution requirement has the effect of prohibiting bilateral trading of a swap that is subject to mandatory clearing once such swap has been admitted to trading on an exchange or swap execution facility. A "swap execution facility" is a new type of "many-to-many" trading system or platform on which multiple participants have the ability to execute and trade swaps by accepting bids and offers made by other participants that are open to multiple participants on the system or platform. Swap execution facilities are subject to Commission regulation and must register with the Commission or be exempt from registration.

Position Limits

The Act expands the existing authority of the CFTC to establish speculative position limits to include swaps traded on an exchange or a swap execution facility or that perform a significant price discovery function. The Act also requires the CFTC to establish aggregate position limits on the number or amount of contracts based on the same underlying commodity held by any person (other than bona fide hedging positions) for each month across contracts traded on an exchange or a foreign board of trade that grants direct access to participants located in the United States, and for swaps that perform a significant price discovery function with respect to regulated entities. For security-based swaps, the SEC and any self-regulatory organization may impose position limits, regardless of trading venue, across security-based swaps and any other instrument correlated with, or based on the same security or group or index of securities as, security-based swaps. The position limits will not apply to positions acquired prior to the effective date of the relevant regulation establishing the position limit, but will be attributed to the trader if its position is increased after such effective date.

Reporting and Real-time Publication of Trade Data

One of the main objectives of the Act is to increase market transparency and regulatory oversight of swaps by requiring the collection and publication of swap transaction data by swap execution facilities and swap data repositories. Under the Act, the Commission is authorized and required to provide rules for the reporting and publication of swap transaction and pricing data. Trade data for swaps subject to mandatory clearing or that are otherwise cleared will be publicly disseminated on a real-time basis by the clearinghouse or as required by the Commission. As a result, trade volume and pricing information will be publicly available as soon as technologically possible following trade execution. In addition, the counterparties to a swap, whether or not cleared, must report the transaction to a swap data repository or, if no repository accepts the swap, to the Commission, within the time frames established by the Commission. Where one party is a swap dealer or a major swap participant, it is incumbent on such party to submit the trade for reporting. For uncleared swaps, the trade data reported to the repository will be made publicly available on a real-time basis in a manner that does not disclose the business transactions and market positions of any person. Trade reporting will not identify the counterparties and may be delayed for block trades. Large swap traders that enter into any swap with significant price discovery function involving an amount or resulting in a position above certain limits established by the Commission must file a separate report with the Commission and maintain detailed books and records concerning such transactions. Before October 19, 2010, the Commission must issue an interim final rule providing for the reporting of swaps that were entered into before July 21, 2010. Such swaps must be reported to a swap data repository or to the Commission by the later of 30 days after the issuance of the interim final rule or such other time frame specified by the Commission.

Segregation of Margin

Any entity that receives margin from a customer to secure a cleared swap must be registered as a futures commission merchant (or, with respect to security-based swaps, as a broker-dealer or a security-based swap dealer). The margin must be segregated from and may not be commingled with any proprietary funds and may not be rehypothecated. For uncleared swaps, a swap dealer or a major swap participant must segregate initial margin received from a counterparty with an independent third-party custodian if the counterparty so requests.

Regulation of Swap Dealers and Major Swap Participants

Definitions of "Swap Dealer" and "Major Swap Participant"

The Act introduces specific requirements applicable to swap dealers and major swap participants. "Swap dealer" is defined to include any person who holds itself out as a dealer in or makes a market in a particular kind of swap as well as any person who "regularly enters into swaps with counterparties as an ordinary course of business for its own account." It is unclear whether the CFTC and SEC will interpret this definition broadly to include principal investors and traders, such as hedge funds, or whether they will develop a "trader exception" to the definition of "swap dealer" similar to the SEC's exclusion of "traders" from the definition of "dealer" under the Exchange Act.

"Major swap participant" includes any person who is not a swap dealer and (1) who maintains a "substantial position in swaps" (excluding positions to hedge commercial risk and positions held by an employee benefit plan), (2) whose total outstanding swap positions create substantial counterparty exposure that could threaten the stability of the U.S. financial markets or (3) who is a highly leveraged non-bank financial entity that maintains a "substantial position in swaps" (including positions to hedge commercial risk or positions held by an employee benefit plan). The definition of "major swap participant" excludes captive finance affiliates that use derivatives to hedge interest rate and foreign currency risk related to 90% or more to the financing or leasing of products, 90% or more of which are manufactured by its parent company or another subsidiary of the parent company. The definition remains to be further developed by the Commission, but will include "systemically important" swap traders.

An entity may be a swap dealer or major swap participant with respect to certain types of swaps, and not others, such that the same entity may act in different capacities depending on the type of swap. Swap dealers and major swap participants are subject to substantially identical requirements (with very few exceptions).

Registration and Operational Requirements

Swap dealers and major swap participants must register with the Commission and are subject to an enhanced regulatory regime, including capital and margin requirements, reporting, recordkeeping, risk management, trade monitoring, documentation, conflict of interest, back-office operational standards, business conduct standards and disclosure requirements.

Business Conduct Standards

The Act raises the standard of care owed by swap dealers (but not major swap participants) that act as advisers to certain "special entities," including federal agencies (although, as mentioned above, swaps with federal agencies as counterparties fall outside the definition of "swap"), States (including political subdivisions of States), state agencies and pension plans, endowments and retirement plans, by imposing a duty to act in the best interests of such entities. 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 the special entity's best interests. Swap dealers and major swap participants also 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).

Capital and Margin Requirements

Swap dealers and major swap participants must meet minimum capital requirements and, in connection with uncleared swap transactions, minimum initial and variation margin requirements as determined by the Commission (or, with respect to swap dealers and major swap participants that are banks, by the relevant bank regulators). These capital and margin requirements are intended to take into account the greater risk for the swap dealer or major swap participant and the financial system arising from the use of uncleared swaps and to ensure the safety and soundness of the swap dealer or major swap participant.

As discussed above, the Act provides for an end-user exception from the clearing requirement, but does not contain an explicit exemption from margin requirements for commercial end-users that enter into uncleared swaps with a swap dealer or major swap participant. As a result, swaps that are customarily not cash collateralized may be swept up by the mandatory margin requirements imposed on swap dealers and major swap participants even though no clearing requirement applies, thereby potentially creating a significant additional capital and liquidity burden for commercial end-users. The Act does, however, permit the use of non-cash collateral as determined by the regulators. In addition, Senators Dodd and Lincoln in a letter to Chairmen Barney Frank and Colin Peterson following the enactment of the Act clarified their intention that the capital and margin requirements introduced by the Act are not to be imposed on end-users, and that margin requirements are not intended to result in the imposition of greater margin transfer obligations by end-users under exempt transactions.

