

# Clients & Friends Memo



## **The Dodd-Frank Act: How it Impacts Specific Industries, Entities and Transactions**

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## **The Dodd-Frank Act: How it Impacts Specific Industries, Entities and Transactions**

**June 22, 2011\***

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# Clients & Friends Memo

## Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act

**August 12, 2010**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) was signed into law by President Obama on July 21, 2010. The Act consists of sixteen distinct Titles on a wide variety of topics. Once implemented by the required regulations, the Act will significantly alter the U.S. financial regulatory system. All financial institutions will be directly and materially affected by the Act’s accompanying regulations, and non-financial institutions that use regulated financial products will be indirectly affected. Additionally, the Act’s amendments to Sarbanes-Oxley and broad changes to executive compensation and corporate governance rules will impact all U.S. public companies.

This Overview Memorandum is intended to provide a very brief summary of those Titles of the Act that are most significant to our clients. In addition to this Overview Memorandum, Cadwalader has prepared a series of memoranda, each discussing a different aspect of the Act and how it will affect different industries, types of entities and transactions. For a list of the related topic-specific memoranda, see Appendix A to this memorandum or visit our website.<sup>1</sup>

The Act was adopted in response to the economic crisis. Accordingly, the Act is intended to create future financial stability, better protect consumers and stimulate lending to underserved communities.

Nonetheless, we emphasize that the Act requires extensive regulations in order to be implemented. Accordingly, the ultimate impact of the Act is in large part still difficult to estimate. In the memoranda accompanying this overview, we have pointed out some of the questions we expect to arise. No doubt many open issues will be addressed in the adoption and implementation of regulations under the Act or in further amendments to the Act. That said, until regulations are proposed, it will be difficult for many of the financial institutions and companies that will be impacted by the Act to adopt more than tentative plans to adapt to its requirements.

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<sup>1</sup> The most recent Cadwalader, Wickersham & Taft Clients & Friends Memos are available here: [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

## I. Title I: Financial Stability

Title I of the Act creates the Financial Stability Oversight Council (“**FSOC**”), which will identify systemically significant nonbank financial firms (“**SSNFs**”) and regulate those institutions in a manner that will be, in certain circumstances, stricter than the current regulatory requirements generally applicable to banks and bank holding companies (“**BHCs**”). Title I also contains the “no de-banking” or “Hotel California” provision, which ensures that entities that are currently large BHCs remain subject to such heightened prudential requirements regardless of whether those institutions continue to be subject to the Bank Holding Company Act by reason of their ownership of an insured depository institution.

For more information on Title I, see [\*“Changes to the Regulation of Banks, Thrifts, and Holding Companies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act”\*](#) and [\*“Regulation of Systemically Significant NonBanks Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”\*](#)

## II. Title II: Orderly Liquidation Authority

Title II of the Act creates a new “orderly liquidation authority” (“**OLA**”) that allows the Federal Deposit Insurance Corporation (“**FDIC**”) to seize control of a financial company whose imminent collapse is determined to threaten the entire U.S. financial system. This measure addresses companies considered “too big to fail.” A determination by the designated government authorities that a failing company poses a systemic risk would authorize the FDIC to seize the entity and liquidate it under the new OLA, preempting any proceedings under the Bankruptcy Code. The only permitted outcome under the OLA is liquidation; rehabilitation, reorganization and debtor-in-possession proceedings are not an option for a financial institution subject to an OLA proceeding. Instead, the FDIC, in nearly all cases, will assume full control in an OLA seizure. Insurance companies, which remain subject to state regulation, are not covered by the OLA, but their holding companies and unregulated affiliates are subject to the OLA. Insured depository institutions will continue to be subject to the FDIA. In extending or maintaining credit, rating agencies, lenders and other potential creditors of a financial institution will now have to consider the effect of the OLA as well as the Bankruptcy Code on an institution that may become subject to Title II. While the OLA is modeled after the FDIC’s existing framework for failed insured depository institutions, there are important differences that are discussed in our related memoranda.

For more information on Title II, see [\*“Orderly Liquidation of Financial Companies, Including Executive Compensation Clawback, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”\*](#)

### III. Title III: Transfer of Powers to the Comptroller of the Currency, the Corporation, and the Board of Governors

Title III of the Act eliminates the Office of Thrift Supervision (“OTS”) as the federal agency responsible for thrift and thrift holding company oversight (although the thrift charter itself is preserved), and distributes the OTS’s existing responsibilities among the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency. In addition, Title III alters the assessment methodology for funding the Deposit Insurance Fund, requiring that assessments be imposed on a depository institution’s total liabilities (and not just its deposit liabilities). Title III also eliminates the 1.5% ceiling on the Fund’s reserve ratio, and authorizes the FDIC to waive dividends when the Fund exceeds the target reserve ratio of 1.35%. Title III also permanently lifts the FDIC coverage limit to \$250,000 and extends the FDIC’s Transaction Account Guarantee (“TAG”) program, which provides unlimited coverage for certain non-interest-bearing commercial transaction accounts, for an additional two years.

For more information on Title III, see [\*“Changes to the Regulation of Banks, Thrifts, and Holding Companies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”\*](#)

### IV. Title IV: Regulation of Advisers to Hedge Funds and Other Institutions

Title IV of the Act, among other things, (i) alters the Securities and Exchange Commission (“SEC”) registration criteria applicable to hedge fund managers and other investment advisers, materially changing the composition of the pool of registered investment advisers, (ii) significantly increases the record-keeping and reporting obligations applicable to registered and unregistered advisers to hedge funds and private equity funds, (iii) raises the “accredited investor” standard for individual investor eligibility to participate in private offerings (including offerings by hedge funds and private equity funds), and gives the SEC broad authority to adjust the “accredited investor” standard going forward, and (iv) applies inflation indexing to the “qualified client” standard under which registered advisers are permitted to charge performance-based compensation.

For more information on Title IV, see [\*“Hedge Fund Regulation Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”\*](#)

### V. Title V: Insurance

Title V of the Act creates the Federal Insurance Office within the Department of Treasury and grants it authority over all lines of insurance except for health insurance, certain long-term care insurance and crop insurance. The Federal Insurance Office is responsible for monitoring all aspects of the insurance industry within the United States, identifying issues

or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system, making recommendations, coordinating federal efforts and developing federal policy on prudential aspects of international insurance matters as well as providing certain periodic reports to the President and Congress regarding insurance regulation and related matters. The Federal Insurance Office is also authorized to negotiate and enter into certain agreements relating to the business of insurance or reinsurance with foreign governments on behalf of the United States, preempting any state laws that are inconsistent with those agreements.

