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Financial Regulatory Reform:

An Overview of The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Risk Management Association

Weil, Gotshal & Manges LLP

President Signs Landmark Financial Reform Bill

On July 21, 2010, President Obama signed into law a package of financial regulatory reforms unparalleled in scope and depth since the New Deal. **The Dodd-Frank Wall Street Reform and Consumer Protection Act** (the legislation)* is a sweeping reaction to perceived regulatory failings revealed by the most severe financial crisis since the Great Depression. After more than two years of congressional inquiries, hearings, and legislative proposals, the legislation includes 15 major parts with 14 stand-alone statutes and numerous amendments to the current array of banking, securities, derivatives, and consumer finance laws.

The legislation is intended to restructure significantly the regulatory framework for the US financial system, with broad and deep implications for the financial services industry where the crisis started. However, its impact will be felt well beyond the financial sector. Aspects of the legislation have the potential to affect all public companies by extending federal regulation of corporate governance. In addition, some of the provisions will affect the US operations of foreign companies as well as global transactions involving US-based businesses, assets, and financial instruments.

Despite its broad reach and more than 2,300 pages of text, few of the legislation's provisions will take effect immediately. The vast majority of the provisions—particularly those with the greatest impact on US and foreign businesses—instruct various regulatory agencies to issue implementing regulations within a specified period. Those periods range from one day to five years, with many provisions to be implemented by rules promulgated within six to 18 months after the legislation was signed into law. In large measure, Congress has delegated both the substantive details of the reforms and their implementation to federal regulators whose authority grew dramatically with the stroke of the President's pen.

Weil's Financial Regulatory Reform Working Group is providing this Overview to highlight, with brief commentary, the major provisions of the legislation and to provide the reader with insights into what may ultimately emerge as a multitude of regulators undertake their respective tasks. Our Overview is more than a recitation of the key provisions of the legislation but less than the tomes that ultimately will be required to address this highly complex and evolving body of law. In the coming weeks and months, we will provide more in-depth updates focusing on discrete aspects of the legislation and the practical implications for our clients and friends in the United States and abroad.

* On June 30, 2010, the US House of Representatives passed the legislation by a vote of 237–192. On July 15, 2010, the US Senate passed the legislation by a vote of 60–39.

Systemic Risk

The centerpiece of the reform package is the establishment of a new framework for monitoring and regulating systemic risk. The crisis highlighted the vulnerabilities of the financial system to risks taken by individual financial services companies due to the highly interconnected nature of the financial sector, and, in some instances, a high degree of concentration. Risk-taking by one company can put the liquidity and solvency of other companies at risk, and one firm's failure can cause multiple failures and create acute financial instability. The severe economic impact of the crisis, the expenditure of billions in taxpayer funds, and the compelling interest in preventing future taxpayer bailouts focused policymakers on the overarching objective of reducing systemic risk.

Despite widespread concern, policymakers in Congress and elsewhere disagreed on how to regulate and reduce systemic risk. Some believed that systemic risk should be separately monitored and regulated, while others maintained that better overall regulation of the various aspects of the financial system will best reduce or mitigate systemic risk. Both perspectives are represented in the legislation. The legislation touches upon nearly every facet of the financial sector, and, for the first time in US history, creates a framework designed solely to regulate systemic risk. That framework largely resides in a powerful council of financial regulators, a new authority allowing the Federal Deposit Insurance Corporation (FDIC) to seize control of a financial company whose imminent collapse is found to threaten the financial system, and enhancements to existing crisis management powers of the Federal Reserve and the FDIC.

Financial Stability Oversight Council (§ 111)*

The legislation squarely settles the question of who will be the nation's systemic risk regulator. Through the Financial Stability Act of 2010, Congress has established a Financial Stability Oversight Council (Council) to monitor sources of systemic risk and promulgate rules that will be implemented by the various financial regulators represented on the Council. In most instances, the Council will reach decisions based on a majority vote. In certain circumstances, however, a supermajority of seven votes will be required, one of which must be cast by the Treasury Secretary—effectively providing him or her with a veto. The Council's collective decision-making model is intended to bring together diverse viewpoints, foster more carefully vetted decisions, and result in a more graduated approach to systemic risk regulation. The model has the potential, however, to foster possible bureaucratic turf battles, gridlock, and decreased accountability among individual regulatory agencies.

* References are to the relevant sections of the legislation.

† The Council also includes five nonvoting members: Director of the Office of Financial Research, Director of the Federal Insurance Office, a state insurance commissioner, a state banking supervisor, and a state securities commissioner.

Who is on the Financial Stability Oversight Council?

The Treasury Secretary will chair the Council, which will have nine additional voting members:

- Chairman of the Federal Reserve Board
- Comptroller of the Currency
- Chairman of the Federal Deposit Insurance Corporation
- Chairman of the Securities and Exchange Commission
- Chairman of the Commodity Futures Trading Commission
- Chairman of the National Credit Union Administration
- Director of Federal Housing Finance Agency
- Director of the Bureau of Consumer Financial Protection
- A Senate-confirmed independent member with insurance expertise

Powers (§§ 112 – 115)

The Council will arguably become the most powerful regulatory body in the United States. Among other things, the Council will have the authority to:

- designate—by supermajority vote—certain companies and other entities as "systemically important"
- instruct the Federal Reserve to impose various measures to regulate systemically important companies, including requiring:
  - enhanced capital and leverage requirements
  - additional liquidity provisioning
  - mandatory contingent capital
  - resolution plans (commonly called "living wills")
  - credit exposure reports
  - concentration limits
  - supplemental public disclosures
  - periodic stress testing
  - other risk management protocols
- permit—by supermajority vote—the Federal Reserve to order systemically important companies to divest assets to avert a "grave threat" to US financial stability
- collect information from financial regulators and elsewhere to monitor the financial system
- identify regulatory gaps and other potential threats to US financial stability
- facilitate greater coordination and conversation among financial regulators
- resolve disputes among member agencies over a particular entity, product, or activity

The Council itself will not be a supervisory body, as it will neither engage in day-to-day examinations of the safety and soundness of particular institutions nor enforce market conduct rules. Those responsibilities will be left to the regulatory agencies represented on the Council. As discussed further below, companies identified by the Council as systemically important will be subject to regulation, supervision, and examination by the Federal Reserve.

Office of Financial Research (§§ 116 & 152 – 154)

To assist the Council in achieving its mission, Congress has created the Office of Financial Research (OFR) within the Treasury Department. Because Council members will meet only periodically and be devoted primarily to running the agencies they head, the OFR will be the central administrative body supporting the Council's agenda. The Director of the OFR will have a nonvoting seat on the Council and will report directly to the Treasury Secretary. As the Treasury Department's expert group on systemic risk, the OFR is charged with collecting data on behalf of the Council from member agencies and market participants. The OFR will no doubt shape the Council's agenda by issuing reports identifying regulatory gaps and various threats to US financial stability, and by making recommendations regarding regulatory and supervisory measures for covered companies.

"Covered Companies" and Other Institutions (§§ 102 & 112)

The most important question for US and foreign businesses is which entities will be subject to the soon-to-emerge systemic risk rules promulgated by the Council and enforced by the Federal Reserve. The dark days of autumn 2008 revealed that many companies outside the traditional banking sector were systemically important. To be sure, large commercial banks were among the hardest hit by the crisis, and their potential failure arguably threatened the stability of the financial system as a whole. But the same was true of a number of large investment banks, broker-dealers, asset management firms, diversified financial companies, and insurance companies—particularly those active in the over-the-counter (OTC) derivatives and overnight repo markets. During the crisis, some entities reincorporated as bank holding companies (BHCs) or obtained other charters to take advantage of various programs offered by the Federal Reserve and the Troubled Asset Relief Program (TARP) established by Congress. Through the legislation, Congress has created a mechanism by which a range of financial firms may be swept into a new systemic risk regulatory and supervisory framework. The following categories of entities will be subject to the Council's registration and reporting requirements and to direct supervision by the Federal Reserve.

"Large, Interconnected" Bank Holding Companies (§§ 102, 112, 115D, & 116)

BHCs with consolidated assets of $50 billion or more that are determined to be large and interconnected BHCs will potentially be subject to a host of supervisory measures, including enhanced capital and leverage requirements, additional liquidity provisioning, and new requirements for contingent capital, resolution plans, credit exposure reports, and concentration limits. All BHCs are currently regulated and supervised by the Federal Reserve for safety and soundness, but those entities falling into the "large, interconnected" category will be separately and additionally regulated under the legislation for systemic risk containment. Along with US-based BHCs, the "large, interconnected" category includes foreign banking organizations treated like BHCs under current law.

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Nonbank Financial Companies (§§ 102, 112 – 115, & 117)

On the premise that systemic importance reaches beyond traditional banks, the legislation creates a broad category of "nonbank financial companies" that is designed to capture any entity predominantly engaged in financial services. To fit within this category, at least 85% of a particular company's consolidated revenues or assets must stem from "activities that are financial in nature"—a defined term under existing law that largely covers banking, lending, underwriting, insurance, investment, and other activities unrelated to general commercial services or manufacturing. In crafting this initial requirement, Congress made a crucial decision not to include large companies outside the confines of the financial sector, even though their demise might threaten US financial stability. The "nonbank financial company" category is nevertheless quite large, extending possibly to thrifts and their holding companies, broker-dealers, investment advisers (potentially including managers of hedge funds and private equity funds), investment banks, and other asset management firms.

Non-US businesses also may be classified as nonbank financial companies if they satisfy certain criteria (see box above) and the Council determines their US presence meets sufficient quantitative and qualitative thresholds. The details of the thresholds for both US and non-US businesses and their application are largely left to the Council to articulate. The Council is also permitted to establish a safe harbor for entities otherwise subject to this classification.

Designated entities will have the benefit of a pre-designation, informal hearing process and potential appeal to a US district court. Moreover, the Council is instructed to consult with the

What constitutes a Nonbank Financial Company?

Assuming a company is predominantly engaged in "activities that are financial in nature," the Council—by a supermajority vote—may designate it as a nonbank financial company (subjecting it to enhanced supervisory measures) based upon, among other things, the following criteria:

- the degree of leverage at the company
- the amount and nature of the company's assets
- the amount and types of the company's liabilities
- the amount of off-balance sheet exposures
- the company's relationships with other nonbank financial companies and BHCs
- the importance of the company as a source of credit for households, businesses, and state and local governments, and as a source of liquidity for the US financial system
- the extent to which assets are managed—as opposed to owned—by the company, and whether the assets are diffuse

federal agency with primary authority over the specific nonbank financial company before making any final determination. If the Council's determination stands, the company will be required to register with the Federal Reserve within 180 days and thereafter be subject to enhanced regulatory and supervisory measures for systemic risk.

The legislation also includes a "Hotel California" provision that automatically places any *former* $50 billion-plus BHC that received TARP assistance into the nonbank financial company category until the Council determines otherwise. Like the poor souls described in The Eagles' classic hit, those companies may "check out [of being a BHC] any time [they] like . . . but [they] can never leave" absent the Council's approval.