Prohibition on Federal Government Assistance to "Swaps Entities"

The Act includes a modified version of the "push-out rule" proposed by Senator Lincoln, which would have prohibited federally insured banks from directly operating or providing credit support to swap dealers. In a compromise worked out in the conference committee, the modified version of the provision prohibits the extension of certain federal assistance, including access to the Federal Reserve discount window and FDIC deposit insurance, to swap dealers or major swap participants that are not insured depository institutions. The prohibition also does not apply to FDIC-insured deposit institutions that constitute swap dealers to the extent they limit their swap activities to (1) hedging activities directly related to the insured depository institution's activities or (2) acting as a swap dealer for swaps involving rates or reference assets (excluding uncleared credit default swaps) that are permissible for investment by a national bank under the National Bank Act (Section 24 (Seventh) of the National Bank Act permits national banks to invest in a wide range of assets including certain fixed income instruments, foreign exchange products and bullion). As a practical matter, the push-out rule prevents FDIC-insured depository institutions from engaging in any other type of swaps activities and forces these institutions to spin out such other swap dealer activities to separately capitalized entities (which may be an affiliate controlled by the same bank holding company) that are effectively ring-fenced from the depository institution in accordance with the requirements of Sections 23A and 23B of the Federal Reserve Act. Insured depository institutions that would be subject to the push-out rule are granted a transition period of up to 24 months following the effective date (which may be extended by another 12 months) to divest or limit their swap activities accordingly. The prohibition will be effective two years following the date of enactment of the Act. In addition, whether or not a swap dealer, any FDIC insured depository institution also is prohibited from engaging in proprietary trading in swaps under the Volcker rule.

Legal Certainty

The Act provides that no swap shall be unenforceable as a result solely of the failure to be cleared. Unless otherwise agreed to by the parties to a swap in their bilateral trading agreement, the enactment of the Act also will not constitute a termination event, force majeure, illegality or similar event under the trading agreement that would permit a party to terminate, renegotiate, modify, amend or supplement the trading agreement. In addition, the Act clarifies that swaps shall not be construed as insurance contracts and preempts any state law attempts at regulating swaps as such.

Regulatory Implementation

The Act will take effect on the later of July 16, 2010 or, to the extent rulemaking is required by any provision of the Act, not less than 60 days after publication of the final rule or regulation implementing such provision. The Act can be expected to be followed by subsequent corrections bills to clarify and correct certain provisions of the Act. Many provisions of Title VII, including the definitions of “swap dealer” and “major swap participant” and other terms, the mechanics of clearing, the commercial end-user exception and the requirements for position limits, reporting, margin and segregation, will have to be detailed in the ensuing regulatory rulemaking process by the CFTC and the SEC. These agencies must jointly implement the provisions of the Act by July 16, 2010.

The Act introduces significant direct regulation of the market for OTC derivatives and the market participants that use them. The full impact of the new regulatory regime will depend in large part on how the Commission implements the provisions of the Act through its rules and regulations. Many conceptual issues still remain to be developed, including the possible scope and operational feasibility of mandated clearing. While the Act is designed to enhance financial stability and transparency and provides certain benefits to the users of OTC derivatives, it will also result in increased transaction and compliance costs. Once these costs become ascertainable, they likely will influence market behavior and the Commission’s rulemaking, as will the financial reform efforts of competing jurisdictions.

Securitization Reform

The Act includes substantial regulatory reforms for the asset-backed securitization process. The reforms are principally focused on risk retention and increased disclosure to investors.

Risk Retention

The Office of the Comptroller of the Currency, the Federal Reserve and the FDIC (collectively, the "Federal Banking Agencies"), together with the SEC, are required to jointly promulgate regulations requiring "securitizers" of asset-backed securities and mortgage-backed securities to retain a portion of the credit risk in securitized assets sold to investors. "Securitizer" is defined to include both an issuer of asset-backed securities and any "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." Securitizers are required to retain an economic interest of not less than 5% of the credit risk in any such asset that is transferred, sold, or conveyed to a third party through the issuance of an asset-backed security. Hedging or transferring away the required retained credit risk is prohibited by the Act and the Federal Banking Agencies and the SEC are required to determine the permissible forms and the minimum duration of the required risk retention. The Federal Banking Agencies and the SEC are also required to promulgate separate rules for risk retention in the case of collateralized debt obligations ("CDOs") and similar instruments collateralized by other asset-backed securities (including those collateralized by CDOs).

Importantly, the Act gives the Federal Banking Agencies and the SEC flexibility to adopt or issue exemptions, exceptions and adjustments to the prescribed risk retention rules for certain institutions or asset classes. Any such adjustment, exemption or exception must (A) help ensure high quality underwriting standards for securitizers and originators and (B) encourage appropriate risk management practices by securitizers and originators, improve the access of consumers and businesses to credit on reasonable terms or otherwise be in the public interest or for investor protection.

Certain government institutions, programs and assets are exempt from the risk retention requirements of the Act, such as the Farm Credit System, the Federal Agricultural Mortgage Corporation and any assets insured or guaranteed by the United States or an agency of the United States. Importantly, the Act specifically states that Fannie Mae, Freddie Mac and the federal home loan banks are not to be considered agencies of the United States, implying that, absent exemptions, these entities will be subject to the risk retention rules.

The Federal Banking Agencies and the SEC are required to promulgate final rules within 270 days of the enactment of the Act. The risk retention requirement must be effective no later than two years after publication of such final rules in the Federal Register, in the case of asset-backed securities generally, and one year after publication, in the case of residential mortgage-backed securities.

Special Rules for Commercial Mortgage-Backed Securities

Securities backed by commercial mortgages are given special consideration under the Act. The SEC and the Federal Banking Agencies are required to specify the types, forms and amounts of risk retention for those assets, which may include:

- retention of a specified amount or percentage of the total credit risk of the asset;
- retention of a first-loss position by a third-party purchaser, provided that the third party holds adequate financial resources, performs specified due diligence and meets the same standards for risk retention required of the securitizer;
- a determination that the underwriting standards and controls for the asset are adequate; and
- adequate representations, warranties and enforcement mechanisms.

Exemption for "Qualified Residential Mortgages"

The Act requires the Federal Banking Agencies, the SEC, the Secretary of Housing and Urban Development and the Director of the Federal Housing Finance Agency to jointly issue regulations to exempt "qualified residential mortgages" from the risk retention requirements.