Title V is designed to promote uniformity in the insurance and the reinsurance market. Title V provides that the placement of non-admitted insurance (*i.e.*, casualty insurance placed with an insurer not licensed to engage in the business of insurance in the related state) is subject to the statutory and regulatory requirements solely of the insured's home state and prohibits, among other things, a state, other than the home state of the insured, to require any premium tax be paid for non-admitted insurance. Title V also promotes uniformity by prohibiting a state from collecting any fees relating to the licensing of a surplus lines broker<sup>2</sup> unless the state participates in the national insurance producer database of the National Association of Insurance Commissioners ("NAIC") or another equivalent uniform database.

Title V requires an insurer ceding (*i.e.*, purchasing) reinsurance to recognize credit if the state of domicile of the ceding insurer is an NAIC-accredited state (or has substantially similar financial solvency requirements in place) and preempts most laws or other actions of a state that is not the domiciliary state of the ceding insurer. Lastly, Title V delegates primary authority to regulate the financial solvency of a reinsurer to the state of domicile of the reinsurer.

For more information on Title V, see [\*"Insurance Reforms Under the Dodd-Frank Wall Street Reform and Consumer Protection Act."\*](#)

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

Title VI of the Act provides for heightened regulation, supervision, examination and enforcement powers over depository institution holding companies and their subsidiaries. Most significantly, Title VI expands the federal affiliate and insider transaction restrictions (Sections 23A, 23B, and 22 of the Federal Reserve Act) in particular with respect to

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<sup>2</sup> The term "surplus lines broker" means an individual, firm, or corporation which is licensed in a state to sell, solicit, or negotiate insurance on properties, risks, or exposures located or to be performed in a state with nonadmitted insurers.

derivatives and sale-repurchase (“repo”) transactions, imposes higher standards for BHCs to engage either in expanded “financial in nature” activities or in M&A activity, and expands the scope of existing national bank lending limits and requires state chartered banks to include derivatives within applicable state lending limits. Title VI also imposes a new nationwide growth cap (applicable both to BHCs and systemically significant nonbank companies), and places a partial moratorium on the creation of, or changes of control in, “nonbank banks.” In addition, Title VI repeals “Regulation Q”, thereby authorizing banks and thrifts to offer interest-bearing transaction accounts to commercial clients.

Title VI also contains the “Volcker Rule,” which prohibits any “banking entity” from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund. Although the Volcker Rule, as originally proposed, would have prohibited a banking entity from sponsoring or investing in a hedge fund or private equity fund, the Merkley-Levin amendment to the Volcker Rule (which was added in conference) creates a small number of limited exceptions to the prohibition, including exceptions for certain bona fide trust arrangements and “seed money” investments for funds organized by the banking entity, which may be retained subject to certain “de minimis” limits. While systemically significant nonbank financial companies are not prohibited from proprietary trading, or sponsoring or investing in a hedge fund or private equity fund, Title VI does subject these entities to additional capital requirements and quantitative limits on such activities.

For more information on Title VI, see [\*“Changes to the Regulation of Banks, Thrifts, and Holding Companies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”\*](#)

## VII. Title VII: Wall Street Transparency and Accountability

Title VII (the “**Derivatives Legislation**”) will give primary authority to the Commodity Futures Trading Commission (the “**CFTC**”) and the SEC (the SEC, together with the CFTC, the “**Commissions**”) to regulate the swaps market, both as to transactions and participants, although the various banking regulators (the “**Bank Regulators**”) will retain substantial authority with respect to banks.

Among other things, the Derivatives Legislation will (i) require that certain “swaps” be traded on exchanges, centrally cleared and publicly reported, (ii) require the registration of both dealers in, and large end users of, swaps, with one or both of the Commissions, (iii) authorize the Commissions to establish a comprehensive regulatory system applicable to these registrants, (iv) require the establishment of new swap market mechanisms, including exchanges, clearing organizations and swap information repositories, and (v) give the Commissions broad and often overlapping powers that they would, in many instances

be required to use jointly, sometimes in conjunction with the Bank Regulators. The impact of the Derivatives Legislation reaches far beyond the swaps markets, having at least indirect application to spot or cash market trading.

Many of the key terms in the Derivatives Legislation are either undefined or are left for the regulators to fill in. Further, there are provisions of the legislation that may not be readily feasible to implement, such as the authority given the Commissions over the capital requirements of end-users. Other provisions may require substantial clarification or amendment, including the definition of the term “swap.”

For more information on Title VII, see [\*“The New Scheme for the Regulation of Swaps, with Appendices on Retroactivity, Special Entities and Tax, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act”\*](#) and [\*“Regulation of End Users of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”\*](#)

#### VIII. Title VIII: Payment, Clearing, and Settlement Supervision

Title VIII, the “**Payment, Clearing and Settlement Supervision Act of 2010**”, provides for increased regulation of and emergency federal assistance to (i) financial market utilities (“**FMUs**”) and (ii) financial institutions that engage in payment, clearing and settlement (“**PCS**”) activities that are in each case deemed to be systemically significant.<sup>3</sup> Title VIII, which is effective immediately upon enactment, provides the FSOC the authority to designate any institution that is an FMU or any PCS activity as systemically important. Upon such a designation, the Federal Reserve is given authority to oversee the prudential regulation of designated FMUs and all financial institutions that engage in the designated PCS activities. Designated FMUs are provided access to the Federal Reserve’s discount window in exigent circumstances and are subject to heightened notice requirements with respect to rule, policy and operational changes that could affect risk. The SEC and the CFTC are also required to consult with the Federal Reserve regarding certain derivatives clearing matters, including mandatory clearing determinations.

#### IX. Title IX: Investor Protections and Improvements to the Regulation of Securities

Title IX of the Act covers a wide range of subject matters including (i) changes to the regulatory requirements applicable to broker-dealers and investment advisers, (ii) new significant requirements relevant to credit rating agencies and structured finance products,

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<sup>3</sup> FMUs are defined to include persons who operate multilateral systems for transferring, clearing or settling payments, securities or financial transactions among financial institutions.

and (iii) rules related to executive compensation and corporate governance that apply to public companies generally, not merely to those engaged in financial activities.