Financial Market Utilities (§§ 802 – 805)

The legislation includes the Payment, Clearing, and Settlement Supervision Act of 2010, which authorizes the Council to designate for supervision by the Federal Reserve, the Securities and Exchange Commission (SEC), or the Commodity Futures Trading Commission (CFTC), as appropriate, entities that engage in systemically important payment, clearing, or settlement activities. These specially designated "financial market utilities" and related payment, clearing, or settlement activities will be designated by a supermajority vote of the Council members based on:

- the value of the transactions processed by the entity or carried out through the activity
- the exposure of the entity to particular counterparties
- the connections between the entity or activity and similar financial market utilities or activities
- the effect that the failure of, or a disruption to, the entity or activity would have on critical markets or the broader financial system
- other factors the Council deems important

The underlying rationale is that certain entities and the activities they carry out are a critical part of the financial system's infrastructure and therefore may be systemically important even if their consolidated assets are small relative to other financial sector firms. These designated financial market utilities and related activities will be subject to a set of systemic risk management standards suitable for their role—such as enhanced collateral, margin, and capital requirements.

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Orderly Liquidation Authority (§§ 204 & 205)

Congress has acknowledged that some financial firms are going to fail, notwithstanding the intricacies of the framework it has designed to regulate and supervise systemically important companies as ongoing entities. During the financial crisis and in its aftermath, a number of policymakers formed the view—despite evidence to the contrary—that the US Bankruptcy Code and the judicial process it entails are ill-suited to govern the resolution of systemically important institutions that become insolvent.

The FDIC receivership framework that governs the resolution of banks is considered the standard model for preventing runs and financial panics due to the predominantly short-term funding sources (namely, demand deposits) that are used to finance bank lending operations. The hallmark of that model is the substantial discretion afforded to the FDIC in determining which non-depository claims to pay and the order in which to pay them. Although the rights of creditors and debtors alike are largely subordinated to the interests of the US government under the FDIC model, Congress has concluded that those drawbacks are outweighed by the flexibility the framework provides regulators in mitigating systemic risk.

As a direct result of that view, the legislation establishes a new mechanism, based largely on the FDIC's resolution process, for the liquidation of systemically important financial companies. That class of company will include those entities regulated by the Council and the Federal Reserve under the systemic risk regime outlined above, as well as any financial company whose imminent failure may have considerable adverse ramifications for the US financial system. This new mechanism is called the Orderly Liquidation Authority (Liquidation Authority).

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The US Bankruptcy Code will continue to apply to most financial companies, except those posing a systemic risk. In those cases, the new Liquidation Authority will preempt the bankruptcy process and permit the FDIC to seize control of the entity and proceed to liquidate it, rather than allowing the company and its creditors to work out restructuring arrangements as permitted under the US Bankruptcy Code. As a consequence of the legislation, lenders, rating agencies, and other counterparties need to consider the different effects of the US Bankruptcy Code and the Liquidation Authority on those financial firms whose failure might pose a systemic risk.

Covered Financial Companies (§ 204)

The Liquidation Authority potentially applies only to a "financial company," defined as a company organized under the laws of the United States that is:

- a BHC
- a designated nonbank financial company regulated for systemic risk
- a subsidiary of any of the foregoing kinds of companies, except insurance companies or insured banks and thrifts
- a broker or dealer registered with the SEC that is also a member of the Securities Investor Protection Corporation (SIPC)

A "financial company" will not fall within the purview of the Liquidation Authority unless the Treasury Secretary specifically designates it as a "covered financial company," which requires a determination that the company is in default or at risk of default and that it presents a systemic risk. But, as discussed below, this empowers the federal government to subject *any* financial company to the Liquidation Authority if the government makes such a determination. State regulators will continue to handle insolvent insurance companies, and insured banks and thrifts will continue to be handled under the existing FDIC framework.

***Systemic Risk Determination* (§ 203)**

Although the Treasury Secretary ultimately will determine whether the "failure of the financial company would threaten US financial stability," the FDIC and the Federal Reserve must initiate the process by recommending that such a determination be made, and the recommendation must be approved by two-thirds of the members of the boards of both the FDIC and the Federal Reserve. If the financial company is a broker-dealer, then the SEC, rather than the FDIC, must make this recommendation. The Treasury Secretary must consult with the President before rendering his or her final determination of systemic risk.

What factors are used to determine systemic risk?

The factors used to determine whether a given company poses a systemic risk include whether:

- the company is in default or in danger of default
- the US financial system would experience serious adverse effects resulting from the company's failure
- the private sector does not present any viable solutions to the prevention of the company's insolvency and a bankruptcy case would not be appropriate
- the FDIC is capable of taking actions that would avoid or mitigate the adverse effects of the company's collapse

***Default or Danger of Default* (§ 203)**

To determine that the financial company is in "default or danger of default," the Treasury Secretary must find that one of the following conditions exists:

- a case under the US Bankruptcy Code has been or is likely to be filed with respect to the company
- the company has incurred, or is likely to incur, losses that will deplete all or substantially all its capital
- the company has assets that are, or are likely to be, less than its debts or other liabilities
- the company is, or likely will be, unable, in the ordinary course of business, to pay back its creditors

Once the Treasury Secretary determines that a company poses a systemic risk and is in default or danger of default, the FDIC may rely on the Liquidation Authority to take steps to place the company in receivership.

***Acquiescence and Judicial Review* (§§ 202 & 207)**

Upon issuing a recommendation that the Liquidation Authority be exercised with respect to a particular company, the Treasury Secretary is required to ask the company's board of directors whether it "acquiesces" to FDIC receivership. Directors who consent to the appointment of the FDIC as receiver will bear no liability for making this choice. If the board of directors does not acquiesce to FDIC receivership, then the Treasury Secretary must petition the US District Court in Washington, DC, which has 24 hours to respond to the Treasury Secretary's petition before an order appointing the FDIC as receiver will be deemed automatically granted by that court. Although further review by the US Court of Appeals and even the US Supreme Court is theoretically available, a lengthy appeals process may not be realistic in most circumstances, particularly because no stay or injunction of the receivership order is permitted under the legislation while an appeal is pending.

FDIC's Powers and Responsibilities as Receiver (§§ 210, 212, & 213)

The Liquidation Authority is just like it sounds—receivership followed by an orderly liquidation. Rehabilitation and reorganization are not permitted. Also, unlike chapter 11 bankruptcies, a debtor under the Liquidation Authority is not permitted to remain in possession of the company; in all cases, the FDIC will assume full control of it.

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Upon the FDIC's appointment as receiver, all existing bankruptcy or other insolvency cases are dismissed, and no further cases may be filed against the company during the liquidation process. The FDIC succeeds to the rights, title, powers, and privileges of the financial company and operates the entity in order to maximize net asset sale value. Under the Liquidation Authority, the FDIC has many of the same receivership powers it has under the current banking laws, but those powers have been modified to address many of the differences between financial companies that pose a systemic risk and insured banks and thrifts in general. In particular, the FDIC's authorities under the new Liquidation Authority include:

- repudiating contracts, avoiding preferential or fraudulent transfers, and enforcing any contracts despite provisions (subject to exception for certain types of contracts) that would ordinarily trigger termination, default, acceleration, or other rights to become effective upon insolvency, but subject to valid and perfected security interests
- transferring the company's assets and liabilities
- forming a bridge financial company that can acquire the assets of the company
- enforcing or disregarding standstill agreements
- recovering up to two years of compensation paid to directors and senior management substantially responsible for the failure
- banning senior management from serving at any financial company if they have engaged in serious misconduct
- appointing itself as a receiver of certain company subsidiaries
- issuing subpoenas
- coordinating with foreign financial regulators with respect to any non-US assets or operations of the company

The FDIC is required to exercise its powers so that the company's creditors and shareholders—and not US taxpayers—bear the company's losses. Shareholders may not receive any payment until all other claims have been fully paid, and the FDIC is charged with ensuring that the claim priority provisions discussed below are followed with respect to any payments to unsecured creditors. Furthermore, the FDIC is required to dismiss those members of the failing company's management responsible for the company's financial condition. Expedited treatment is to be granted to claims against officers, directors, and other parties involved in the company's operations.

Priorities of payments to unsecured creditors under the Liquidation Authority

1. FDIC's expenses as receiver
2. Amounts owed to the United States
3. Up to $11,725 in wages, salaries, commissions, or benefits earned by individual employees
4. General liabilities
5. Obligations subordinated to general creditors
6. Wages, salaries, or commissions owed to senior management and directors
7. Interests of shareholders, members, and general or limited partners

Orderly Liquidation Fund (§ 210)

The legislation also directs the Treasury Department to establish an Orderly Liquidation Fund that will be managed by the FDIC. Although the FDIC may borrow from the US Treasury, the agency is required to replenish any amounts borrowed through ex-post assessments on claimants and, if necessary, risk-based assessments on financial companies with consolidated assets of $50 billion or more. Congress has thus fashioned the Liquidation Authority to ensure that it will not be paid for by taxpayers but by members of the financial industry and those who directly benefited from a prior resolution.

Enhanced Powers of the Federal Reserve and FDIC
(§§ 1104 & 1105)

A final pillar of the new framework for US systemic risk regulation is the enhancement of the various crisis-management powers of the Federal Reserve and the FDIC. In many ways, these enhancements—often dubbed "foam on the runway" by Washington insiders—may be a necessary tool to safeguard US financial stability in the event of another crisis. In the autumn of 2008, the US government found itself largely without the legal authority to take steps necessary to prevent financial instability from spiraling out of control. When the moment came to "break the glass," government officials found there was little behind that proverbial glass but arcane statutory authorities poorly designed for financial crises. Moreover, many of the provisions on which the US government was forced to rely permitted assistance only to particular entities, thereby sharpening the perception that its response was a "bailout" of individual companies. To address those limitations, the legislation amends the Federal Reserve's lending authority under section 13(3) of the Federal Reserve Act and the FDIC's authority to provide guarantees.

. . . Congress has explicitly forbidden the Federal Reserve to lend to insolvent borrowers under the revised section 13(3). Going forward, section 13(3) may be used only to provide liquidity and not as a back door for equity injections. Insolvent companies must face bankruptcy or—if their failure is adjudged to be a threat to US financial stability—the Liquidation Authority. . . .

Since its enactment in 1932, section 13(3) has authorized the Federal Reserve to make tailored emergency loans to businesses as well as individuals in unusual or exigent circumstances. However, this authority sat unused from the Great Depression until the financial crisis, when the Federal Reserve relied on it to provide funding to individual firms and establish assistance programs. Although such measures have been controversial, Congress has decided to retain section 13(3), while eliminating the Federal Reserve's ability to lend to individual companies outside a program or facility with "broad-based eligibility," thus precluding the possibility of one-off bailouts. In order to establish a broad-based facility or program, the Federal Reserve must first obtain permission from the Treasury Secretary. In addition, Congress has explicitly forbidden the Federal Reserve to lend to insolvent borrowers under the revised section 13(3). Going forward, section 13(3) may be used only to provide liquidity and not as a back door for equity injections. Insolvent companies must face bankruptcy or—if their failure is adjudged to be a threat to US financial stability—the Liquidation Authority discussed above.