However, it is important to note that only securities backed entirely by qualified residential mortgages are intended to be exempt. If an asset-backed security is backed by just one asset that is not a "qualified residential mortgage"—including, for example, mortgages that do not meet the criteria in the definition of "qualified residential mortgage" or tranches of other asset-backed securities—even if every other asset in the collateral pool is a "qualified residential mortgage," then the security will not be eligible for the exemption.

The Act requires the above agencies to take into account a number of underwriting and product factors when defining the term "qualified residential mortgage" that indicate a lower risk of default, based on historical performance data, including:

- documentation and verification of the financial resources relied upon to qualify the mortgagor;
- standards with respect to (i) the residual income of the mortgagor, (ii) the ratio of housing payments to monthly income of the mortgagor and (iii) the ratio of total monthly installment payments to monthly income of the mortgagor;
- product features and underwriting standards designed to mitigate potential for "payment shock" on adjustable rate mortgages;
- mortgage guarantee insurance or other credit enhancements; and

- limitation on features demonstrated to indicate a higher risk of borrower default, such as balloon payments, negative amortization, prepayment penalties and interest-only features.

Allocation of Risk Retention

The Federal Banking Agencies and the SEC are required to "reduce the percentage of risk retention obligations required of the securitizer by the percentage of risk retention obligations required of the originator." In performing such an allocation, the agencies and the SEC are required to consider whether the assets sold to the securitizer have terms, conditions and characteristics that indicate low credit risk and whether market conditions create incentives for imprudent origination standards. Additionally—short of allowing the retained credit risk to be transferred to a third party—the agencies and the SEC are required to consider the impact of such risk retention allocation on the access to credit by consumers and businesses at reasonable terms.

Disclosure

The Act requires enhanced reporting and disclosure by the issuer regarding the quality of the assets underlying the asset-backed securities. The Act requires the SEC to adopt regulations requiring each issuer of an asset-backed security to disclose information for the assets backing that security. In adopting such regulations, the SEC is required to:

- set data-format standards for asset-backed security disclosure, and
- require issuers to disclose asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence, including:
    - unique identifiers for loan brokers or originators;
    - the nature and extent of the compensation of the broker or the originator of the assets backing the security; and
    - the amount of risk retention by the originator and the securitizer.

The Act also requires securitizers to disclose repurchase requests of assets securitized across all trusts aggregated by the securitizer, so that investors may identify underwriting deficiencies. Issuers filing registration statements are also required to perform a due diligence review of the assets underlying an asset-backed security and to disclose those due diligence findings. Finally, the Act directs the SEC to adopt rules requiring credit rating agencies to include in their ratings reports a description of the representations, warranties and enforcement mechanisms available to investors in asset-backed securities and how they differ from those in issuances of similar securities.

Key Open Questions

- *Content of final regulations.* The Act sets out many broad guidelines, but gives few specific rules for the risk-retention and disclosure process. Many of the key implementational issues will require final regulations before securitizers can gain full confidence in the requirements of the Act, in particular what kinds of exceptions and exemptions will be created and what types of entities and transactions will be able to make use of them.

- *Harmonization with agency regulations*. The Act is not entirely consistent with existing regulatory proposals from federal agencies—namely the SEC. In a rule proposal issued on April 7, 2010 (the "Proposed Rules"), the SEC proposed a number of regulatory reforms that would apply to all "structured finance products"—a term designed to be broader than the traditional definition of asset-backed security. The Proposed Rules include risk-retention requirements as well, but focus on a 5% test of each class of securities issued in a securitization—not merely 5% of the credit risk of the underlying collateral. As such, the Proposed Rules would require 5% retention of a "vertical slice" of a transaction—i.e. 5% of each tranche of securities issued, with exceptions for certain revolving asset classes such as credit card securitizations which already commonly incorporate vertical retention slices in the form of required transferor interests in excess of 5%. The Proposed Rules also establish significant additional disclosure standards, including significant data requirements and increased disclosure for privately-issued transactions in line with that required in a public, registered transaction. The FDIC has issued its own proposals as well, applying to banks in particular, which will also need to be harmonized with the Act.

- *Significant additional disclosure requirements*. The SEC will need to align its proposed regulations with the Act prior to their finalization, but it is clear that both the Act and the Proposed Rules favor significant new disclosure requirements and securitizers will need to comply with a significant new disclosure regime in whatever form the final rules may take. The Act also removes the ability of an asset-backed issuer to rely on the automatic suspension of reporting requirements under Section 15(d) of the Exchange Act if the securities of each class to which the issuer's registration statement relates are held by less than 300 persons (the Act authorizes the SEC to adopt separate suspension rules for asset-backed issuers). This provision, combined with the "public-like" disclosure requirement for privately-issued asset-backed transactions—if finalized as set forth in the Proposed Rules—could lead to significantly increased initial and ongoing disclosure requirements for a wide range of both public and private asset-backed transactions.

Orderly Liquidation Authority

Title II of the Act creates the Orderly Liquidation Authority (the "Authority"), which empowers the FDIC to seize and wind down troubled non-bank financial companies whose failure would destabilize the financial system of the United States. The Authority combines elements of the FDIC's existing resolution authority (for failing insured depository institutions) under the Federal Depository Insurance Act (the "FDI Act") with certain provisions of the Bankruptcy Code. When invoked, the Authority will fully preempt the Bankruptcy Code and the rules and case law thereunder with respect to the failing firm.

Overview of the Orderly Liquidation Authority

Covered financial companies. The Authority may be invoked with respect to any "financial company" that is not an insured depository institution. A "financial company" is defined as any U.S. company that is (i) a bank holding company, (ii) a non-bank financial company supervised by the Federal Reserve, (iii) any company predominantly engaged in activities that are financial in nature or incidental thereto (which include, among others, securities underwriting and dealing, insurance activities and merchant banking) or (iv) any subsidiary of the foregoing predominantly engaged in activities that are financial in nature or incidental thereto, other than a subsidiary that is an insured depository institution or an insurance company. Among certain entities specifically excluded from "financial companies" are Fannie Mae and Freddie Mac. For a company to be predominantly engaged in financial activities, at least 85% of its consolidated annual gross revenue must be financial in nature (or derived from the ownership or control of insured depository institutions). A financial company for which the FDIC has been appointed receiver pursuant to the Authority is referred to as a "covered financial company."

Several aspects of this definition are notable:

- *Banks*. Because an insured depository institution cannot become a covered financial company, the Authority does not supersede the FDIC's authority pursuant to the FDI Act to appoint itself receiver for insured depository institutions.