As to broker-dealers and investment advisers, Title IX is primarily significant for requiring the SEC to conduct studies and to impose rule requirements relating to the services that they provide to retail customers and to other customers that the SEC may designate. The Title also provides a good number of statutory amendments, including provisions relating to short sales and securities lending under Subtitles B and I, transaction reporting by large shareholders and Section 16 insiders under Subtitle B, amendments to Securities Investors Protection Act provisions relevant to broker-dealer insolvency under Subtitles B and I, additional regulation of the municipal securities markets under Subtitle H, and restructuring of the SEC under Subtitle F. For more information on Title IX and its impact on broker-dealers and investment advisers, see *[“Changes to the Regulation of Broker-Dealers and Investment Advisers Under Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act.”](#)* For more information as to Title IX’s application to investment advisers, see *[“Hedge Fund Regulation Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”](#)*

Subtitle C of Title IX, entitled “Improvements to the Regulation of Credit Rating Agencies,” institutes reforms in the regulation, oversight and accountability of nationally recognized statistical rating organizations (“NRSROs”). The Act expresses Congressional concerns with the conflicts of interest faced by credit rating agencies and with the inaccuracy of ratings on structured finance products, which “contributed significantly to the mismanagement of risks by financial institutions and investors,” resulting in the need for “increased accountability on the part of credit rating agencies.” The consistent theme of the provisions of Subtitle C of Title IX is to identify and eliminate conflicts of interest and restore confidence in the ratings process. Subtitle D of Title IX, entitled “Improvements to the Asset-Backed Securitization Process,” institutes reforms to the asset-backed securitization process by requiring (i) risk retention (“skin in the game”), (ii) increased disclosure and (iii) ongoing periodic reporting. For more information on Subtitles C and D, see *[“Reforms to the Asset-Backed Securitization Process and the Regulation of Credit Rating Agencies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”](#)*

Subtitles E and G of Title IX include broad changes to executive compensation and corporate governance rules for publicly traded companies and financial institutions, including mandatory non-binding shareholder votes on executive compensation and golden parachutes, compensation committee independence requirements, certain executive compensation disclosures, and “clawbacks” of erroneously awarded compensation. These subtitles also require disclosure regarding employee and director hedging, financial

institutions' incentive-based compensation arrangements, and disclosures of the relationship between the chairman and CEO of a company. Finally, Title IX places limits on broker voting and increases proxy access for shareholders. For more information on these issues, see [\*“Executive Compensation and Corporate Governance Provisions Under the Dodd-Frank Wall Street Reform and Consumer Protection Act”\*](#) and [\*“Amendments to SOX, Including Section 404\(b\) Exemption for Nonaccelerated Filers, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act.”\*](#)

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

Title X of the Act establishes the Bureau of Consumer Financial Protection (“**BCFP**”) as an independent bureau within the Federal Reserve. The BCFP will have authority to issue rules applicable to all financial institutions, including depository institutions, that offer financial products and services to consumers. The BCFP will have examination and enforcement authority with respect to consumer financial laws over very large banks and nonbank financial institutions. The BCFP will not have authority over insured depository institutions and credit unions with assets of \$10 billion or less.

**XI. Title XI: Federal Reserve System Provisions**

Title XI of the Act limits the authority of the Federal Reserve to engage in emergency lending and requires certain audits of the Federal Reserve with respect to its emergency lending activities during the financial crisis. The Title also establishes the position of Vice Chairman for Supervision at the Federal Reserve.

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

Title XII of the Act authorizes the Secretary of the Treasury to establish certain programs directed at improving access to basic financial products for underserved communities.

**XIII. Title XIII: Pay It Back Act**

Title XIII (the “**Pay It Back Act**”) amends the Emergency Economic Stabilization Act of 2008, the American Recovery and Reinvestment Act of 2009 (“**ARRA**”) and other related acts to limit the Troubled Asset Relief Program (“**TARP**”) and earmark certain funds to be used for deficit reduction. Specifically, the Pay It Back Act, among other things, reduces the amount of TARP funds available to the Secretary of the Treasury by \$225 billion, ends the Secretary of the Treasury’s ability to fund new programs under TARP as of June 25, 2010 and requires certain funds received by the Secretary of the Treasury to be used to reduce the deficit, including funds received in connection with: (i) the sale of certain Fannie Mae, Freddie Mac and Federal Home Loan Bank obligations owned by the U.S.

Department of Treasury, (ii) the payment of certain fees by Fannie Mae or Freddie Mac to the U.S. Treasury under certain programs authorized under the Housing and Economic Recovery Act of 2008, (iii) the rejection by States of certain funds made available to states or local governments under ARRA and (iv) the failure to use certain discretionary appropriations made available under ARRA by December 31, 2012.

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

Title XIV of the Act, the “**Mortgage Reform and Anti-Predatory Lending Act**,” provides for increased disclosure requirements with respect to origination of residential mortgage loans. The Act contains a significant increase in regulation of mortgage loan origination and servicing practices. In particular, it sets new criteria under the Truth in Lending Act for creditors to originate mortgage loans, and restricts certain lending activities with respect to certain high cost residential mortgage loans. These restrictions become effective six months following enactment of the statute. The remainder of the provisions become effective when regulations are promulgated pursuant to the Act.

**XV. Title XV: Miscellaneous Provisions**

Title XV contains a number of unrelated provisions, including (i) a requirement that the U.S. Executive Director at the International Monetary Fund (the “**IMF**”) consider a country’s public debt relative to its gross domestic product and to oppose extending IMF loans unlikely to be repaid in full, (ii) an amendment to the Securities Exchange Act of 1934 (the “**Exchange Act**”) to add a disclosure requirement by companies using minerals originating in the Democratic Republic of Congo, (iii) a provision imposing safety reporting requirements by public issuers that operate coal mines, (iv) amendments to the Exchange Act requiring issuers involved in resource extraction to disclose payments made to a foreign or U.S. government for the purpose of development of oil, natural gas, or minerals, (v) a report by the Comptroller General assessing the relative independence, effectiveness, and expertise of presidentially appointed inspectors general, and (vi) a study to evaluate the impact of “core deposits” and “brokered deposits” at U.S. banking institutions.

**XVI. Title XVI: Section 1256 Contracts**

Title XVI amends Section 1256 of the Internal Revenue Code to provide that interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, credit default swaps, and similar agreements are not treated as Section 1256 contracts. Had Section 1256 applied to these financial instruments, they would have been required to be marked-to-market annually for tax purposes, and any gain or loss would have been 60% long-term and 40% short-term capital gain or loss, potentially giving rise to inappropriate timing and character

mismatches. The amendments will apply to taxable years beginning after the date of the enactment of the Act.

For more information on Title XVI, see ["The New Scheme for the Regulation of Swaps, with Appendices on Retroactivity, Special Entities and Tax, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act."](#)

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We hope you find this helpful. Please feel free to contact the Cadwalader attorneys with whom you ordinarily work if you have any questions about the Act or this memorandum and you will be directed appropriately depending on the specific subject matter.