The legislation makes similar changes to the FDIC's emergency authority. The legislation clarifies that the FDIC's current systemic risk authority, which provides it greater flexibility in terms of resolution costs for banks and thrifts, may be used only when an institution is placed in receivership. In other words, the FDIC may not provide "open bank" assistance under its systemic risk authority; the depository must first be closed. Like the changes to section 13(3) above, Congress has eliminated the FDIC's ability to bail out banks and thrifts on an individual basis. At the same time, the FDIC is empowered to establish, with congressional approval, a broad-based financial stabilization guarantee program available to solvent depositories or solvent holding companies of depositories. To establish such a program, the boards of both the FDIC and the Federal Reserve must conclude a "liquidity event" that threatens US financial stability has taken place.

Banking Industry

Significant aspects of the legislation relate to changes in the regulation of banks, thrifts, holding companies, and related institutions. The reforms to the banking industry are largely embodied in two separate statutes: the Enhancing Financial Institution Safety and Soundness Act of 2010 and the Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010. As discussed below, these two statutes not only substantially restrict the activities in which certain institutions may engage, but also address the consolidation of US financial regulators.

Regulatory Reorganization (§§ 300 – 378)

Compared to other countries, the US financial regulatory structure is highly fragmented, and—as the financial crisis has demonstrated—presents a number of challenges in today's highly interconnected and global economy. With respect to the banking industry alone, the US has six federal prudential regulators: the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency (OCC), the National Credit Union Administration (NCUA), the Federal Housing Finance Agency (FHFA), and the Office of Thrift Supervision (OTS). Operating alongside these entities are various market regulators such as the SEC, the CFTC, the Federal Trade Commission (FTC), and a host of other regulatory agencies at the federal and state level. No other country has a similarly complex financial regulatory structure, making the United States unique in its "alphabet soup" of regulators.

Effective one year after the enactment of the legislation (with a potential extension of up to six months), the OTS will be abolished and its relevant authorities divided among the survivors of the regulatory reorganization.

Dissolution of the OTS (§§ 311 – 327)

Despite the numerous hearings in which the testifying experts overwhelmingly favored consolidation of the US financial regulatory structure, Congress has decided to dissolve only one agency—the OTS. As the issuer of charters for federal savings associations (commonly called thrifts) and the regulator of federal and state thrifts and savings and loan holding companies (SLHCs), the OTS has faced a considerable amount of criticism as many of the institutions it has regulated and supervised have required bailouts or been placed into FDIC receivership or bankruptcy. Effective one year after the enactment of the legislation (with a potential extension of up to six months), the OTS will be abolished and its relevant authorities divided among the survivors of the regulatory reorganization. The Federal Reserve will regulate and supervise SLHCs; the OCC will regulate and supervise federally chartered thrifts; and the FDIC will regulate state-chartered insured thrifts. The current array of OTS regulations will remain in effect and be transferred as appropriate to the jurisdictions of the Federal Reserve, the OCC, and the FDIC. However, to the extent the transferred OTS regulations are irreconcilable with similar requirements (*i.e.*, capital and leverage ratios) issued by the agencies assuming the OTS's former powers, the OTS regulations seem unlikely to survive.

Primary regulators of financial institutions

Type of Financial Institution	Primary Federal Supervisor
Bank Holding Companies	Federal Reserve
Financial Holding Companies	Federal Reserve
S&L/Thrift Holding Companies	Federal Reserve
National Banks	OCC
Federally Chartered Thrifts	OCC
State-Chartered Member Banks of the Federal Reserve System	Federal Reserve
FDIC-Insured State-Chartered Non-Member Banks	FDIC
FDIC-Insured State-Chartered Thrifts	FDIC
Federal Credit Unions	NCUA
FDIC-Insured State-Chartered Credit Unions	NCUA
Fannie Mae, Freddie Mac, & Federal Home Loan Banks	FHFA

Regulation and Supervision in the Banking Industry (§ 604)

In addition to abolishing the OTS, the legislation makes subtle but significant changes to the present regulatory structure. Under current law, the Federal Reserve has regulatory and supervisory authority over all BHCs and financial holding companies (FHCs), but is limited in its ability to take measures against certain functionally regulated subsidiaries (*e.g.*, SEC- or CFTC-regulated entities) of these holding companies. This limited authority is generally referred to as "Fed Lite."

Many believe a major cause of the crisis was a lack of coordination among regulators, combined with a lack of accountability for any single regulator supervising a complex financial institution in its entirety. Consequently, the legislation authorizes the Federal Reserve to make examinations and bring enforcement actions against subsidiaries of the holding companies it primarily regulates, regardless whether such subsidiaries are also regulated by another body. Although the legislation requires advance notice to the relevant federal or state regulator, the removal of Fed Lite from the regulatory structure will arguably make the Federal Reserve the most important and powerful regulator in the banking industry. This is particularly true in light of the Federal Reserve's central role in systemic risk regulation discussed above.

Volcker Rule (§ 619)

The legislation places a number of substantive restrictions on the activities of banks*—one of the most important of which is the so-called "Volcker Rule," named after former Federal Reserve Chairman Paul Volcker, who initially proposed it. The Volcker Rule is actually two separate rules: (1) a prohibition on proprietary trading, and (2) a ban on certain hedge fund and private equity activities. These controversial restrictions, discussed further below, stem from Congress's view that banks and thrifts have moved too far beyond traditional lending and deposit-taking into other business lines that present undesirable risks to insured deposits. The Volcker Rule is particularly controversial because many believe there is little evidence that the prohibited activities played a factor in the financial crisis. Indeed, some have cited the profitability of proprietary trading and hedge fund and private equity activities as critical in offsetting banks' massive losses from mortgages and other traditional loan portfolios.

The Volcker Rule is actually two separate rules: (1) a prohibition on proprietary trading, and (2) a ban on certain hedge fund and private equity activities.

The Volcker Rule will apply to all "banking entities," a term that includes banks, thrifts, BHCs, SLHCs, and their affiliates. The prohibitions will also apply to the US operations of foreign banks. Nonbank financial companies regulated under the new systemic risk regime are technically not subject to the Volcker Rule, but Congress has directed the Federal Reserve to impose additional capital requirements and quantitative limits on them to mitigate the perceived risks inherent in proprietary trading and hedge fund and private equity activities.

Prohibition on Proprietary Trading (§ 619)

The Volcker Rule prohibits any banking entity from buying and selling any security, derivative, or other financial instrument for its "trading account," as opposed to the accounts of customers.

* For example, the legislation contains a host of detailed rules for banks and other insured depositories related to minimum capital and leverage requirements, mergers and acquisitions, branching restrictions, lending limits, and transactions involving management and directors.

Certain transactions are, however, generally excluded from the ban on proprietary trading, including:

- customer transactions
- transactions in connection with underwriting or market-making activities
- bona fide risk-mitigating or hedging activities
- buying and selling of securities in the context of an insurance business
- transactions in US government or government-sponsored enterprise securities
- proprietary trading by a non-US controlled banking entity that occurs outside the United States

Ban on Hedge Fund and Private Equity Activities (§ 619)

The Volcker Rule also prohibits banking entities from acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring any hedge fund or private equity fund, subject to certain exceptions. Under the legislation, the terms "hedge fund" and "private equity fund" include any issuer exempt from registration as an investment company under section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act). The relevant regulators may also include "similar funds" through rulemaking. A banking entity "sponsors" a hedge fund or private equity fund if it serves as the general partner or managing member of the fund, selects or controls (or has employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, or shares the same or a similar name with the fund. The prohibition will not apply to any non-US controlled banking entity if the interests in a given fund are not offered or sold to US residents.

Despite the expansive scope of the ban, a key exception will allow US banking entities to organize and offer private equity or hedge funds if a number of requirements are met—specifically, if the banking entity:

- provides bona fide trust, fiduciary, or investment advisory services to the fund;
- organizes and offers the fund only to customers and only in connection with the provision of trust or related services;
- does not make, acquire, or retain an interest other than a seed investment in the fund and satisfies each of the following two requirements:
  - within one year of the fund's establishment, the banking entity's investment is reduced to 3% or less of the total ownership interest in the fund
  - the aggregate of all the banking entity's investments in private equity and hedge funds is 3% or less of the banking entity's Tier 1 capital;
- avoids certain transactions specified in the detailed affiliate rules of the Federal Reserve Act with respect to the fund;

- does not guarantee, assume, or insure the fund's obligations or performance;
- does not share the same or a similar name with the fund;
- does not allow an ownership interest by any director or employee not directly engaged in providing services to the fund; *and*
- discloses that losses will be borne solely by investors.

Although this exemption will make it possible for banking entities to devote significant resources to hedge fund and private equity activities in the coming years, some of the larger financial institutions in the United States currently exceed both of the 3% thresholds. The major form of relief Congress has granted these banking entities is the potentially lengthy time frame for the Volcker Rule's implementation.

As a practical matter, therefore, forced divestments under the Volcker Rule could take place anywhere from approximately three to possibly 12 years after the enactment of the legislation.

Implementation Period (§ 619)

Like many other provisions in the legislation, the Volcker Rule comes into force only when the regulators issue final rules implementing it. However, given the significant and potentially disruptive impact the prohibitions might have, Congress has given the Council six months to complete an initial study and issue recommendations on how best to implement the Volcker Rule. Within nine months after the study or within two years of the enactment of the legislation, the Federal Reserve and other regulators will consider the Council's findings and issue their final, coordinated regulations making the Volcker Rule officially "effective." Nevertheless, "effective" does not really mean immediately effective, because Congress has given banking entities two years after the rules are issued to comply with the Volcker Rule. Furthermore, the Federal Reserve and other regulators at their discretion may issue up to three one-year extensions to individual banking entities. Additional extensions of up to five years are available in connection with commitments to funds considered "illiquid." As a practical matter, therefore, forced divestments under the Volcker Rule could take place anywhere from approximately three to possibly 12 years after the enactment of the legislation. Even with the potential for a lengthy divestment period, however, the Volcker Rule is a radical alteration of the bank regulatory landscape—particularly for the nation's largest financial institutions.

Derivatives for Banks (§§ 608 & 716)

As discussed below, a key component of the legislation is a new regulatory regime for the OTC swaps market. Banks have been singled out, however, for additional restrictions relating to derivatives. The same rationale underlying the Volcker Rule—that banks should not engage in purportedly high-risk transactions when taxpayer money is on the line—is arguably what has driven Congress to regulate the swaps activities of insured depositories. Although some policymakers recently advanced proposals that would prohibit banks, thrifts, and their affiliates from dealing in derivatives altogether, the final version of the legislation is more benign. To ensure that the Federal Reserve's discount window and other federal programs available for banks are not used to subsidize swaps trading, the legislation prohibits federal assistance to any dealer or major participant in the swaps or securities-based swaps market. The result of this so-called "push out" provision is to force swaps activities (other than certain hedging swaps) from an insured depository to an affiliate within the larger BHC or SLHC structure. As a result, financial institutions may continue to deal in those pushed-out swaps but they must do so outside their bank or thrift subsidiaries.