- *Insurance companies*. Insurance companies may become covered financial companies, but the Authority provides that they nonetheless be liquidated or rehabilitated under state law.

- *Brokers or dealers*. When a broker or dealer registered under Section 15(h) of the Exchange Act and a member of the SIPC becomes a covered financial company, it is considered a "covered broker or dealer." For such companies, upon the FDIC being appointed receiver, the SIPC will be appointed trustee with the powers and duties provided by the Securities Investor Protection Act (the "SIPA") subject to certain of the FDIC's powers as receiver. The Authority requires that all obligations relating to customer property or customer name securities be discharged promptly, prior to other claims and in a manner and amount at least as beneficial to the customer as if the covered broker or dealer had been liquidated and the proceeds thereof distributed in a proceeding under the SIPA.

- *Subsidiaries.* The FDIC may appoint itself receiver of any U.S. "covered subsidiary" of a covered financial company, with the same powers as it possesses with respect to a covered financial company, upon the joint determination of the FDIC and the Treasury Secretary that (i) the covered subsidiary is in default or danger of default, (ii) such action would avoid or mitigate serious adverse affects on the financial stability or economic conditions of the United States and (iii) such action would facilitate the orderly liquidation of the covered financial company (collectively, a lesser showing than is required for the designation of a covered financial company). A "covered subsidiary" is defined as any covered financial company subsidiary that is not an insured depository institution, an insurance company or a covered broker or dealer.[3]

Commencement of orderly liquidation. For the FDIC to be appointed receiver of a financial company, three hurdles must be cleared. First, two-thirds of the Board of Governors of the Federal Reserve and two-thirds of the Board of Directors of the FDIC (or, in the case of a broker or dealer, two-thirds of the SEC Commissioners, and, in the case of an insurance company, the director or the Federal Insurance Office) must recommend that the Treasury Secretary appoint the FDIC receiver for the financial company.

Second, the Treasury Secretary, in consultation with the President, must determine that (i) the financial company is in default or in danger of default, (ii) the failure of the financial company and its resolution under otherwise applicable law would have serious adverse affects on the financial stability of the United States, (iii) no viable private sector alternative is available to prevent the financial company's default, (iv) any effect on the claims or interests of creditors, counterparties and shareholders of the financial company and other market participants is appropriate given the impact that imposing the Authority would have on the financial stability of the United States, (v) any action by the FDIC as receiver would avoid or mitigate the serious adverse effects on the financial stability of the United States, taking into consideration, among other things, the moral hazard that may result in the future, (vi) a federal agency has ordered the financial company to convert all of its convertible debt instruments that are subject to regulatory order and (vii) the company meets the definition of a "financial company."

Finally, unless the board of directors of the company consents or acquiesces to the receivership, the Treasury Secretary must petition the U.S. District Court for the District of Columbia for an order authorizing the receivership. The court must determine whether the Treasury Secretary's determination that the financial company is default or in danger of default and satisfies the definition of a "financial company" is arbitrary and capricious. If the court finds that such determination is not arbitrary and capricious, or fails to make a determination within 24 hours, the FDIC will be appointed receiver. The term of the receivership is three years from the date of the appointment, subject to up to two one-year extensions on certain conditions.

Mandatory Terms

Certain overarching requirements distinguish the Authority from the FDI Act and the Bankruptcy Code. The FDIC must, with respect to all actions pursuant to the Authority, (i) determine that

3 The reference to a "covered broker or dealer," rather than a "broker or dealer," may be an error, as a covered broker or dealer is (by definition) a covered financial company, for which the FDIC has already been appointed receiver.

such action is necessary for the financial stability of the United States and not only to preserve the covered financial company, (ii) ensure that the shareholders of the covered financial company do not receive payment until after all other claims are fully paid, (iii) ensure that unsecured creditors bear losses according to the prescribed priority, (iv) ensure that the management and directors responsible for the failed condition of the covered financial company are removed and (v) not take an equity interest in any covered financial company or covered subsidiary.

General Powers

Upon its appointment as receiver, the FDIC will succeed to the rights, titles and powers of the covered financial company and its assets, stockholders, officers and directors. Subject to enforceable and perfected security interests, the FDIC must liquidate and wind-up the affairs of the covered financial company. The FDIC may operate and collect all obligations on behalf of the covered financial company. In addition, the FDIC may transfer any of the covered financial company's assets or liabilities—including to a newly-established "bridge financial company," as described below—or merge the covered financial company without obtaining any approvals, other than regulatory approvals (which are to be processed on an expedited basis). Upon its appointment as receiver, the FDIC may obtain a 90-day stay in any judicial action or proceeding in which the covered financial company is or becomes a party.

Funding

Orderly liquidation fund. The FDIC may deploy funds it determines necessary or appropriate for the orderly liquidation of the covered financial company —including by making loans to, purchasing or guaranteeing the assets of or assuming the obligations of the company or any related bridge financial company. The FDIC may recoup any such funds on a priority basis and may draw funds for such purposes from an "Orderly Liquidation Fund" to be established in the Treasury. The Orderly Liquidation Fund will initially be funded with proceeds of obligations issued to the Treasury, the aggregate amount of which with respect to any covered financial company may not exceed certain specified limits. The FDIC may draw from the Orderly Liquidation Fund only pursuant to an "Orderly Liquidation Plan" acceptable to Treasury Secretary.

Assessments. If unable to repay the obligations issued to the Treasury within 60 months, the FDIC must make assessments: first, on claimants that received greater payments from the covered financial company than similarly-situated claimants, other than certain payments necessary to the operation of the receivership, and, second, pursuant to a "risk matrix" recommended by the Financial Stability Oversight Council on bank holding companies and other financial companies with at least $50 billion in consolidated assets and non-bank financial companies supervised by the Federal Reserve. The risk matrix must take into account, among other things, the risks presented by such companies to the financial system and the extents to which such companies benefited from the orderly liquidation and contributed over the previous 10 years to the failure of the covered financial company.

Bridge Financial Companies

Organization and capitalization. The Authority follows the FDI Act's "Good Bank / Bad Bank" mechanism by allowing the FDIC to organize "bridge financial companies" with respect to a covered financial company. The FDIC may capitalize a bridge financial company in its discretion. A bridge financial company may obtain unsecured credit and, if unable to do so, may issue first priority debt, secured by unsecured assets or a junior lien on secured assets. The bridge financial company may also grant senior or equal liens to existing liens (other than related to "qualified financial contracts," described below) if the FDIC demonstrates to a federal court that there is adequate protection for the existing lien holders.