Appendix A

- I. "Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act"
- II. "Changes to the Regulation of Banks, Thrifts, and Holding Companies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act"
- III. "Regulation of Systemically Significant NonBanks Under the Dodd-Frank Wall Street Reform and Consumer Protection Act"
- IV. "Orderly Liquidation of Financial Companies, Including Executive Compensation Clawback, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act"
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- XII. "Amendments to SOX, Including Section 404(b) Exemption for Nonaccelerated Filers, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act"

# Clients & Friends Memo

## Changes to the Regulation of Banks, Thrifts, and Holding Companies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

July 20, 2010

The focus of this Memorandum is on the material changes to U.S. banking regulation made by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act” or the “Dodd-Frank Act”), including the potential regulation by the Board of Governors of the Federal Reserve System of nonbank financial companies deemed systemically significant.<sup>1</sup>

The organization of the Memorandum is as follows:

Section I describes the procedure for designating a nonbank company as subject to Federal Reserve supervision.

Section II describes the new regulatory requirements imposed on bank holding companies and on those nonbank companies designated for Federal Reserve supervision.

Section III describes the new capital obligations on depository institutions and BHCs, regardless of size.

Section IV describes the elimination of the Office of Thrift Supervision and the realignment of regulatory responsibilities among the remaining banking agencies and the Securities &

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

<sup>1</sup> This memorandum reflects portions of Titles I, III, VI, and VII of the Act as passed by the House of Representatives and the Senate.

Title I will also subject systemically significant nonbank financial companies to Federal Reserve supervision and regulation. This memorandum is particularly focused on the regulation of banks and banking organizations. Our separate memorandum, [Regulation of Systemically Significant NonBanks Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#), is focused on Title I's application to nonbanking organizations.

Exchange Commission, including the shift in authority over certain investment bank holding companies from the SEC to the Federal Reserve.

Section V describes the changes to the Federal Deposit Insurance system, including changes to the deposit assessment process and the reserve ratios of the Deposit Insurance Fund.

Section VI describes the Act's provisions designed to restrain the growth of certain financial services companies, including the application of growth caps applicable to nonbank financial companies subject to Federal Reserve supervision.

Section VII discusses the Act's prohibition on an insured depository institution acting as a swap dealer.

Section VIII describes the requirements of the "Volcker Rule."

Section IX describes changes to bank lending limits.

Section X discusses the tightening of the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act.

Finally, Section XI discusses the changes to the insider transaction restrictions of Section 22 of the Federal Reserve Act.

## I. Supervision of Systemically Significant Firms

Title I of the Act contains sweeping provisions that authorize the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") to supervise previously unregulated (or under-regulated) firms – including those firms that are neither banks nor affiliated with banks – engaged in various financial activities where those firms' activities are deemed systemically significant with respect to the U.S. financial system. Firms so designated (the Act refers to such firms as "Nonbank financial companies supervised by the Board of Governors"<sup>2</sup> – herein we refer to them as "systemically significant nonbank financial firms" or "**SSNFs**") would then be subjected to heightened supervision and prudential regulation by the Federal Reserve, as explained below.

*Creation of the FSOC.* Title I of the Act establishes the Financial Stability Oversight Council ("**FSOC**"), whose voting members include each of the heads of the Federal Reserve, OCC, Bureau of Consumer Financial Protection ("**BCFP**"), CFTC, SEC, FDIC, Federal Housing Finance Agency

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<sup>2</sup> See Dodd-Frank Act § 102(a)(4)(D).

(“**FHFA**”), and National Credit Union Administration (“**NCUA**”), as well as an independent member appointed by the President.<sup>3</sup> The FSOC has general authority to issue recommendations to the “primary financial regulatory agencies”<sup>4</sup> regarding heightened standards and safeguards as to the conduct of financial activities that “create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies (“**BHCs**”) and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities.”<sup>5</sup> The primary regulatory agencies are generally obligated to implement an FSOC recommendation by rule within ninety days.<sup>6</sup>

*Process for Designation as Systemically Significant.* The most significant power that the FSOC will exercise directly, rather than through “recommendations,” is to designate a nonbank firm an SSNF. The FSOC is empowered to impose such a designation if it finds that (i) the nonbank firm is “predominantly engaged” in activities that are “financial in nature” under Section 4(k) of the Bank Holding Company Act (the “**BHC Act**”); and (ii) “material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company, could pose a threat to the financial stability of the United States.”<sup>7</sup>

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- <sup>3</sup> See Dodd-Frank Act § 111. Title I also establishes the Office of Financial Research (“**OFIR**”), which is generally tasked with facilitating the management of data that the FSOC collects in connection with FSOC reporting requirements imposed on Large BHCs and SSNFs under Section 116. See Dodd-Frank Act § 152.
- <sup>4</sup> Note that “primary financial regulatory agency” is a defined term referring, generally, to the federal or state regulatory authority having “primary” supervisory jurisdiction over an entity. See Dodd-Frank Act § 2(12). Note also that the various titles of the legislation contain variations on this defined term, and each variation operates to confer jurisdiction with respect to certain activities on one or another “primary” regulatory agency.
- <sup>5</sup> See Dodd-Frank Act § 120.
- <sup>6</sup> See Dodd-Frank Act § 120(c)(2).
- <sup>7</sup> See Dodd-Frank Act § 113; see also *Some Concerns with the Regulation of Large Nonbank Holding Companies* (Cadwalader, June 3, 2010), available at [http://www.cadwalader.com/assets/client\\_friend/060310RegLargeNonBankHoldingCos.pdf](http://www.cadwalader.com/assets/client_friend/060310RegLargeNonBankHoldingCos.pdf).

A nonbank firm is deemed “predominantly engaged” in activities that are “financial in nature”<sup>8</sup> if such activities (i) contribute 85% or more of annual gross revenues of the firm, or (ii) account for 85% or more of the firm’s total consolidated assets.<sup>9</sup> SSNF designation can be applied to a foreign firm if its US operations are deemed significant.<sup>10</sup> Further, a subsidiary may be designated a SSNF if the parent company is not, which means that the calculation of the 85% test is not required to be made at the ultimate parent level. Thus, the population of entities that could potentially be designated as SSNFs is extremely large.