A second important change in the legislation is the inclusion of derivatives as a category of transactions covered by sections 23A and 23B of the Federal Reserve Act. Section 23A imposes certain collateral requirements and transaction size restrictions for covered transactions between a bank and its affiliates, and section 23B requires that those transactions be on an arm's-length basis. Until now, derivatives have been excluded from sections 23A and 23B, and it was unclear whether the Federal Reserve had the power to include them by regulation. The legislation squarely settles that issue by making derivatives a covered transaction, and by directing the Federal Reserve to issue rules that take credit exposures into account when determining collateral requirements. The result is that certain swaps and similar instruments routinely executed within a single banking organization could require outside counterparties.

Derivatives

The derivatives section of the legislation is arguably as important to Congress's reforms as the new systemic risk framework and changes to the banking industry. Indeed, one may view the reforms to the OTC swaps market as an additional pillar supporting systemic risk regulation. In the summer before the recent financial crisis, the notional amount of the credit derivatives portion of the swaps market reportedly approximated the combined total of the GDPs of every country in the world.

For the last decade, swaps transactions have been virtually unregulated and have often taken the form of highly customized bilateral agreements. As a result, margin requirements (if any) have not been uniform. In trading out of swap positions, counterparties often would simply write offsetting contracts. The result of all this trading was a so-called "daisy chain" of counterparties throughout the financial system, with little transparency and gross notional amounts that bore little discernable relationship to actual exposure. When counterparties began failing to meet margin requirements or even declaring insolvency, this chain of counterparties created the possibility of a systemic domino effect, the dimensions of which could not be estimated with precision and were potentially catastrophic.

The legislation attempts to resolve the perceived systemic risk and transparency deficiencies of the current OTC swaps market by requiring the centralized clearing of all swaps suitable for the clearing process. The daisy chain of counterparties is broken with each swap because, when a contract is cleared, the clearinghouse serves as the counterparty to each of the original parties to the swap. While the overall risk in the financial system is not necessarily reduced, the risk is concentrated and made visible in the clearinghouse. Regulators can then carefully monitor the clearinghouse to ensure it is well-managed and well-capitalized. The legislation charges the CFTC and the SEC with the joint oversight of the OTC swaps market; the SEC will regulate security-based swaps and the CFTC will regulate all other kinds of swaps. The CFTC and the SEC are required to consult with each other and with the relevant bank regulators when exercising their rulemaking authorities in this regard.

Jurisdiction of Agencies

Security-based swaps	SEC
Mixed swaps	SEC
All other swaps	CFTC

The legislation broadly defines "swap" to ensure that the term encompasses interest rate swaps, foreign exchange swaps, credit default swaps, commodity swaps, and many other transactions. A security-based swap is a swap based on a narrowly based security index, a single security or loan, or the occurrence or nonoccurrence of an event relating to a single issuer of a security or the issuers of securities in a narrowly based security index. The CFTC and the SEC also have the power to define swaps and security-based swaps further through their rulemaking authority. A third category of swaps, known as "mixed swaps," will be jointly defined by the CFTC and the SEC and will be regulated as security-based swaps. Under the legislation, a swap—even though it passes certain risks from one party to the other—is not considered to be insurance and may not be regulated as an insurance contract under the laws of any state.

The cornerstone of the legislation with respect to derivatives is the centralized clearing requirement.

Centralized Clearing Requirements (§§ 721 – 774)

The cornerstone of the legislation with respect to derivatives is the centralized clearing requirement. Congress has mandated centralized clearing for all swaps that the CFTC or the SEC determines should be cleared through a registered clearinghouse, and that are otherwise accepted by one or more clearinghouses for clearing.

In General (§§ 723, 727, 763, & 766)

The CFTC and the SEC must review each swap, or any group, category, type, or class of swaps, and consider the following in determining whether mandatory clearing should apply:

- the existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data
- the availability of the clearinghouse's rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded
- the effect on the mitigation of systemic risk, taking into account the size of the market for the contract and the resources of the clearinghouse
- the effect on competition, including appropriate fees and charges applied to clearing
- the existence of reasonable legal certainty in the event of the insolvency of the clearinghouse or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property
- any other factors the CFTC or the SEC deems appropriate

If a swap is required by the CFTC or the SEC to be cleared, then the swap must also be executed on a regulated exchange or a swap execution facility (SEF), which is a facility that accepts bids and offers made by multiple participants. SEFs generally will be required to disclose all executed swap transactions in a time period as close to immediate as technologically possible—unless it is a block trade. If neither an exchange nor an SEF is willing to list the swap, counterparties to the contract will nevertheless be required to comply with any relevant CFTC or SEC recordkeeping and reporting requirements, as well as applicable capital and margin requirements.

What is a financial entity?

The legislation defines a "financial entity" as *any* one of the following:

- a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant
- a person predominantly engaged in activities in the banking or financial sectors
- a commodity pool or a private fund
- an employee benefit plan

The legislation exempts from the mandatory clearing requirement a party that is using swaps to hedge or mitigate commercial risk and notifies the CFTC or the SEC of how it generally meets its financial obligations associated with entering into non-cleared swaps.

Customized Swaps (§§ 723, 727, 731, 763, 764, & 766)

Highly customized swaps that are not suitable for clearing may still be consummated; however, these swaps must be reported to a trade repository or to the CFTC or the SEC, which must periodically release aggregate data on all non-cleared swaps. Moreover, swap dealers and major swap participants (MSPs), discussed below, entering into non-cleared swaps may be subject to potentially significant capital and margin requirements.

End-User Exemption (§§ 723 & 763)

One of the biggest political battles regarding the legislation was over what should be exempted from the centralized clearing requirement. Most commercial and industrial companies that participate in the OTC swaps market to hedge commercial risks—commonly known as "end-users"—argued that requiring them to register with regulators or join a clearinghouse was overly burdensome. These companies, along with the banks that service them, successfully obtained from Congress an exemption in the legislation for end-users. The legislation exempts from the mandatory clearing requirement a party that is using swaps to hedge or mitigate commercial risk and notifies the CFTC or the SEC of how it generally meets its financial obligations associated with entering into non-cleared swaps. A public company must obtain the approval of the relevant committee of its board of directors in order to use the exemption.

One major drawback is that a "financial entity" is ineligible for the end-user exemption.

The legislation directs the CFTC and the SEC to consider whether to exclude certain small banks and other financial institutions from the definition of a "financial entity." In addition, with respect to CFTC-regulated swaps, the legislation excludes from the definition of a "financial entity" any entity whose primary business is providing financing for products its parent company or affiliate has manufactured, and that uses derivatives to hedge underlying commercial risks related to interest rate and foreign currency exposures (Excluded Financial Entities).

The critical point is that the legislation focuses as much on the "who" as on the "what." It is not enough to hedge commercial risk to be exempt; the hedging party must also be a company other than a financial entity. The practical significance of this rather narrow end-user exemption is that a financial company such as a pension fund or mutual fund complex that enters into OTC swaps solely to hedge risk would nevertheless be subject to the centralized clearing requirement.

At one stage in the legislative process, Congress had expressly exempted non-cleared swaps from margin requirements if at least one party to such swaps qualified for the end-user exemption for each relevant category of swaps. Despite the deletion of this language from the legislation, Senators Dodd and Lincoln emphasized that Congress clearly stated that margin requirements are not to be imposed on end-users. Such exemption is not expressly found in the legislation. The legislation requires the regulators to impose margin requirements for swap dealers and MSPs with respect to non-cleared swaps. Senators Dodd and Lincoln may have read this language to refer only to requirements pursuant to which swap dealers and MSPs *post* margin, not *require* it from their end-user customers. Even if the margin requirements only required posting by swap dealers and MSPs, however, those entities would be likely to pass the added costs on to their end-user customers. Presumably, other language in the legislation indicating that capital and margin requirements should be appropriate for the risks associated with non-cleared swaps gives regulators the ability to exempt, at their discretion, swaps involving end-users from margin requirements.

Indeed, the International Swaps and Derivatives Association, Inc. recently stated that approximately $370 billion would be required in additional capital and liquidity in order for US companies to meet the prospective margin requirements for their current derivatives exposure, which would reach $1 trillion if markets returned to 2008 end-of-year levels.

Regulation of Swap Dealers and Major Swap Participants (§§ 721 – 765)

Given the role some believe swaps played in the recent financial crisis, Congress has determined that the risk exposure of systemically important entities in the swaps market (*i.e.,* swap dealers and MSPs) must be regulated. Swap dealers and MSPs that are depository institutions will be subject to capital and margin requirements imposed by their primary regulator (*i.e.*, the Federal Reserve, the OCC, the FDIC, *et al.*), and swap dealers and MSPs that are not depository institutions will be subject to capital and margin requirements imposed by the CFTC or the SEC. In addition to risk exposure regulation, swap dealers and MSPs will also be subject to conduct regulation—such as disclosure and reporting requirements and business conduct standards—by the CFTC or the SEC.

What is a major swap participant?

The legislation defines an MSP as any person that is not a swap dealer and that meets *any* of the following criteria:

- maintains a substantial position in swaps (excluding positions held for hedging or mitigating commercial risk and positions maintained by an employee benefit plan for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan)
- holds outstanding swaps that create substantial counter-party exposure that could have serious adverse effects on US financial stability
- is a highly leveraged financial entity, which is not otherwise subject to capital requirements established by any federal bank regulator and maintains a substantial position in any major swap category

The legislation requires the CFTC and the SEC to define "substantial position" in a way that is prudent for the effective monitoring and supervision of systemically important entities.

Classifications of Swap Dealers and MSPs (§§ 721 & 761)

The legislation provides that an insured depository institution shall not be considered to be a swap dealer in connection with CFTC-regulated swaps to the extent it enters into a swap with a customer in connection with originating a loan with that customer.

A "swap dealer" is defined in the legislation as any person that satisfies *any* of the following criteria:

- holds itself out as a dealer in swaps
- makes a market in swaps
- regularly enters into swaps with counterparties in the ordinary course of business for its own account
- engages in any activity causing the person to be commonly known as a dealer or market maker in swaps in connection with CFTC-regulated swaps

With respect to CFTC-regulated swaps, the legislation carves out Excluded Financial Entities from the definition of an MSP. A person may be designated as a swap dealer or MSP for a single type, class, or category of swap. It is therefore possible for a given company to be classified, for example, as an end-user with respect to commodity swaps, a swap dealer with respect to credit default swaps, and an MSP with respect to interest rate swaps.