Transfer of assets and liabilities. In transferring assets and liabilities to a bridge financial company, no more liabilities than assets may be transferred. If the FDIC establishes any bridge financial companies with respect to a covered broker or dealer, it generally must transfer to one bridge financial company all customer accounts and associated customer name securities and customer property, unless they are promptly to be transferred to another qualifying broker or dealer. In addition, in transferring assets or liabilities to a bridge financial company, the FDIC may depart from the general rule to treat similarly-situated creditors similarly if it determines that its action is necessary to maximize the value of or the return on the covered financial company's assets and all similarly situation creditors receive at least the amount they would have received in a Chapter 7 liquidation (or, for a covered broker or dealer, a case under the SIPA).

Treatment of Claims

Claims determination. The claims process under the Authority begins with the FDIC publishing notice to the creditors to present their claims by a date at least 90 days following such notice. Within 180 days thereafter, the FDIC will disallow untimely claims and claims not proven to its satisfaction (subject to federal court review). The Authority provides for an expedited determination process for claimants alleging certain secured interests and that irreparable injury would occur if the expedited process were not followed.

Under the Bankruptcy Code, in contrast, the debtor files debt schedules with the Bankruptcy Court. Creditors who agree with the scheduled amounts need take no action for their claim to be allowed. Those who disagree must file proofs of claims, thereby forcing the debtor to file a claims objection with the court.

Valuation of claims. The maximum liability of the FDIC to any claimant, and the minimum amount the FDIC must pay such claimant, is the amount such claimant would have received in a Chapter 7 liquidation (or, for a covered broker or dealer, in a case under the SIPA) (the "Liability Limits"). The FDIC may make payments to claimants in excess of the Liability Limits if the FDIC determines that such additional payments are necessary or appropriate to minimize losses to the FDIC as receiver.

Secured claims. Secured claims must be paid to extent of the fair market value of the assets securing them. Claim amounts in excess of such fair market values will be paid according to the priority scheme for expenses and unsecured claims.

Priority of expenses and unsecured claims. Expenses and unsecured claims are to be paid according to a specified order of priority, beginning with the payment of administrative expenses of the receiver and amounts owed to the United States as the highest priority and concluding with the payment of obligations to equity holders of the covered financial company as such as the lowest priority.

The FDIC may depart from the general rule to treat similarly-situated creditors similarly so long as such claimants receive at least as much as the FDIC's Liability Limits and the FDIC determines that dissimilar treatment is necessary (i) to maximize value of the assets of the covered financial company, (ii) to initiate and continue operations essential to implementation of the receivership or any bridge financial company or (iii) to maximize the return (or minimize the loss) from the sale of the assets of the covered financial company.

Under the Bankruptcy Code, in contrast, judges have only allowed similarly-situated claimants to be treated dissimilarly when the benefits of such dissimilar treatment accrue to all claimants.

Contracts

General. The Authority generally tracks the FDI Act with respect to the treatment of contracts. The FDIC may repudiate any contract (other than contracts respecting credit from any Federal Reserve bank or the FDIC) entered into prior to its appointment as receiver that the FDIC determines to be burdensome and the repudiation of which will promote the orderly liquidation of the covered financial company.

Damages. As a general rule, damages for repudiated contracts are limited to actual direct compensatory damages, determined as of the date the receiver was appointed or, in the case of qualified financial contracts, the date of repudiation. Particular rules apply to the calculation of damages for service contracts, qualified financial contracts, debt obligations, contingent claims, leases and contracts for the sale of real property.

Ipso facto clauses. So-called "ipso facto clauses"—other than those contained in director or officer liability insurance contracts, financial institution bonds and qualified financial contracts, as described below—are unenforceable against covered financial companies. Such provisions grant counterparties termination, acceleration or other rights upon the insolvency of the covered financial company, the appointment of the FDIC as receiver or other events in connection therewith. Counterparties may terminate, accelerate or exercise rights on the basis of other defaults, but generally may not do so without the FDIC's consent for 90 days following the appointment of the FDIC as receiver.

The FDIC may also render unenforceable ipso facto clauses in contracts of a covered financial company's subsidiaries or affiliates which contracts contain obligations that are guaranteed or otherwise supported by or linked to the covered financial company if it transfers the guaranty or support obligation and all related assets to a bridge financial company (or a third party that is not insolvent, in bankruptcy or subject to a similar proceeding) prior to 5:00 p.m. on the business day after it has been appointed receiver or, otherwise, if it provides adequate protection in respect of the obligations.

Qualified financial contracts. As under the FDI Act, particular rules apply to "qualified financial contracts," which are defined as securities contracts, commodity contracts, forward contracts, repurchase contracts, swap agreements and similar agreements as the FDIC may determine by regulation, resolution or order. The FDIC has until 5:00 p.m. on the business day after it has been appointed receiver to transfer any qualified financial contracts of a covered financial company. During such time, and any time after the FDIC has transferred such contracts, counterparties are stayed from exercising their rights under ipso facto clauses (though they may exercise rights tied to other defaults). If the FDIC decides to transfer a qualified financial contract, it must transfer, to a single financial institution, all of the qualified financial contracts between the covered financial company and the counterparty to such contract or any of its affiliates, together with all associated claims, property and credit enhancement. Such financial institution may be a bridge financial company, but, if not a bridge financial company, may not be insolvent, in bankruptcy or subject to a similar proceeding.

If the FDIC does not transfer a qualified financial contract, the counterparty may exercise its rights under ipso facto clauses and any setoff rights. The counterparty's rights under so-called "walkaway clauses," which suspend, condition or extinguish a counterparty's payment obligations solely because of the insolvency of the covered financial company or the appointment of the FDIC as receiver, are however unenforceable.

Avoidable Transfers and Setoffs

The Authority generally follows the Bankruptcy Code with respect to the avoidance of fraudulent or preferential transfers and the defenses thereto. The FDIC may recover the property or value transferred pursuant to an avoided transfer from (i) the initial transferee or person for whose benefit transfer was made or (ii) any transferee of such initial transferee who takes for value, in good faith and without knowledge of the voidability of the transfer (or any direct or indirect good faith transferee of such person).

The Authority also generally follows the Bankruptcy Code with respect to "setoff rights," the rights of creditors to offset debts owed by them to the covered financial company by the amount of their allowed claims. The Authority departs from the Bankruptcy Code, however, by allowing the FDIC to transfer assets free and clear of setoff rights, but provides that the claimant who thereby loses its setoff rights be entitled to a claim, senior to the rights of all unsecured creditors, for the value of such rights.