*SSNF Criteria.* When deciding whether to designate a firm an SSNF, the FSOC must consider a series of factors, including its:

- leverage;
- off-balance-sheet exposures;
- transactions and relationships with other significant firms;

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<sup>8</sup> See Dodd-Frank Act § 163(b). The Gramm-Leach-Bliley Act of 1999 established the category of activities that are “financial in nature.” See BHC Act Section 4(k) (12 U.S.C. § 1843(k)). Generally, “financial in nature” activities include such additional activities that are permissible for a bank holding company (“**BHC**”) that qualifies as and has elected to become a “financial holding company” (“**FHC**”). “Financial in nature” encompasses a fairly sweeping list of activities, some of which would seem unlikely to be fundamental to the financial stability of the United States, including:

- lending
- trust and safekeeping activities
- securitization of assets
- merchant banking
- underwriting and dealing in securities
- mutual fund activities
- check cashing and money transmitting
- insurance agency and underwriting
- investment advisory services
- “finder” activities
- activities permissible for a BHC outside of the United States and which the Federal Reserve has determined is “usual in connection with the transaction of banking” abroad (such as management consulting, general data processing, and travel agency), and
- activities that are “closely related to banking” under Section 4(c)(8) of the BHC Act, including: servicing loans; real estate and personal property appraising; arranging commercial real estate equity financing; real estate settlement servicing; leasing personal or real property; check guaranty services; credit bureau services; collection agency services; acquiring debt in default; asset management, servicing, and collection activities; management consulting and counseling activities; employee benefits consulting services; career counseling services; courier services; printing and selling certain encoded items; and data processing services.

<sup>9</sup> See Dodd-Frank Act § 102(a)(6).

<sup>10</sup> See Dodd-Frank Act § 113(i). The FSOC must consult with the appropriate foreign regulatory authorities when designating foreign firms SSNFs.

- the importance of the firm as a source of credit and liquidity for the United States financial system;
- the importance of the firm as a source of credit for low-income, minority, or underserved communities in the United States;
- whether the firm is a manager rather than owner of assets;
- the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
- whether the firm is subject to prudential standards on a consolidated basis in its home country or already regulated by a U.S. financial regulatory agency;
- the amount and nature of the firm's U.S. financial assets;
- how the firm funds its operations.

The FSOC must notify a firm of its determination and provide the firm an opportunity for a hearing to contest its findings.<sup>11</sup> In the event of an unsuccessful contest (we assume most firms will contest designation as an SSNF given the substantial burdens that will follow from it), judicial recourse is limited. The firm may appeal the determination in federal district court, but the court may only overturn the FSOC's determination if it finds the determination "arbitrary and capricious."<sup>12</sup> Designated firms must register with the Federal Reserve within 180 days after receiving a final FSOC determination.<sup>13</sup>

## II. Regulation of SSNFs and Large BHCs

*Mandatory Heightened Prudential Standards.* SSNFs and those BHCs with total consolidated assets of \$50 billion or more ("**Large BHCs**") will be required to comply with "prudential standards" that would be stricter than those imposed on existing banks and BHCs. Certain "prudential standards" *must* be adopted by rule, including:

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<sup>11</sup> See Dodd-Frank Act § 113(e).

<sup>12</sup> See Dodd-Frank Act § 113(h). Note that the Act requires the Federal Reserve to issue regulations that provide a "safe harbor" from designation as an SSNF for certain "types or classes" of nonbank financial companies. See Dodd-Frank Act § 170.

<sup>13</sup> See Dodd-Frank Act § 114.

- **Risk-based capital and leverage requirements;**<sup>14</sup>
- **Liquidity requirements;**<sup>15</sup>
- **Risk management requirements**, including the establishment of board-level “risk committees”;<sup>16</sup>
- **Resolution plan (or “living will”) requirements**, including the obligation of the SSNF or Large BHC to report periodically to the Federal Reserve, the FSOC, and the FDIC its plan for its own “rapid and orderly resolution in the event of material financial distress or failure”;<sup>17</sup>
- **Periodic credit exposure reporting requirements**, including reports of exposures *to or from* other SSNFs or Large BHCs;<sup>18</sup> and
- **Concentration limits.**<sup>19</sup>

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<sup>14</sup> Although the leverage ratio requirement is to be defined in the Federal Reserve rulemaking, the Federal Reserve is required to apply a debt-to-equity ratio limit of 15-to-1 for Large BHCs and SSNFs that are found to pose a “grave” threat to U.S. financial stability. In addition, any leverage or risk-based capital provisions adopted by the Federal Reserve must require that certain “off-balance-sheet activities” must be included in the capital computations. “Off-balance-sheet activity” means an existing liability of a company that is not currently a balance sheet liability, but may become one upon the happening of some future event, including the following transactions, to the extent that they may create a liability:

- Direct credit substitutes in which a bank substitutes its own credit for a third party, including standby letters of credit.
- Irrevocable letters of credit that guarantee repayment of commercial paper or tax-exempt securities.
- Risk participations in bankers’ acceptances.
- Sale and repurchase agreements.
- Asset sales with recourse against the seller.
- Interest rate swaps.
- Credit swaps.
- Commodities contracts.
- Forward contracts.
- Securities contracts.
- Such other activities or transactions as the Federal Reserve may, by rule, define.

Dodd-Frank Act § 165(j), (k).

<sup>15</sup> Dodd-Frank Act § 165(b)(1)(A)(ii).

<sup>16</sup> Dodd-Frank Act § 165(b)(1)(A)(iii). The regulations to be adopted by the Federal Reserve *must* require that BHCs with assets of \$10 billion or more would be required to establish a risk committee composed of a certain number of independent directors and at least one “risk management expert”; such regulations *may* require that BHCs with assets of less than \$10 billion establish such a committee. Irrespective of the regulations, the Dodd-Frank Act states that publicly traded SSNFs *must* establish a risk committee within one year after becoming an SSNF. Dodd-Frank Act, § 165(h).

<sup>17</sup> See Dodd-Frank Act § 165(b)(1)(A)(iv), (d)(1).

<sup>18</sup> Dodd-Frank Act § 165(b)(1)(A)(iv), (d)(2).

*Potential Heightened Prudential Standards.* In addition, the Federal Reserve *may*, but is not *required* to, adopt prudential standards applicable to SSNFs and Large BHCs relating to:

- **Contingent capital requirements**, including the requirement that SSNFs and Large BHCs hold a minimum amount of contingent capital that is convertible into equity in times of financial stress;<sup>20</sup>
- **Short-term debt limits**, to be calculated as a percentage of the SSNF's or Large BHC's capital and surplus;<sup>21</sup>
- **Enhanced public disclosures**,<sup>22</sup> and
- Other prudential standards recommended by the FSOC or deemed appropriate by the Federal Reserve.