Capital and Margin Requirements (§§ 724, 731, 763, & 764)

The practical import of these classifications is that swap dealers and MSPs will be subject to new (or in some cases additional) capital rules as well as initial and variation margin requirements to be established by bank regulators, the CFTC, or the SEC. The agencies will review all the activities of the swap dealers and MSPs—including unregulated activities—when setting capital requirements. This could result in capital requirements being imposed on a given swap dealer or MSP, in part, due to the activities of its affiliates or subsidiaries. As noted above, depending on the regulators' interpretation, the margin requirements may apply to end-users as well as to swap dealers and MSPs, so even entities that avoid being classified as swap dealers and MSPs may be affected by some of the same rules as swap dealers and MSPs.

The legislation also requires that for uncleared CFTC-regulated swaps, a swap dealer or MSP must first notify its counterparty that it has the right to require that the initial margin posted with that swap dealer or MSP be maintained in a segregated account with an independent third-party custodian.

Reporting and Recordkeeping Requirements (§§ 712, 731, & 764)

All swap dealers and MSPs will be required to maintain certain records, including:

- daily trading records of swaps and other related records (including related cash or forward transactions)
- all recorded communications
- daily trading records for each of its counterparties and customers
- a complete audit trail to allow for trade reconstructions

Conduct of Business Requirements (§§ 731 & 764)

Swap dealers and MSPs will be required to follow certain additional requirements, including the mandated disclosures to non-swap dealer and non-MSP counterparties of information regarding material risks, incentives, and conflicts of interest associated with a transaction. Any communication with these counterparties must be made on a good faith and fair dealing basis.

And perhaps most important, Congress has required swap dealers and MSPs—when entering into swaps with a governmental entity, employee benefit plan, or endowment—to have a reasonable belief that the counterparty is represented by an independent representative that meets certain standards. Given the potential exposure of swap dealers and MSPs to liability for a violation, this new obligation could make it quite difficult for pension and other funds to participate in the swaps market altogether.

Conflict of Interest Regulations (§§ 725, 731, 764, & 765)

Congress has directed the CFTC and the SEC to issue rules mitigating conflicts of interest between a swap dealer or MSP and organizations that act as clearinghouses or SEFs in which such swap dealer or MSP has a material debt or equity investment. Swap dealers, MSPs, futures commission merchants, and certain brokers will be required to implement conflict-screening mechanisms to separate employees engaging in research or analysis from those conducting trading or clearing activities.

Position Limits (§§ 737 & 763)

The legislation expands the CFTC's authority to limit the size of an entity's overall derivatives portfolio via a newly granted power to impose aggregate position limits for contracts traded on exchanges or non-US boards of trade as well as any swaps that perform or affect a significant price discovery function. The SEC must establish similar limits (including related hedge exemption provisions) on the size of positions in any security-based swaps that may be held by any person.

Disruptive Trading, Market Manipulation, and Abusive Swaps (§§ 714, 731, 741, 747, & 753)

The CFTC and the SEC have each been granted the authority to issue a report as to any swaps they find "detrimental" to US financial stability. These agencies also have broad authority to ban any swaps they deem "abusive." The terms "detrimental" and "abusive" are not defined in the legislation but will likely be defined by the CFTC and the SEC through rulemakings or by a series of orders. The legislation also prohibits any person from entering into a swap with knowledge that the swap could be used by its counterparty as a means to defraud a third party, and similarly prohibits the use of false information in connection with swap transactions. In addition, the legislation conforms the market manipulation standard under the commodities laws to the standards under the securities laws. These reforms all work to toughen the culpability standard for the manipulation of derivatives markets, with violators potentially subject to substantial civil and criminal penalties.

Implementing Rules, Extraterritoriality, and Grandfathering (§§ 712, 715, 722, 723, 763, 764, & 772)

As discussed above, the legislation establishes a general framework for the comprehensive regulation of OTC swaps but leaves many of the details to the regulators. The legislation requires the CFTC and the SEC to develop implementing rules for all relevant provisions within 360 days, and each regulator may use emergency and expedited procedures to implement the new requirements sooner. In addition, both agencies may ban foreign parties from participating in US derivatives markets if they determine that the regulation of derivatives in the foreign country may destabilize or adversely affect the US financial system.

The new derivatives rules apply only to swaps activity in the US, but can also apply to certain foreign activities that have a direct and significant connection with activities in, or effect on, US commerce, *or* contravene any rules designed to prevent the evasion of US derivatives laws. For security-based swaps, which are regulated by the SEC, only the evasion jurisdictional hook applies. It remains to be seen how broadly regulators will interpret each of the components of the legislation's extraterritoriality clause.

The legislation allows participants in the swaps market to apply to the CFTC within 60 days after the enactment to remain subject to the laws in effect prior to the enactment of the legislation. The CFTC may allow the applicant to continue operating under the old regime for no longer than one year. Thus, grandfathering is not automatic and is limited to one year going forward. Moreover, grandfathering does not apply to all obligations under the legislation. For example, recordkeeping and reporting requirements under the legislation will nevertheless apply during the grandfathering period. Similarly, while existing trades will be permanently grandfathered from the central clearing requirement even without application, they will be subject to the new margin and capital requirements.

Hedge Funds and Private Equity

Since the collapse and subsequent bailout of Long-Term Capital Management in 1998, Congress, the SEC, and other policymakers have argued that advisers to private funds should be required to register with a regulatory body and be subject to monitoring on an ongoing basis. Hedge fund trading of complex instruments such as credit default swaps and widespread short-selling during periods of market distress have placed the industry under considerable public scrutiny. Traditional private equity funds, unlike hedge funds, do not normally trade complex financial instruments and are not nearly as interconnected with the financial system, but their activities are sometimes misunderstood and equated with those undertaken by hedge funds. The recent crisis has provided those intent on regulating hedge fund and private equity advisers with the opportunity to do so through the Private Fund Investment Advisers Registration Act of 2010.

Elimination of the Private Adviser Exemption and Modification of the Intrastate Adviser Exemption
(§§ 402 – 403)

The legislation eliminates the "private adviser" exemption (for advisers to fewer than 15 clients) and substantially modifies the "intrastate adviser" exemption from registration under the Investment Advisers Act of 1940 (Advisers Act). Numerous private fund managers currently rely on these exemptions—the private adviser exemption in particular. Advisers to private funds (except for venture capital funds and family offices) with assets under management of at least $150 million will now be required to register as investment advisers with the SEC. These changes will become effective one year after the enactment of the legislation.

Until recently, an investment adviser that advised fewer than 15 clients and neither held itself out to the public as an adviser nor acted as an adviser to a registered investment company was exempt from registration. Under the legislation, however, an adviser to a "private fund"—regardless of the number of clients—must register with the SEC unless the adviser falls within one of the specifically enumerated exemptions discussed below. Congress's definition of "private fund" includes any issuer that would be an investment company but for the availability of certain exemptions found in the Investment Company Act. As a result, private funds generally will include hedge funds, private equity funds, and venture capital funds.

Furthermore, before the legislation, an investment adviser to a private fund was exempt from registration if all its clients were residents of the same state in which the adviser was headquartered and the adviser refrained from providing advice regarding exchange-listed securities. Under the legislation, unless another exemption applies, an adviser that previously would have qualified under this exemption will be required to register if it has even a single client that qualifies as a private fund.

The legislation eliminates the "private adviser" exemption (for advisers to fewer than 15 clients) . . . under the Investment Advisers Act of 1940. . . .

New Exemptions from Registration
(§§ 402 – 403 & 407 – 409)

The legislation creates five new narrow exemptions from registration and increases the threshold amount that triggers mandatory SEC registration for state-registered advisers. The new exemptions and the increased threshold are designed to exempt smaller hedge fund and private equity advisers from SEC registration, allowing the SEC to concentrate on private fund advisers perceived to have a greater impact on investors and markets.

Venture Capital Advisers (§ 407)

The legislation provides a carve-out for advisers to venture capital funds. The SEC is charged with defining "venture capital fund" within one year after the enactment of the legislation. However, venture capital fund advisers who satisfy the exemption must comply with additional SEC reporting and recordkeeping requirements. Those reports and records will include information that the SEC believes is useful in protecting investors and promoting the public interest.

Foreign Private Advisers (§§ 402 & 403)

The legislation exempts certain foreign private advisers from registration. To qualify, advisers must meet all the following criteria:

- have no place of business in the United States;
- have fewer than 15 US-based clients and investors in private funds at any time;
- have assets under management attributable to US-based clients and investors in private funds of less than $25 million or such higher amount as the SEC, by rule, deems appropriate; *and*
- not hold themselves out to the public in the US as an investment adviser.

Many advisers to foreign-based private funds also serving US clients and investors will be unable to meet this somewhat narrow exemption.

Advisers to Small Business Investment Companies (§ 403)

An adviser that advises only "small business investment companies" licensed under the Small Business Investment Act of 1958, other than an entity that has elected to be regulated or is regulated as a business development company pursuant to the Investment Company Act, is exempt from registration.

Family Offices (§ 409)

An adviser that constitutes a "family office" is similarly exempt from registration. The legislation requires the SEC to define family office, and the definition is likely to be consistent with the SEC's previous policy of granting exceptions under the Advisers Act for investment advice provided to one or more members of a single family.

De Minimis Assets (§ 408)

The legislation provides a de minimis exemption from SEC registration for managers that advise one or more private funds and have assets under management of less than $150 million in the United States. Under this exemption, advisers to smaller funds will not have to register, but will still be required to maintain records and file annual or other reports as determined by the SEC.

Mandatory Threshold for Registration Increased (§ 410)

The legislation increases the threshold of assets under management, triggering mandatory SEC registration under the Advisers Act from $25 million to $100 million for advisers who are required to be registered with the state where their headquarters are located. This increased threshold could significantly reduce the number of smaller investment advisers currently registered with the SEC.

Disclosure and Examination Requirements (§ 404)

The records and reports of an investment adviser will be deemed to include the reports and records of the private funds it advises. The legislation also directs the SEC to conduct periodic inspections of the records of private funds maintained by a registered adviser, and authorizes the SEC to conduct other examinations it deems necessary.

Generally, disclosure of information is protected to the same extent as if provided pursuant to the Advisers Act, and the SEC may not compel advisers to disclose proprietary information to the public—including sensitive, nonpublic information regarding investment or trading strategies, analytical or research methodologies, trading data, and intellectual property. Nonetheless, the SEC may not withhold information from Congress, a federal department, agency, or self-regulatory organization (SRO) requesting information within the scope of its jurisdiction, or a US court in connection with a federal enforcement action.

Short-Selling and Accredited Investors (§§ 413 & 417)

The legislation requires the SEC to investigate the state of short-selling (including the incidence of the failure to deliver shares sold short) and submit a study to Congress. The study must address the feasibility of real-time short-selling reporting and a pilot program for public companies to have trades of their stock marked in real time as "short," "market maker short," "buy," "buy-to-cover," or "long."

What records and reports will the SEC track?