Actions against Senior Executives and Directors

The FDIC may recover from any current or former senior executive or director substantially responsible for the failed condition of a covered financial company any compensation received by such person during the two-year period preceding the appointment of the FDIC as receiver (or at any time prior to the FDIC's appointment, in the case of fraud). The FDIC may also prohibit a senior executive or a director of a covered financial company from participating in the affairs of <u>any</u> financial company for at least 2 years if it determines that, in exchange for financial gain, the person violated laws, engaged in unsound business practices or breached fiduciary duties and such breach involved dishonesty or demonstrated willful or continuing disregard for the safety and soundness of the company.

Rulemaking

In addition to specifically required regulations, the Authority contains a general authorization for the FDIC to prescribe such rules and regulations as it considers necessary or appropriate to implement the Authority.

Securities Litigation

The Act contains several procedural and substantive provisions that will facilitate enforcement of the securities laws through civil litigation, and will expand the scope of remedies available to injured private parties and the penalties and sanctions available in government actions.

New Provisions Affecting Regulatory Enforcement and Remedies

New Liabilities for Swap Dealers

The Act subjects swap dealers and security-based swap dealers to "business conduct" standards to be prescribed by rule by the CFTC. These standards will require swap dealers to verify the eligibility of swap transaction counterparties, to communicate based on the principles of "fair dealing and good faith," and to disclose certain material information (including conflicts of interest). The Act also imposes on swap dealers a fiduciary duty in their dealings with "special entities" (governmental entities and pension plans, endowments and employee benefit plans as defined under Section 3 of ERISA).

- *Swap dealers and security-based swap dealers acting as advisers*. Where swap dealers act as advisers, the Act creates additional antifraud conduct requirements.

- *No private right of action against swap dealers for breaches of new duties*. The power to enforce the substantive provisions governing swap dealer conduct is limited to the CFTC, and, in certain cases, a "prudential regulator" assigned to cover the specific swap dealer at issue.

- *Private right of action for market manipulation*. The Act extends the private cause of action in Section 22(a)(1) of the Commodity Exchange Act to claims for market manipulation in swap transactions. This liability provision also extends to aiders and abettors.

New Anti-manipulation Provisions

The Act expands the anti-manipulation provisions in Section 9 of the Exchange Act to cover all securities (including options) other than government securities. Previously, the reach of Section 9 had been limited to securities registered on a national securities exchange, and to options transactions occurring through a national securities exchange. Section 9 includes a private right of action for victims of market manipulation. The Act similarly extends the provisions governing short sales to all non-government securities. The Act also specifically makes unlawful the manipulative short sale of any security via any means of interstate commerce or a national securities exchange, and it requires the SEC to prescribe rules providing for certain public disclosures and notifications to investors relating to short sales of securities.

Whistleblower Protection

The Act creates substantial monetary awards for whistleblowers in any SEC or CFTC enforcement action resulting in a sanction of over $1,000,000, with award amounts determined as a percentage of the SEC's recovery. It also grants whistleblowers a private right of action against employers that retaliate. This right of action enables whistleblowers to claim reinstatement, back pay and litigation costs and attorneys' fees.

"Bad Actors" Excluded from Regulation D Offerings

The Act directs the SEC to issue rules that will disqualify certain "bad actors" from the private offering safe harbor in Rule 506 of Regulation D under the Securities Act. The SEC is required to adopt rules substantially similar to Rule 262, which currently applies to Rule 505 offerings and disqualifies issuers that have, among other things, been subject to an injunction or convicted of a felony or misdemeanor in connection with the purchase or sale of a security. In addition, the SEC is required to issue rules specifically disqualifying a person that is subject to a final order by a state securities, banking or insurance authority, a federal banking agency or the National Credit Union Administration that (i) bars the person from association with any entity regulated by such authority from engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or (ii) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct.

Strengthening SEC Enforcement

The Act strengthens the SEC's enforcement powers in three keys respects. First, it allows the SEC, under certain circumstances, to impose monetary penalties in administrative cease and desist proceedings against any person, not only regulated entities. Second, it expands federal court subject matter jurisdiction to regulatory and criminal antifraud actions against (i) persons taking "significant steps in furtherance" of a violation, even where the securities transaction takes place outside the United States and (ii) persons engaging in conduct outside the United States that has a foreseeable impact within the United States. Although this provision does not cover private lawsuits, the Act requires a study to determine whether this jurisdictional provision should be modified to include private civil litigation. Third, the Act specifies that control person liability under Section 20(a) of the Exchange Act applies in SEC enforcement actions, as well as in private actions.

Aiding and Abetting Liability

The Act clarifies the required mental state for a defendant accused of aiding and abetting a securities violation, stating that the government need only prove that the defendant acted "knowingly or recklessly." The Act's aiding and abetting provisions impose liability upon "any person that knowingly or recklessly provides substantial assistance to another person in violation" of any provision of the Securities Act or the Investment Company Act, and upon "any person that knowingly or recklessly has aided, abetted, counseled, commanded, induced, or procured a violation" of any provision of the Advisers Act.

Central Bank, Stoneridge and Gustafson Survive

The Act stops short of creating a private cause of action against persons who aid or abet violations of the federal securities laws. Senator Arlen Specter and Representative Maxine Waters introduced amendments at various stages of the bill's evolution seeking to create such a private right of action. These proposed amendments, if enacted, would have overturned the Supreme Court's decisions in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) and *Stoneridge Investment Partners, LLC* v. *Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008). These proposed amendments received substantial press coverage; however, the House-Senate conference committee ultimately did not adopt the amendments. Rather, the Act requires the Comptroller General to conduct a study of the potential impact of authorizing such a private right of action in the future.

Separately, Senator Carl Levin proposed an amendment that would have overturned *Gustafson* v. *Alloyd Co.*, 513 U.S. 561 (1995), the Supreme Court case holding that private securities transactions are insulated from the liability provisions of Section 12(a)(2) of the Securities Act. The proposed amendment would have extended Section 12(a)(2) liability for sellers' material misstatements and omissions in securities prospectuses to offering memoranda used in private placements of securities. Ultimately, the conference committee did not adopt the amendment.

Additional Provisions

Title IX of the Act contains several additional measures designed to facilitate regulatory enforcement, including provisions allowing nationwide service of subpoenas, enhancing confidentiality of materials submitted to the SEC and strengthening remedies available under the securities laws by increasing cash advances for customer claims in SIPC proceedings. 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, but it requires studies and reports on the impact of such private rights, leaving open a potential avenue for their creation.

Ultimately, the Act's provisions, particularly those contained within Title IX, have the potential to increase exposure to civil liability, particularly in regulatory enforcement actions, for violators of the federal securities laws.