*Early Remediation Regulations.* In addition, the Federal Reserve, after consultation with the FSOC and the FDIC, is required to adopt regulations regarding early remediation requirements, involving a series of specific remedial actions to be taken by a SSNF or Large BHC that is experiencing financial distress<sup>23</sup>

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<sup>19</sup> Dodd-Frank Act § 165(b)(1)(A)(v). In addition, the Act provides for a hard credit exposure limit of 25% of capital stock and surplus of the SSNF to any "unaffiliated company." "Credit exposure" is defined as:

- all extensions of credit to the company, including loans, deposits, and lines of credit;
- all repurchase agreements and reverse repurchase agreements with the company, and all securities borrowing and lending transactions with the company, to the extent that such transactions create credit exposure for the SSNF or Large BHC;
- all guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit) issued on behalf of the company;
- all purchases of or investment in securities issued by the company;
- counterparty credit exposure to the company in connection with a derivative transaction between the company and the SSNF or Large BHC; and
- any other similar transactions that the Federal Reserve, by regulation, determines to be a credit exposure.

Section 165(e) also contains an "attribution rule" similar to that found in Section 23A of the Federal Reserve Act (12 U.S.C. § 371c), such that transactions with one party in which the proceeds of the transaction are ultimately transferred to, or that benefit, a second party are treated as a transaction directly with the second party for purposes of the credit concentration limits. The credit concentration limits (including the 25% cap) are not effective until three years after enactment.

<sup>20</sup> See Dodd-Frank Act § 165(b)(1)(B)(i), (c). However, the Federal Reserve may adopt contingent capital requirements only following the FSOC's completion of its study regarding contingent capital.

<sup>21</sup> See Dodd-Frank Act § 165(b)(1)(B)(ii), (g).

<sup>22</sup> See Dodd-Frank Act § 165(b)(1)(B)(iii), (f).

<sup>23</sup> See Dodd-Frank Act § 166 (mandatory and subject to Federal Reserve rulemaking). Early remediation regulations issued by the Federal Reserve are likely to generally resemble the FDIC's "prompt corrective action" requirements. The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") mandated that banking regulators take "prompt

*Reporting.* SSNFs and Large BHCs must submit certain reports to the Federal Reserve and FSOC, which in some cases may be duplicates of reports already provided to foreign authorities or other U.S. federal or state regulatory authorities.<sup>24</sup> The reports are intended to keep the Federal Reserve and FSOC informed as to the reporting entity's financial condition, risk control systems, transactions with depository institution subsidiaries, and "activities and operations [that] could, under adverse circumstances, have the potential to disrupt financial markets or affect the overall financial stability of the United States."

*Examination and Enforcement.* The Act subjects an SSNF and its subsidiaries to Federal Reserve examination authority with respect to (1) the nature of the operations and financial condition of the SSNF and its subsidiaries; (2) the financial, operational, and other risks of the SSNF and its subsidiaries that may pose a threat to the safety and soundness of the SSNF and its subsidiaries or to the financial stability of the United States; (3) the systems for monitoring and controlling such risks; and (4) compliance by the SSNF and its subsidiaries with the requirements of the Act.<sup>25</sup> The Federal Reserve is also granted authority to issue cease-and-desist orders against an SSNF for engaging in unsafe and unsound practices.<sup>26</sup> In addition, if the Federal Reserve determines that the primary financial regulatory agency having supervisory authority over a functionally regulated subsidiary of an SSNF has not done enough to force the subsidiary to cease the unsafe and unsound practice, the Federal Reserve may initiate enforcement action against the subsidiary *as if the subsidiary were a BHC* subject to Federal Reserve supervision.<sup>27</sup> Finally, the Federal Reserve is required to conduct annual "stress tests" of SSNFs and Large BHCs that evaluate whether such entities have capital that is adequate on a total consolidated basis to absorb losses resulting from adverse economic conditions.<sup>28</sup>

*Financial Silos for SSNFs.* Bank regulation is largely premised on the concept of "the separation of banking and commerce" – banks are confined to a fairly narrow range of activities, and companies

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corrective action" ("PCA") when an institution's capitalization rating falls below the top two capitalization categories. See 12 U.S.C. § 1831o. PCA may include an increase in the monitoring of the institution, requiring the institution to raise more capital, requiring the institution to merge with a more highly capitalized institution, or closure of the institution. Similarly, the Federal Reserve's early remediation regulations must establish requirements for (i) limits on capital distributions, acquisitions, and asset growth; (ii) capital restoration plan and capital-raising requirements; (iii) limits on transactions with affiliates; (iv) management changes; and (v) asset sales. Dodd-Frank Act § 166(c).

<sup>24</sup> See Dodd-Frank Act §§ 116(b); 161(c).

<sup>25</sup> See Dodd-Frank Act § 161(b) (subjecting SSNFs to Federal Reserve examination).

<sup>26</sup> See Dodd-Frank Act § 162. The SSNF would be treated as if it were a BHC for purposes of FDIA cease-and-desist authority.

<sup>27</sup> See Dodd-Frank Act § 162(b)(2).

<sup>28</sup> See Dodd-Frank Act § 165(i). Note that the Act appears to confer very broad discretionary authority on the Federal Reserve to require stress testing of any "nonbank financial company," which as the term is defined in the act would include any U.S. or non-U.S. company that is engaged "predominantly" in activities that are "financial in nature" under BHC Act § 4(k).

that control banks (*i.e.*, in most cases, Federal Reserve – regulated BHCs) and the other nonbank affiliates of banks are also confined to a limited range of activities permitted under the BHC Act.<sup>29</sup> SSNFs (which, by their nature, are not BHCs and therefore typically engage in a broader range of activities permitted to corporations generally) could not comply with the BHC Act's activity restrictions without significant divestitures or changes in their activities.

The Act does not require an SSNF (or its parent) to conform its activities to Section 4 of the BHC Act or otherwise shed any activities not permissible for a BHC.<sup>30</sup> The Act does, however, authorize the Federal Reserve to require the “siloining” of any of the SSNF's BHC-eligible activities from the remainder of its activities. The Federal Reserve is authorized to issue regulations that would require any SSNF to create an intermediate holding company to “silo” all or a part of the activities of the SSNF that are deemed to be “financial in nature” under BHC Act Section 4(k) – potentially compelling a significant restructuring of the SSNF. The Act further states that such “siloining” is mandatory where the Federal Reserve determines that, essentially, it would be difficult to properly supervise the “financial in nature” activities of the SSNF if such an intermediate holding company was not created.<sup>31</sup> The Act carves out from the siloining requirement any “internal financial activities” that are engaged in on behalf of the SSNF or an affiliate (such as the SSNF's internal treasury or accounts payable functions). Further, the Act extends the Federal Reserve's “source of strength” doctrine to the SSNF's parent company, which would require the SSNF's parent company to provide financial support to the intermediate holding company.<sup>32</sup>

Any forced siloining may have significant burdens associated with it, even beyond the need to undergo a corporate reorganization, and the variety of legal, accounting and tax issues that the reorganization itself may raise. For example, personnel, systems, facilities, licenses, documents, intercompany and third party agreements, expenses, etc. may need to be realigned to be consistent with the newly siloed financial activities.