Congress has instructed the SEC to require investment advisers to maintain records and file certain periodic reports detailing the following:

- total assets under management;
- types of assets held;
- use of leverage;
- counterparty credit risk exposure;
- trading and investment positions;
- trading practices;
- valuation policies and practices;
- side letters or arrangements treating some investors more favorably than others; *and*
- information the SEC deems to be in the public interest or necessary for systemic risk monitoring.

In addition, Congress has revisited the accredited investor standard for individuals and modified the current Regulation D standard promulgated under the Securities Act of 1933 (Securities Act) to exclude the value of a person's primary residence from the calculation of net worth. After the fourth anniversary of the enactment of the legislation, the SEC is directed to increase the personal net worth standard from the current $1 million and to review, once every four years, the individual accredited investor standard and make any changes necessary for investor protection. Other criteria for the accredited investor determination remain unchanged in the legislation. Nonetheless, the SEC may adjust the accredited investor definition for individuals (excluding the net-worth standard discussed above) for the protection of investors, in the public interest, and in light of the economy. Like a number of other measures in the legislation, the changes to the accredited investor rules reflect Congress's belief that many Americans did not understand the complexity of their investments and financial arrangements. This may be particularly true of those who qualified as hedge fund or private equity investors on the basis of rising home values that eventually declined sharply.

Securities Regulation

The virtual collapse of the asset-backed securities (ABS) markets during the recent financial crisis—particularly those segments based on pooled residential and commercial mortgage loans—revealed serious problems in the securitization process. One of these problems, in Congress's view, has been overreliance by loan originators, securitizers, and investors alike on a flawed credit rating structure. Congress similarly became concerned about the risks posed to investors in another market sector that was negatively affected by the recent crisis—the municipal securities market. To address some of the factors perceived by Congress as having contributed to the problems in the securitization market—and enhance the ABS and municipal markets—the legislation contains several important reforms, most of which must be implemented by agency rulemakings.

Securitizations (§§ 941 – 945)

Although the financial crisis has had a devastating effect on the securitization markets, certain aspects of those markets have been criticized as playing a role in the meltdown. Some critics have maintained that the incentives of both mortgage originators and underwriters of securities backed by those mortgages were not fully aligned with the incentives of investors who eventually purchased the securities. Underwriters and originators have been largely compensated on the basis of the initial sale of the securitized products and the underlying assets, respectively. But the benefits (and burdens) accrue to investors only with the longer-term performance of those assets.

"Skin-in-the-Game" Requirement (§§ 941 & 944)

Congress has accordingly directed federal bank regulators and the SEC jointly to prescribe rules requiring securitizers of ABS to retain an economic interest ("skin in the game") in the credit risk (generally 5%) of any asset transferred, sold, or conveyed to a third party through the issuance of an ABS. That economic interest may not be hedged or transferred to a third party. The legislation defines an ABS as a fixed-income or other security collateralized by a self-liquidating financial asset (*i.e.*, a loan, lease, mortgage, or receivable) that allows the holder of the security to receive payments depending primarily on cash flow from the asset. Congress has made the definition broad enough to cover collateralized debt and mortgage obligations.

As with most of the bright-line rules in the legislation, the 5% risk-retention requirement has some exceptions. Securitizers will not be required to retain any portion of the credit risk for an asset that is transferred, sold, or conveyed if all the assets that collateralize the ABS are "qualified residential mortgages." Congress has directed federal bank regulators and the SEC, together with the US Department of Housing and Urban Development (HUD) and the FHFA, jointly to define the category of "qualified residential mortgages" after considering certain product and underwriting features that have historically been associated with lower default risks. Most likely, the category will include a large portion of those loans originated by Fannie Mae and Freddie Mac.

As with most of the bright-line rules in the legislation, the 5% risk-retention requirement has some exceptions. Securitizers will not be required to retain any portion of the credit risk for an asset that is transferred, sold, or conveyed if all the assets that collateralize the ABS are "qualified residential mortgages."

In addition, the legislation directs the regulators to establish various asset classes with different credit risk retention rates, including ABS backed by automobile loans, commercial mortgages, home mortgages, and any other asset class deemed appropriate. For each asset class, the relevant regulators (*e.g.*, Federal Reserve, OCC, and FDIC) will establish underwriting standards specifying the terms, conditions, and characteristics of a loan that indicate a reduced credit risk. Most important, the regulations may provide that if an originator meets these reduced credit risk standards, then the securitizer may retain less than 5% of the credit risk. In this respect, these rules may provide the equivalent to an additional exemption.

The legislation also contemplates the establishment of total or partial exemptions from risk retention for the following:

- any loan or other financial asset made, insured, guaranteed, or purchased by any institution that is subject to the Farm Credit Administration
- any securitization of an asset issued or guaranteed by the United States or a US agency (except Fannie Mae and Freddie Mac)
- certain state and municipal securitizations of assets (related to the cases above)

The required risk-retention amount may also be allocated between an originator and a securitizer as deemed appropriate by the regulators.

Supplemental Disclosure Requirements (§§ 942 – 946)

In addition to the risk-retention requirement, the legislation requires more disclosure in the securitization process. Congress has directed the SEC to adopt regulations requiring ABS issuers to disclose—for each tranche or class of security—information regarding the specific assets backing that security. To enable investors to compare data across securities in similar types of asset classes, the SEC is required to establish standardized disclosure formats. At a minimum, the SEC rules must require ABS issuers to disclose asset-level or loan-level data necessary for investors independently to perform due diligence, including:

- the identity of the loan broker or originator
- the extent and nature of the broker's or originator's compensation
- the amount of risk retained by the securitizer and the originator

The legislation instructs the SEC to promulgate regulations regarding the use of representations and warranties in the ABS market to require any securitizer to disclose fulfilled and unfulfilled repurchase requests across all the securitizer's securitizations, such that investors may be able to identify originators with underwriting deficiencies. Finally, the SEC is required to issue rules relating to the registration statement that ABS issuers are required to file, which will require the issuer to perform a due diligence analysis of the assets underlying the ABS and disclose the nature of that analysis to potential investors. With these provisions, Congress seeks to ensure that investors will be provided with sufficient disclosures to make an informed decision regarding an ABS investment.

The regulations issued under this part of the legislation are to become effective with respect to residential mortgage ABS one year after final rules are published and with respect to all other ABS two years after final rules are published.

Credit Rating Industry (§§ 932, 933, 935 & 939)

In the wake of the financial crisis, the systemic importance of credit rating agencies (CRAs) and their role in capital formation and as gatekeepers in the debt markets have become the subject of extended debate among government and market participants alike. Under the legislation, the credit rating industry will be subject to heightened oversight, regulation, and expanded liability. To administer these reforms, Congress has directed the SEC to establish an Office of Credit Ratings, discussed below. Like many other components of the legislation, Congress has delegated significant details regarding these reforms to the SEC's rulemaking discretion.

Office of Credit Ratings (§ 932)

The legislation establishes an independent office within the SEC called the Office of Credit Ratings (OCR), with a mandate to promote accuracy of credit ratings and prevent conflicts of interest. The OCR will conduct a review of each CRA at least annually to evaluate each CRA's compliance with the legislation's governance, management, and operational requirements. In addition, each CRA will be required to maintain an internal system to ensure compliance with various accountability and ethics requirements, including controls with respect to conflicts of interest and post-employment activities of former CRA employees.

Civil Liability (§§ 933 & 939G)

The legislation subjects CRAs to significant private litigation and will not allow CRAs to rely on the safe harbor provided for forward-looking statements under the Securities Act. Consequently, it will be easier for private litigants to sue CRAs. In addition, the legislation nullifies Rule 436(g) of the Securities Act, which exempted credit ratings provided by nationally recognized statistical rating organizations (NRSROs) from being considered part of a registration statement prepared or certified by an "expert" and thereby under the "expert liability" regime of section 7 and section 11 of the Securities Act. Given the small number of CRAs and the very substantial liability CRAs potentially may incur, one may expect the industry to approach ratings differently than in the past.

In addition, the SEC may fine CRAs or their associated persons for certain violations of the securities laws. If a violation affects the integrity of a rating, then the violation may eventually lead to the suspension or revocation of a CRA's registration with the SEC.

Internal Controls and Other Restrictions (§§ 932, 935, & 939B)

The legislation imposes new restrictions and requirements on a CRA's corporate governance, internal controls, transparency, conflicts of interest, and liability exposure under the securities laws. At least half of a CRA's board of directors must qualify as independent directors. Each CRA's board of directors and senior credit officer will be responsible for the procedures and methodologies applied to the credit ratings it issues. Similar to the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), the legislation requires a CRA's CEO to attest to the effectiveness of the firm's internal controls in the form of a certification submitted to the SEC. The legislation also establishes new professional standards for ratings analysts, including qualifying exams and continuing education.

In addition, the legislation directs the SEC to promulgate new rules that require an internal separation of the credit rating activity from sales and marketing activity within individual CRAs, although the SEC has been directed to provide an exception for smaller CRAs under certain circumstances. Furthermore, CRAs will be required to report to the SEC when a former CRA employee becomes employed by an underwriter or obligor of a security or money market instrument subject to a rating by that CRA and undertake a one-year look-back review to evaluate whether any conflicts of interest relating to the employee influenced the rating.

The legislation also requires material changes to rating procedures and methodologies to be applied consistently and publicly disclosed. Users of credit ratings must be notified of material changes to any procedures and methodologies or upon the identification of a significant error in those procedures or methodologies. CRAs must also consider in their ratings any information they find credible and potentially significant about an issuer that is received from a third-party source, although CRAs are not required to initiate a search for that kind of information. The intended aim of Congress in mandating these disclosures of rating procedures and methodologies is to make ratings performance data more transparent and easily evaluated and enable investors to compare credit ratings among CRAs.

In addition, the legislation directs the SEC to promulgate new rules that require an internal separation of the credit rating activity from sales and marketing activity within individual CRAs . . . .

Initial Ratings of Structured Finance Products (§ 939F)

The CRAs' issuer-pays business model has been the subject of recurring criticism and often is used to highlight the conflicts of interest seen as pervasive in the credit rating industry, particularly with respect to structured finance products. Accordingly, Congress has directed the SEC to carry out a study that analyzes the credit rating process for structured finance products and the associated conflicts of interest. Following submission of the study's reported findings, which is to occur within two years of the enactment of the legislation, the SEC is required to establish a system to prevent a structured finance product issuer, sponsor, or underwriter from selecting the CRA determining and monitoring the initial credit ratings of structured finance products. Unless the SEC concludes that a different approach would better protect investors and serve the public interest, the SEC is required to create a new SRO that will assign CRAs, on a random or rotating basis, to provide initial ratings of structured finance products. Structured finance products covered by the rule include ABS and any structured product based on one or more ABS.