What Foreign Private Issuers Need to Know About the Dodd-Frank Act

While the Act will have its greatest impact on the U.S. financial system and on financial institutions operating in the United States, the Act also contains a number of provisions that will have a significant effect on corporate governance of companies listed on U.S. exchanges (both financial institutions and non-financial institutions). Other provisions of the Act will have an effect on disclosure practices and potential liability of companies with reporting obligations to the SEC.

We discuss below the provisions of the Act that will impact foreign private issuers that are listed in the United States or otherwise have SEC reporting obligations. We note that various provisions of the Act will apply only to companies that are subject to the SEC's proxy rules (which apply to domestic reporting companies and those non-U.S. companies that either do not qualify as foreign private issuers or do qualify but have voluntarily subjected themselves to the U.S. proxy rules). For ease of reference, we refer below to all of these as "domestic SEC reporting companies."

We note that because the United States, unlike an increasing number of other jurisdictions, tends to allow foreign companies that are listed in the United States to follow their home country corporate governance requirements and practices, the impact of the Act on foreign private issuers is expected to be far less significant than will be the case for domestic U.S. public companies.

Changes that Impact Foreign Private Issuers

The following are the corporate governance and disclosure provisions of the Act that do, or may well, apply to foreign private issuers:

Compensation Committees Requirements

The Act requires the SEC to direct the national securities exchanges to require that each member of the compensation committees of U.S. listed companies be independent, to require that the compensation committee be given adequate funding and certain oversight responsibilities and to set forth certain independence considerations for compensation committee advisers.

Foreign private issuers that provide annual disclosures of the reasons why they do not have an independent compensation committee are not subject to the independence requirements, but are subject to the other requirements in respect of compensation committees. Foreign private issuers that are "controlled companies" (companies where more than 50% of its shares are controlled by a single individual, group or other issuer) are not subject to any of the foregoing compensation committee requirements. The SEC has authority to exempt companies from these requirements based on relevant factors, such as the size of the company.

While the Act does not require companies to have compensation committees per se (meaning, for example, that NASDAQ companies that do not have compensation committee structures may be able to continue that practice pending further rulemaking from the exchange), those companies that do must have fully independent compensation committees, subject to the exceptions described above. Further, in determining independence for this purpose, the Act requires the securities exchanges to consider certain factors, including the source of compensation for the director (such as any consulting, advisory or other compensatory fees paid by the company) and whether the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

The Act further provides that compensation committees will have the sole discretion to hire compensation consultants, legal counsel and other advisers and shall be directly responsible for the appointment and compensation, and oversight of the work, of the consultant and other advisers. Companies would be required to provide appropriate funding for the retention of such advisers. When engaging compensation consultants, legal counsel or other advisers, however, compensation committees must consider certain independence factors to be determined by the SEC, including (i) what other services the employer of the consultant or adviser provides to the company, (ii) the amount of fees the employer of the consultant or adviser receives from the company as a percentage of revenue for such employer, (iii) the policies and procedures related to conflicts of interest of the employer of the consultant or adviser, (iv) any business or personal relationships between the consultant or adviser and the members of the compensation committee and (v) any stock of the company owned by the consultant or adviser. These factors must be competitively neutral among categories of consultants and advisers. The Act further specifies that the engagement of consultants or advisers under these new rules will in no way require the compensation committees to act in accordance with the consultant or adviser's recommendations.

Internal Control Attestation Requirements

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. This exemption applies to smaller public companies as well as to larger companies whose only public securities are debt securities.

Incentive-Based Compensation Clawback

The Act requires the SEC to direct the national securities exchanges to require listed "issuers" to develop and implement policies providing for the "clawback" of incentive-based compensation paid to current or former executive officers following a restatement due to material non-compliance of the company with financial reporting requirements under securities laws. These policies must apply to incentive-based compensation (including stock options) paid during the three-year period preceding the restatement, and the recovery would be the amount in excess of what otherwise would have been paid to the officer.

The Act goes beyond the clawback provision contained in the Sarbanes-Oxley Act, which applies only to compensation received by the CEO and CFO during the 12-month period following the first issuance of the restatement and only if the restatement resulted from misconduct.

As the Act refers to "issuers" it is unclear whether the SEC can, or would, exclude foreign private issuers from these requirements, even though they represent a further "federalization" of corporate governance matters, and even though clawback remedies might best be left to contractual provisions in employment agreements or terms of compensation plans. The Act furthers a trend in which compensation can be clawed back even though the officers in question were not directly involved in the actions that gave rise to the restatement. We note, for example, that in June 2010 the SEC defeated a motion to dismiss in an action against a CEO under the Sarbanes-Oxley Act clawback provision (SEC v. Jenkins), in which it is seeking the return of bonus payments and proceeds of stock sales from the CEO notwithstanding the fact that it did not charge the CEO with any wrongdoing. The court rejected the notion that the misconduct triggering clawback must be the officer's, focusing instead on the misconduct of the company, acting through the efforts of its officers and employees.

Use of Credit Ratings in Registration Statements

The Act nullifies Rule 436(g) under the Securities Act, effective July 22, 2010. Rule 436(g) had exempted credit rating agencies from being treated as "experts" for purposes of liability under the securities laws in respect of ratings information contained in registration statements. Going forward, as a general matter, issuers that include their credit ratings in their registration statements or other documents incorporated therein by reference must either obtain the consent of the relevant rating agencies (which may not be possible because a number of rating agencies have indicated their unwillingness to provide such consents) or remove the ratings information from their registration statements and such other documents.

Because of the significant impact this change will have on the use of credit ratings in registered securities offerings, the SEC staff has issued guidance for corporate issuers and no-action relief for asset-backed issuers to assist in managing the transition. The guidance provides an exemption for "disclosure-related ratings information" that relates only to changes to a credit rating, the liquidity of the registrant, the cost of funds for the registrant or the terms of agreements that refer to credit ratings. The guidance also exempts certain free-writing prospectuses, term sheets and press releases and certain registration statements declared effective prior to July 22, 2010.

Disclosure Regarding Conflict Minerals

As part of an effort that is gaining adherents in a variety of jurisdictions to reduce the level of violence in the Democratic Republic of Congo and adjoining countries by targeting trade in minerals that are used to finance the conflict in the DRC, the Act directs the SEC to promulgate rules requiring annual disclosure as to whether "conflict minerals" necessary to the functionality or production of product manufactured by the company originated in the DRC or an adjoining country. These rules will also require those companies that do disclose origination of conflict minerals in the DRC or an adjoining country to submit to the SEC (and post on their corporate website) a report covering the reporting company's diligence in respect of the source and chain of custody of such minerals, together with an independent private sector report, certified by the company. These reports are also to include a description of products manufactured by the company that are not "conflict free," facilities used to process conflict minerals, efforts to determine the origin of the conflict minerals and country of origin of conflict minerals.