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<sup>29</sup> See *Some Concerns with the Regulation of Large Nonbank Holding Companies* (Cadwalader, June 3, 2010), available at [http://www.cadwalader.com/assets/client\\_friend/060310RegLargeNonBankHoldingCos.pdf](http://www.cadwalader.com/assets/client_friend/060310RegLargeNonBankHoldingCos.pdf).

<sup>30</sup> See Dodd-Frank Act § 167(a).

<sup>31</sup> See Dodd-Frank Act § 167(b)(1)(B).

<sup>32</sup> The Act states, “A company that directly or indirectly controls an intermediate holding company established under this section shall serve as a source of strength to its subsidiary intermediate holding company.” Dodd-Frank Act § 167(b)(3). “Source of strength” is not defined in Section 167. Prior to the enactment of the Dodd-Frank Act, a “source of strength” doctrine was reflected solely in Federal Reserve Board regulations and not in the banking statutes; the regulations provide that “A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks ....” 12 C.F.R. § 225.4(a)(1). A separate provision of the Dodd-Frank Act codifies source of strength doctrine with respect to traditional bank holding companies, savings and loan holding companies, and holding companies for nonbank banks, but explicitly limits the obligation to serving as a “source of *financial* strength” to its depository institution subsidiaries. Dodd-Frank Act § 616(d).

*Limitation on Certain Acquisitions.* Section 163 of The Act subjects SSNFs to the prior approval requirements of the BHC Act with respect to certain transactions by the SSNF, including acquisition of shares or assets of a bank or BHC.<sup>33</sup> Thus, the Act effectively lowers the maximum ownership interest a SSNF can hold in a bank or thrift, from 24.9% (without filing a Section 3 application under the BHC Act) or 9.9% (without filing a Change-in-Bank Control Act application) to 4.9%. A further limitation that the Act imposes on SSNFs and Large BHCs is a requirement that SSNFs and Large BHCs give prior notice to the Federal Reserve if the company to be acquired has assets in excess of \$10 billion. In short, this gives the Federal Reserve the authority to oversee the acquisition by a nonbank SSNF of another large nonbank financial company, a regulatory hurdle that would have to be accounted for in the accomplishment of virtually any strategic acquisition by an SSNF.

*Cessation of Activities.* The Act grants the Federal Reserve broad authority to require Large BHCs and SSNFs to terminate certain activities and divest certain assets if the Federal Reserve determines that the Large BHC or SSNF poses a “grave threat” to U.S. financial stability.<sup>34</sup> Specifically, the Federal Reserve may: (1) limit the ability of the firm to merge with, acquire, consolidate with, or otherwise become affiliated with another company; (2) restrict the ability of the firm to offer a financial product or products; (3) require the company to terminate one or more activities; (4) impose conditions on the manner in which the company conducts one or more activities; or (5) require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities. The exercise of such powers with respect to nonbank financial companies does not have a precedent and there is no way to know how the procedure by which they may be exercised, how frequently, or the criteria to be used in deciding to exercise the authority.

*No De-banking.* Section 117 of the Act (often referred to as the “Hotel California” provision) applies to entities that were, as of January 1, 2010, BHCs with consolidated assets of \$50 billion or more and received assistance under the Capital Purchase Program. Section 117 provides that these entities (or their successors) will automatically be regulated by the Federal Reserve as SSNFs if they ever cease to be a BHC. As a result, such entities (or their successors) will remain subject to the SSNF provisions of the Act, including Federal Reserve supervision and examination and the capital requirements and quantitative limits of the Volcker Rule, regardless of their size at any time or whether they continue to be BHCs.

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<sup>33</sup> See Dodd-Frank Act § 163(a).

<sup>34</sup> See Dodd-Frank Act § 121.

### III. Increased Capital Obligations on all Depository Institutions and BHCs

*The Collins Amendment.* Section 171 of the Act (known as the “Collins Amendment”) eliminates the ability of BHCs to utilize hybrid securities as an element of Tier 1 capital.<sup>35</sup> The provision achieves this result by requiring the federal banking agencies to utilize presently existing capital requirements applicable to FDIC-insured banks as a benchmark in establishing the minimum requirements applicable to BHCs and SSNFs.<sup>36</sup> The effect of eliminating hybrid securities as an element of Tier 1 capital is that trust preferred and cumulative preferred securities will no longer count as Tier 1 capital for BHCs.<sup>37</sup>

The limitation on Tier 1 capital will not apply to existing hybrid capital instruments issued by BHCs with assets of less than \$15 billion. Hybrid capital instruments issued by such entities prior to May 19, 2010 will continue to count as Tier 1 capital. In addition, BHCs subject to the Federal Reserve’s Small Bank Holding Company Policy Statement (generally, BHCs with assets of less than \$500 million)<sup>38</sup> will be exempt from the Collins Amendment’s limitation on Tier 1 capital. Existing hybrid capital instruments will be gradually excluded (there is a 3-year phase-in period) from the Tier 1 capital calculations of BHCs and SSNFs beginning on January 1, 2013.

The Collins Amendment does not apply to SSNFs.

*No Procyclical Capital Requirements.* In addition, Section 616 requires the agencies adopt, by regulation, capital requirements that are countercyclical in nature (*i.e.*, which require increases in capital in times of economic expansion and decreases in time of economic contraction) with respect to BHCs, SLHCs, and foreign branches operating within the U.S.

*Source of Strength Doctrine Codified.* Section 616 codifies the “source of strength doctrine,” the Federal Reserve’s policy that a BHC be equipped to act as a source of financial support for its subsidiary banks.<sup>39</sup> Section 616 extends the source of strength doctrine to apply to nonbank BHCs and thrift holding companies. Section 616 also requires holding companies to provide periodic reports to the appropriate federal banking agencies assessing its ability to act as a source of strength, and requires joint agency rules implementing the source of strength requirements.