Removal of Credit Rating Entities from Federal Laws (§ 939)

Historically, the Federal Deposit Insurance Act, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, the Investment Company Act, the National Bank Act, the Securities Exchange Act of 1934 (Exchange Act), and certain other federal statutes have relied on NRSROs and minimum credit ratings issued thereby as a proxy for the riskiness of debt instruments in a variety of regulatory contexts. The legislation generally eliminates statutory references to NRSROs and minimum credit ratings, and these references will be replaced with a concept of credit-worthiness, which will be defined by the relevant regulator.

Municipal Securities (§§ 975 – 979)

Many state and local governments have been adversely affected by the financial crisis, enabling the SEC to persuade Congress to grant it greater authority over municipal securities. The legislation requires "municipal advisers" to register under section 15B of the Exchange Act, and imposes liability on municipal advisers for fraudulent, deceptive, or manipulative acts or practices. A municipal adviser is any person that undertakes a solicitation of a municipal entity or provides advice to or on behalf of a municipal entity with respect to municipal derivatives, investment strategies, or the issuance of municipal securities. Congress has, however, excluded from that category broker-dealers or municipal securities dealers serving as underwriters, registered investment advisers, registered commodity trading advisers, and professionals providing legal and engineering advice.

Congress has also expanded the authority of the Municipal Securities Rulemaking Board (MSRB) with respect to rulemaking, disciplinary proceedings, and the assessment of fees. Moreover, Congress has established an Office of Municipal Securities within the SEC to administer the SEC's rules with respect to municipal securities dealers, advisers, investors, and issuers. The Office must coordinate with the MSRB in rulemaking and enforcement actions, and the Director of the Office will report to the SEC Chairman.

Insurance Industry

Although the banking industry was at the very center of the financial meltdown, a number of large insurance companies were adversely impacted by the crisis. As a result of certain regulatory reforms in 1999, the insurance industry became far more intertwined with the banking system. This resulted in, among other developments, the emergence of diversified financial holding companies (some of which may be subject to systemic risk regulation). Unlike the banking industry, however, the insurance industry has been regulated almost exclusively at the state level. The gradual transformation of various sectors within the insurance industry into national and even international businesses, along with the lingering effects of the financial crisis, led Congress to reconsider a potential role for the US government in regulating the insurance industry. While the reforms in the legislation are relatively modest in that regard, they are still noteworthy.

Federal Insurance Office (§ 502)

For the first time, Congress has created a federal agency charged with monitoring and, to a very limited extent, regulating the insurance industry. Specifically, the legislation creates a Federal Insurance Office (FIO) within the Treasury Department. The role of the FIO is focused on national coordination of the insurance sector, mitigation of systemic risk, and facilitation of international regulatory cooperation. The FIO's authority extends to all lines of insurance other than health insurance, certain types of long-term care insurance, and crop insurance.

What will the Federal Insurance Office do?

The FIO's principal functions will include:

- declaring state insurance laws to be preempted by international agreements regarding insurance regulation
- monitoring the insurance industry, including identifying regulatory gaps that may expose the financial system to systemic risk
- recommending specific insurance companies for designation as nonbank financial companies (and thus supervised by the Federal Reserve) for systemic risk mitigation purposes
- developing federal policy on international insurance matters
- reporting to Congress on domestic and international reinsurance markets, as well as the report discussed below regarding potential steps to modernize and improve insurance regulation in the United States
- monitoring access of underserved communities and certain other groups to affordable insurance products
- consulting with states on national and international insurance matters

Noteworthy among the FIO's regulatory powers is the authority to deem state insurance laws preempted by international agreements regarding insurance regulation. The Director may exercise that authority to the extent he or she finds that a state insurance law results in less favorable treatment to non-US insurers domiciled in jurisdictions subject to international agreements regarding insurance regulation than to domestic insurers. Excluded from this preemption authority are state laws relating to rates, premiums, underwriting, sales practices, coverage requirements, and (unless discriminatory against non-US insurers) capital and solvency requirements. Although the Treasury Secretary has long had the authority to negotiate for increased access to foreign markets for US insurers and reinsurers and to prevent discrimination against foreign insurers and reinsurers by state regulatory bodies, this authority arguably has been eclipsed by the overall lack of federal regulation of the insurance sector. Congress has now accordingly granted the Treasury Department further authority to preempt state law in negotiating international agreements with foreign countries.

Within 18 months after the enactment of the legislation, the FIO must conduct a study and issue a report of its legislative, administrative, and/or regulatory recommendations to modernize and improve insurance regulation in the United States. This report will also outline the potential impact of federal regulation in this arena. To facilitate this study, the FIO has been provided with subpoena power to obtain industry and company information from insurers when the information is not publicly available or possessed by a state insurance regulator.

Despite conferring these considerable powers on the FIO, Congress has left state-based insurance regulation for the most part undisturbed. The legislation does not grant the FIO or the Treasury Department general supervisory or regulatory authority over the business of insurance, but rather aims to streamline state regulation with uniform national and international insurance regulations and standards. The legislation represents a relatively narrow, but nonetheless significant, toe-hold by the US government in insurance regulation.

Surplus Insurance and Reinsurance Reforms
(§§ 522, 523, & 532)

The legislation streamlines the regulation of surplus lines insurance and reinsurance by providing that only the state in which a policyholder resides or is headquartered will have the power to collect and allocate premium tax obligations related to surplus lines insurance. The placement of surplus lines insurance will be exclusively subject to the legal requirements of that state (including as to producer licensing). Congress has also provided incentives for states to participate in the national insurance producer database of the National Association of Insurance Commissioners (NAIC) by preventing states from collecting licensing fees if they do not, and has also provided a streamlined process for the placement of surplus insurance for certain large commercial purchasers.

Perhaps most important in terms of streamlining, if a ceding insurer is domiciled in an NAIC-accredited state or has solvency requirements substantially similar to those required for NAIC accreditation, then a non-domiciliary state may not deny credit for reinsurance. Non-domiciliary states also may not do any of the following:

- restrict or eliminate the rights of reinsurers to resolve disputes pursuant to contractual arbitration clauses
- restrict or eliminate choice of law contractual agreements
- enforce reinsurance contracts on different terms than those set forth in the reinsurance contract

Under the legislation, the domiciliary state of the reinsurer possesses the exclusive authority to regulate the financial solvency of the reinsurer. Consequently, surplus lines insurers and reinsurers are now subject to the regulatory authority of only one state, thereby avoiding potentially conflicting regulation in this arena from competing jurisdictions. This new single-state regime is designed to promote certainty and efficiency, and some believe it is the first logical step toward direct federal regulation of insurance companies in the United States.

Consumer and Investor Protection

A significant portion of the legislation is devoted to measures specifically intended to protect consumers and investors. Based on the belief held by some that lax consumer regulation—particularly with respect to retail mortgages—significantly contributed to the economic crisis, Congress has dramatically transformed the federal regulation of consumer financial services. The overhaul likely will usher in an era of increased substantive rulemaking and other supervisory controls, as well as increased federal and state enforcement and private civil litigation. During the financial crisis, many investors in stocks and other securities suffered devastating losses. Consequently, Congress has seen fit to respond with several new protections for investors and whistleblowers.

Establishment of the Bureau of Consumer Financial Protection (§§ 1011, 1012, 1021, 1025, 1026, 1029, & 1031)

The portion of the legislation entitled the Consumer Financial Protection Act of 2010 (CFPA) establishes the Bureau of Consumer Financial Protection (BCFP) within the Federal Reserve to regulate consumer financial products and services. The BCFP, which will consolidate and strengthen consumer protection responsibilities currently managed by the Federal Reserve, the OCC, the OTS, the FDIC, the NCUA, the FTC, and HUD, will have extensive authority to regulate and enforce substantive standards for any person that engages in the offer or sale of a financial product or service to any consumer.

Despite being formally an entity within the Federal Reserve, the BCFP will enjoy significant operational and policymaking independence.

The BCFP will be led by a presidentially appointed, Senate-confirmed director. Despite being formally an entity within the Federal Reserve, the BCFP will enjoy significant operational and policymaking independence. For example, the Federal Reserve Board is prohibited from intervening in the issuance of any BCFP order, rule, examination, or enforcement action. The BCFP will have its own dedicated, non-appropriated funding supply in the form of mandatory annual transfers from the Federal Reserve's earnings.

The BCFP's central mission will be to implement and enforce relevant federal laws to ensure that markets for consumer financial products and services are "fair, transparent, and competitive." The BCFP is specifically tasked with protecting consumers from discrimination and "unfair, deceptive, or abusive acts and practices."

The BCFP will have supervisory, rulemaking, and enforcement authority over "covered persons" for all consumer finance activities except insurance, as well as CFTC- and SEC-regulated services. This generally will include any person that offers or provides a consumer financial product or service. There are two important points here. First, nonbank entities will be regulated in the same manner and by the same regulator as their bank counterparts engaging in the same activities (*i.e.*, mortgage companies and consumer finance companies). Second, the BCFP is the first agency dedicated *solely* to consumer protection that will supervise and examine these entities.

The BCFP will have limited examination authority over banks, thrifts, and credit unions with $10 billion or less in assets because the federal banking agencies will be responsible for examining and enforcing these institutions' compliance with federal consumer financial laws. This exclusion largely reflects a compromise that allows smaller financial institutions to have a single supervisor.

A number of entities will be exempt from the BCFP's authority, including any entity regulated by a state insurance regulator, the SEC, a state securities commission, the CFTC, or the Farm Credit Administration. In addition, while subject to relevant BCFP regulations, certain retailers, merchants, and other sellers of nonfinancial services are exempt from BCFP supervision and enforcement. Automobile dealers similarly are exempt.

Enforcement/Statutory Preemption (§ 1044)

The longstanding preemption policy debate concerns the complex layering of federal and state consumer financial laws that has made nationwide compliance challenging for many companies. While the trend in recent years has favored more federal preemption and hence greater uniformity, the legislation reverses that trend by affording states greater legislative and enforcement latitude. For example, Congress has authorized states to enact stricter substantive protections and allows state attorneys general to initiate civil actions, including against banks, to enforce the federal consumer financial protection laws. With respect to national banks, the OCC may on a case-by-case basis preempt a state law only if that law "prevents or significantly interferes" with the bank's ability to do business and if federal consumer protection laws address the issue.

Mortgage Reform and Predatory Lending
(§§ 1402, 1403, 1414, 1421, & 1463)

In a statute entitled the Mortgage Reform and Anti-Predatory Lending Act of 2010, the legislation sets minimum underwriting standards for mortgages by requiring lenders to verify that consumers have a reasonable ability to repay at the time the mortgage is consummated. Certain high-quality, low-cost loans (defined as "qualified mortgages") are presumed to meet this standard. Underwriting is also addressed by appraisal reforms. The legislation prohibits lenders from making a higher-cost mortgage without first obtaining a written appraisal. It establishes enforceable federal appraisal independence standards that prohibit the parties involved in a real estate transaction from influencing the independent judgment of an appraiser through collusion, coercion, and bribery. Federal oversight of the state appraisal regulatory system is also enhanced.