"Conflict minerals" include coltan, cassiterite, gold, wolframite, or their derivatives, or other minerals designated by the U.S. Secretary of State to be financing conflict in the DRC. A product is "conflict free" for purposes of the Act if it does not contain conflict minerals that directly or indirectly finance or benefit armed groups in the DRC or an adjoining country.

Disclosure Obligations for those in Extractive Industries

The Act requires the SEC to promulgate rules requiring reporting companies engaged in resource extraction (commercial development oil, natural gas or minerals) to disclose in an annual report to the SEC information relating to any "payments" made to foreign governments (including companies owned by foreign governments) or the federal government for the purpose of commercial development of oil, natural gas or minerals. Payments include taxes, royalties, fees, bonuses, production entitlements or any other material benefits SEC determines is part of commonly recognized revenue streams for resource extraction. The SEC will make a compilation of the information publicly available online.

In addition, the Act requires operators of coal or other mines to disclose certain information relating to mine safety. As general matter, these disclosure requirements relate to actions taken by U.S. federal mining regulators pursuant to the Federal Mine Safety and Health Act. Accordingly, to the extent that a foreign private issuer's mining operations are not within the jurisdiction of either of these regulators, this section does not create any additional disclosure requirements. There is, however, an exception to this in the requirement to disclose the "total number of mining-related fatalities" for each coal or other mine for which the issuer or a subsidiary of the issuer is an operator. This disclosure requirement is not modified by reference to regulation or regulatory action under the Federal Mine Safety and Health Act and as a consequence, should be disclosed by foreign private issuers until the SEC clarifies whether these rules apply to both U.S. domestic companies and to foreign private issuers. This section of the Act becomes effective on August 20, 2010.

Contacts

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

Corporate Governance and Disclosure

Mark S. Bergman	44-20-7367-1601	mbergman@paulweiss.com
David S. Huntington	212-373-3124	dhuntington@paulweiss.com
John C. Kennedy	212-373-3025	jkennedy@paulweiss.com
Raphael M. Russo	212-373-3309	rrusso@paulweiss.com
Frances F. Mi	212-373-3185	fmi@paulweiss.com

Executive Compensation

Robert C. Fleder	212-373-3107	rfleder@paulweiss.com
David S. Huntington	212-373-3124	dhuntington@paulweiss.com
John C. Kennedy	212-373-3025	jkennedy@paulweiss.com
Lawrence I. Witdorchic	212-373-3237	lwitdorchic@paulweiss.com
Frances F. Mi	212-373-3185	fmi@paulweiss.com

Private Fund Adviser Regulation

Yvonne Y.F. Chan	212-373-3255	ychan@paulweiss.com
Robert M. Hirsh	212-373-3108	rhirsh@paulweiss.com
David S. Huntington	212-373-3124	dhuntington@paulweiss.com
Marco V. Masotti	212-373-3034	mmasotti@paulweiss.com
Philip A. Heimowitz	212-373-3518	pheimowitz@paulweiss.com
Amran Hussein	212-373-3580	ahussein@paulweiss.com
Jennifer A. Spiegel	212-373-3748	jspiegel@paulweiss.com

The Volcker Rule

Mark S. Bergman	44-20-7367-1601	mbergman@paulweiss.com
Robert D. Goldbaum	212-373-3028	rgoldbaum@paulweiss.com
Robert M. Hirsh	212-373-3108	rhirsh@paulweiss.com
David S. Huntington	212-373-3124	dhuntington@paulweiss.com
David K. Lakhdhir	44-20-7367-1602	dlakhdhir@paulweiss.com
Marco V. Masotti	212-373-3034	mmasotti@paulweiss.com

Over-the-Counter Derivatives Regulation

Manuel S. Frey	212-373-3127	mfrey@paulweiss.com
David S. Huntington	212-373-3124	dhuntington@paulweiss.com

Securitization Reform

David S. Huntington	212-373-3124	dhuntington@paulweiss.com
Jordan E. Yarett	212-373-3126	jyarett@paulweiss.com
T. Robert Zochowski Jr.	212-373-3762	rzochowski@paulweiss.com

Regulation of Credit Rating Agencies

Mark S. Bergman	44-20-7367-1601	mbergman@paulweiss.com
Andrew J. Ehrlich	212-373-3166	aehrlich@paulweiss.com
David S. Huntington	212-373-3124	dhuntington@paulweiss.com
John C. Kennedy	212-373-3025	jkennedy@paulweiss.com

Financial Stability and Regulation

Mark S. Bergman	44-20-7367-1601	mbergman@paulweiss.com
David S. Huntington	212-373-3124	dhuntington@paulweiss.com
David K. Lakhdhir	44-20-7367-1602	dlakhdhir@paulweiss.com
Da-Wai Hu	212-373-3170	dhu@paulweiss.com

Orderly Liquidation Authority

David S. Huntington	212-373-3124	dhuntington@paulweiss.com
Andrew N. Rosenberg	212-373-3158	arosenberg@paulweiss.com
Da-Wai Hu	212-373-3170	dhu@paulweiss.com

Securities Litigation

Brad S. Karp	212-373-3316	bkarp@paulweiss.com
Susanna M. Buergel	212-373-3553	sbuergel@paulweiss.com
Charles E. Davidow	202-223-7380	cdavidow@paulweiss.com
Andrew J. Ehrlich	212-373-3166	aehrlich@paulweiss.com
David S. Huntington	212-373-3124	dhuntington@paulweiss.com
Daniel J. Kramer	212-373-3020	dkramer@paulweiss.com
Richard A. Rosen	212-373-3305	rrosen@paulweiss.com

Foreign Private Issuers

Mark S. Bergman	44-20-7367-1601	mbergman@paulweiss.com
Andrew F. Foley	212-373-3078	afoley@paulweiss.com
David S. Huntington	212-373-3124	dhuntington@paulweiss.com
David K. Lakhdhir	44-20-7367-1602	dlakhdhir@paulweiss.com
Edwin S. Maynard	212-373-3024	emaynard@paulweiss.com
Tong Yu	81-3-3597-6306	tyu@paulweiss.com

NEW YORK
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

LONDON
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

BEIJING
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

TOKYO
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

HONG KONG
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

WASHINGTON, D.C.
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

www.paulweiss.com

0810MS