Additional new mortgage-related consumer protections include limits on financial incentives (including payments known as "yield spread premiums") that consumer advocates believe encourage mortgage brokers and other mortgage originators to steer consumers to higher-cost mortgages. New prohibitions are also established on single-premium credit insurance, mandatory arbitration clauses, and prepayment penalties for adjustable-rate mortgages and mortgages that do not meet the definition of a qualified mortgage.

The legislation enhances and expands the scope of consumer protections for high-cost loans under the Home Ownership and Equity Protection Act (HOEPA) and requires additional disclosures to consumers. The HOEPA provisions prohibit:

- the financing of points and fees
- excessive fees for payoff information, modifications, or late payments
- practices viewed as increasing the risk of foreclosure (such as balloon payments, encouraging a borrower to default, and call provisions)

Investor Advisory Committee (§ 911)

In the realm of investor protection, the legislation establishes a new permanent Investor Advisory Committee (IAC) to consult with and advise the SEC on matters such as making recommendations to Congress for legislative changes on the regulation of securities products, trading strategies and fee structures, the effectiveness of disclosures, and other investor protection initiatives. The IAC will be comprised of the head of a newly created Office of the Investor Advocate (see box to right), a representative of senior citizens, a representative of state securities commissions, and 10 to 20 representatives of individual and institutional investors appointed by the SEC. The IAC will not have any designated public company representation, and its Chairman and Vice Chairman may not be employed by any public company. The legislation requires the SEC to disclose promptly its assessment of any IAC findings or recommendations and the actions it intends to take to address them.

What are the responsibilities of the Office of the Investor Advocate?

An Office of the Investor Advocate (OIA) will be created within the SEC but with independent reporting obligations to Congress. The head of the OIA will be appointed by the SEC Chairman. The OIA will be charged with:

- assisting retail investors to resolve significant problems with the SEC or with SROs
- identifying areas in which investors would benefit from changes to SEC regulations or SRO rules
- identifying problems that investors have with financial service providers and investment products
- analyzing the potential impact on investors of proposed SEC and SRO rules
- proposing appropriate related changes to rules and regulations to promote investor interests

Whistleblower Incentives and Protections (§ 922)

The legislation is intended to increase the reporting of securities laws violations by enhancing existing rewards and protections for whistleblowers. The existing whistleblower rewards program is limited to insider trading cases, caps rewards at 10% of the funds collected as sanctions, and, according to a recent report from the SEC's Office of Inspector General, has enjoyed only "minimal" success. Under the new enhanced program, a whistleblower providing "original" information to the SEC that leads to a successful enforcement action resulting in monetary sanctions exceeding $1 million will be eligible for a reward of between 10% and 30% of the funds collected as sanctions. Whistleblower protections will also be enhanced: a whistleblower will now be able to sue a retaliating employer directly in federal court, whereas previously a whistleblower had to exhaust administrative remedies. In addition, Congress has clarified that existing whistleblower protections under the Sarbanes-Oxley Act apply to both parent companies and affiliates whose financial information is included in the parent's consolidated financial statements.

Corporate Governance and Executive Compensation

The financial crisis, coupled with public shock over a few mammoth frauds and widespread adverse reaction to certain now highlighted business practices, led Congress to focus on ways to enhance corporate accountability to shareholders and investor protection overall. The governance provisions of the legislation affect public companies broadly—and, in particular, boardroom practices—well beyond the financial services industry where the crisis originated. Some observers believe they create the potential for a significant shift in governing power from boardrooms to shareholders. Perhaps the most significant impact on how boards and institutional shareholders function and relate to each other, however, may come indirectly from the array of provisions that will increase financial and market transparency. These provisions, previously discussed, include increased regulation of derivatives trading,* hedge funds, private equity funds, and credit rating agencies.

Some widely discussed governance proposals—majority voting for directors, limits on executive compensation, and mandatory board risk committees for nonfinancial companies—did not make their way into the final legislation. However, as discussed below, many significant changes have been included, including proxy access authority, say-on-pay, further limits on broker discretionary voting, requirements for compensation committee and adviser independence, heightened disclosure of compensation and board leadership, and mandatory clawback policies.

Proxy Access Authority (§ 971)

The legislation gives the SEC express discretionary authority to adopt rules and procedures relating to the inclusion of shareholder board nominees in a company's proxy solicitation materials. It provides that the SEC has the authority to mandate that shareholders be provided "proxy access," significantly lowering the cost of nominating a director candidate to run against a nominee proposed by the board. We expect the SEC to move quickly toward final rulemaking to fulfill the Chairman's commitment that proxy access be in effect for the 2011 proxy season. The legislation also clarifies that the SEC has broad discretion to consider exemptions from the requirement based on factors such as the potential for disproportionate burdens on small companies.

Say-on-Pay (§ 951)

The legislation amends the Exchange Act to require companies to include a provision in certain proxy statements for a nonbinding shareholder vote on the compensation of executives as disclosed pursuant to SEC rules. This "say-on-pay" vote would occur annually, biennially, or triennially, as determined by a separate shareholder vote held at least every six years. Both votes are required to be included in the company's proxy statement for the first annual or other meeting of shareholders occurring following the six-month anniversary of the enactment of the legislation. Although this "say-on-pay" vote is not binding on the company, it will likely apply greater pressure on boards to consider shareholder viewpoints in executive compensation decisions. The legislation also targets executive "golden parachutes," requiring certain disclosures and a nonbinding separate shareholder vote with respect to compensatory arrangements of "named executive officers" that are based on or relate to an M&A transaction involving a shareholder vote. The SEC is authorized, however, to create exemptions and is instructed to consider an exemption for small companies that might be disproportionately affected.

The legislation also amends the Exchange Act to require every institutional investment manager subject to section 13(f) of the Exchange Act to report at least annually how it cast its votes on these nonbinding items.

The governance provisions of the legislation affect public companies broadly—and, in particular, boardroom practices—well beyond the financial services industry where the crisis originated.

Broker Discretionary Voting (§ 957)

The SEC must direct national securities exchanges to prohibit member brokers from voting customer shares without first receiving voting instructions from the beneficial owner with respect to the following: director elections (other than uncontested director elections of registered investment companies), executive compensation, and any other "significant matter" as determined by the SEC. This will reduce the influence of traditionally management-friendly brokers on these matters. Since the New York Stock Exchange (NYSE) has already eliminated broker discretionary voting on share compensation plans and in uncontested director elections, the principal impact of this provision is to prevent discretionary voting on a "say-on-pay" proposal, which the NYSE currently considers "routine."

Compensation Committee and Adviser Independence (§ 952)

The SEC must direct national securities exchanges to require that each member of a listed company's compensation committee satisfy a heightened standard of independence. This standard will consider factors such as the receipt of consulting or advisory fees and "affiliate" status and therefore is likely to be very similar to that currently applicable to audit committee members. In

* As discussed above, use of the end-user exemption is conditioned upon approval by the relevant board committee.

addition, the compensation committee must be authorized to retain, compensate, and oversee compensation consultants, legal counsel, and other advisers to assist in fulfilling its duties. Of particular note, the compensation committee may only select an adviser after taking into consideration various factors to be identified by the SEC that speak to the adviser's independence. "Controlled companies" are exempt from these requirements and the SEC may allow the exchanges to exempt other categories of companies. The SEC must issue rules covering these requirements within 360 days after the enactment of the legislation.

. . . the compensation committee may only select an adviser after taking into consideration various factors to be identified by the SEC that speak to the adviser's independence.

Disclosure of Board Leadership (§ 972)

The SEC must issue rules requiring companies to disclose in annual proxy statements why they have separated or combined the positions of chairman of the board and CEO. This mandate has already been fulfilled, however, by changes to SEC proxy disclosure rules that took effect on February 28, 2010. Under the SEC's current rules, a company soliciting proxies for the annual election of directors must describe its board leadership structure and explain why it has determined that the structure is appropriate (*e.g.*, the reason for choosing to separate or combine the positions of chairman and CEO). Both the SEC's new rules and the legislation appear responsive to the view that by requiring companies to articulate the rationale for their leadership structures, boards with combined chairman/ CEO positions may be encouraged to consider whether separating the two will foster greater board independence.

Additional Executive Compensation Disclosures (§ 953)

The SEC must issue rules requiring companies to describe clearly in annual proxy statements the relationship between executive compensation actually paid and the company's financial performance. The description must discuss or illustrate stock price performance and dividend policy. The SEC must also issue rules requiring disclosure in certain SEC filings (such as the Form 10-K and proxy statement) of (a) the median of the annual total compensation of all the company's employees except the CEO, (b) the annual total compensation of the CEO, and (c) the ratio of (a) to (b).

Clawback of Incentive Compensation (§ 954)

The SEC must instruct national securities exchanges to require each listed company to develop, implement, and disclose a "clawback" policy. Under the mandated policy, if a company is required to restate its financial statements due to material noncompliance with relevant reporting requirements, the company must recover from current and former executive officers any excess incentive compensation based on the erroneous data received during the three-year period preceding the date on which the company becomes required to prepare the restatement. The listing standard will be far broader than the clawback provision in the Sarbanes-Oxley Act, which permits the SEC (but not the company or its shareholders) to recoup monies for the company from only the CEO and the CFO extending back 12 months, and is applicable only in cases involving misconduct leading to restatement of the financial statements.

Hedging by Employees and Directors (§ 955)

The SEC must issue rules requiring companies to disclose in their annual proxy statements whether any employee or director is permitted to purchase financial instruments that are intended to hedge or offset any decrease in the market value of any equity securities granted by the company as part of compensation or held by that person. One concern with hedging by directors and employees is that it may adversely affect the alignment of their interests with those of shareholders as well as cause a "disconnect" with the incentive effect equity compensation awards are designed to enhance.

Compensation Structures of Financial Institutions (§ 956)

Within nine months after the enactment of the legislation, the appropriate federal regulators, jointly, are required to prescribe regulations or guidelines to require certain financial institutions with assets of $1 billion or more to disclose to their appropriate federal regulators the structures of all incentive-based compensation arrangements offered by those institutions to a degree sufficient to determine whether the structure provides executives, employees, directors, or principal shareholders with excessive compensation, fees, or benefits or otherwise could lead to material financial losses. The regulators are also instructed to adopt regulations or guidelines that prohibit incentive-based arrangements that the regulators determine encourage inappropriate risks or that could lead to material losses. Ultimately, the guidelines could influence the compensation structures of nonfinancial companies as well.

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Weil's Financial Regulatory Reform Working Group includes more than 35 subject matter experts from across the Firm's 1200 attorneys in various departments, practice groups, and offices around the world. If you have questions regarding this document, please call Heath Tarbert, head of the Working Group, at 202 682 7177, or any of the members listed below.

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RMA acts as a liaison between the financial services industry and bank regulatory agencies. As a not-for-profit, professional association, RMA does not lobby on behalf of the industry. However, RMA meets often with industry regulators to discuss issues of mutual concerns such as the impact of a slowing economy on bank portfolios.

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