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<sup>35</sup> Note that the Basel III negotiations have included a proposal to eliminate hybrid capital instruments as an element of Tier 1 capital. See Speech by Hervé Hannoun at the 45<sup>th</sup> SEACEN Governor’s Conference, *Towards a Global Financial Stability Framework* (Feb. 26, 2010), available at <http://www.bis.org/speeches/sp100303.pdf>.

<sup>36</sup> The leverage and risk-based capital requirements applicable to insured state chartered banks is found at 12 C.F.R. Part 325.

<sup>37</sup> Compare 12 C.F.R. Part 225, App. A, Section II(A)(1)(a) with 12 C.F.R. Part 325, App. A, Section I(A)(1).

<sup>38</sup> 12 C.F.R. Part 225, App. C.

<sup>39</sup> See 12 C.F.R. § 225.4(a).

#### IV. Regulatory Realignment

The Act significantly alters the financial regulatory agency jurisdictional landscape, with one agency (the Office of Thrift Supervision (“OTS”)) eliminated, another agency (the BCFP) established, and existing responsibilities shifted – and in many cases overlapping – between the remaining three federal banking agencies (the OCC, the FDIC and the Federal Reserve).<sup>40</sup>

*OTS Eliminated.* Sections 311 through 313 of The Act eliminate the OTS. The supervisory and rulemaking authority of the OTS over savings and loan holding companies (“SLHCs”) is transferred to the Federal Reserve. The supervisory and rulemaking authority of the OTS over federal thrifts is transferred to a newly created deputy comptroller position within the OCC, while the supervisory (but not rulemaking) authority of the OTS over state thrifts is transferred to the FDIC.<sup>41</sup>

These responsibilities will be transferred one year after the enactment of the Act, but may be delayed an additional six months by the Secretary of the Treasury, after consultation with the Director of the OTS, the Comptroller of the Currency, the Chairman of the Board of Governors, and the Chairperson of the FDIC. The OTS will be eliminated 90 days after the transfer date. The seat of the Director of the OTS on the FDIC board of directors will be re-assigned to the new Director of the BCFP.<sup>42</sup>

*Thrift Charter Preserved.* While the thrift charter is not eliminated (as was contemplated by the original Senate bill), the elimination of the OTS as an agency dedicated to thrifts diminishes the value and separate identity of the thrift charter, especially following the elimination of the standalone Savings Association Insurance Fund in 2006 and the curtailment of thrift holding company activities in 1999 with the elimination of the “unitary thrift holding company” exemption.<sup>43</sup>

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<sup>40</sup> The Dodd-Frank Act also provides a mechanism for addressing disputes among FSOC member agencies regarding their respective jurisdiction over certain entities, activities, or products. In the event of a dispute, a member agency may apply to the FSOC and request a nonbinding recommendation as to which agency may properly exercise jurisdiction over the entity, activity, or product. See Dodd-Frank Act § 116. The membership of the FSOC generally includes all the federal financial regulatory authorities, including the Secretary of the Treasury.

<sup>41</sup> Rulemaking authority (but not supervisory authority) over state thrifts would be transferred to the OCC.

<sup>42</sup> The Dodd-Frank Act § 336.

<sup>43</sup> Prior to the enactment of GLBA in 1999, unitary thrift holding companies – holding companies that controlled only one thrift – were exempt from the activity restrictions of the Home Owners' Loan Act and therefore were permitted to engage in, or be affiliated with, commercial entities. GLBA grandfathered existing unitary thrift holding companies but required any newly created unitary thrift holding company to comply with the activity restrictions of HOLA. See 12 U.S.C. § 1467a(c)(9)(A). Thus, after the enactment of GLBA, commercial entities were effectively prohibited from acquiring or establishing a thrift unless the commercial entity conformed its activities to the restrictions imposed by HOLA.

A third competitive advantage of the federal thrift charter – the ability to branch nationwide – is also diluted by a separate provision of the Dodd-Frank Act, Section 613, which confers on banks the ability to branch *de novo* into any state, provided

*Federal Reserve Supervision of Functionally Regulated Subsidiaries.* Section 604 of the Act moderately expands the Federal Reserve's authority over "functionally regulated subsidiaries" – in essence, certain federally or state regulated securities companies or state regulated insurance companies – that are owned by a BHC or financial holding company ("FHC").<sup>44</sup> Existing law requires the Federal Reserve to limit its examination of functionally regulated subsidiaries to certain extraordinary situations; for example, if the Federal Reserve believes the subsidiary poses material risk to the holding company.<sup>45</sup> Section 604 removes some of these restrictions and grants the Federal Reserve examination and supervisory authority over a functionally regulatory subsidiary of a BHC to ensure compliance with the BHC Act, but requires the Federal Reserve to rely on examination reports prepared by the functional regulator and to notify the functional regulator before conducting an examination of the functionally regulated subsidiary. In addition, Section 604 repeals a provision that barred the Federal Reserve from exercising enforcement or rulemaking authority over functionally regulated subsidiaries except in extraordinary situations.<sup>46</sup>

*OCC and FDIC Given Back-Up Examination Authority over Non-Bank Affiliates.* Section 605 of the Act confers on the OCC and the FDIC the responsibility to conduct back-up examinations of holding company subsidiaries engaged in bank-eligible activities. Under existing law, the Federal Reserve has exclusive examination authority over the nonbank subsidiaries of a BHC or FHC (other than functionally regulated subsidiaries), and the Federal Reserve was free to examine (or not) these subsidiaries as it saw fit. Section 605 now requires the Federal Reserve to conduct examinations of a BHC's nonbank subsidiaries engaged in bank-eligible activities "in the same manner, subject to the same standards, and with the same frequency as would be required if such activities were conducted in the [BHC's] lead insured depository institution." Section 605 further provides that, if the Federal Reserve fails to conduct the required examination of the nonbank subsidiary, the regulator of the lead insured depository institution (*i.e.*, the OCC in the case of national banks or federal thrifts, or the FDIC in the case of state non-Member banks or state thrifts) may recommend in writing that the Federal Reserve do so.<sup>47</sup> If the Federal Reserve fails to provide

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that the law of that state permits a bank chartered by that state to establish a branch at that same location. Under existing law, a bank can *de novo* branch into a new state only if that state expressly has opted into *de novo* interstate branching, and thus banks had been at a competitive disadvantage to federal thrifts which were permitted to branch across state lines regardless of whether the state had authorized *de novo* interstate branching. See 12 U.S.C. § 36(g)(1)(A); 12 U.S.C. § 1828(d)(4)(A).

<sup>44</sup> A "functionally regulated subsidiary" includes a registered broker-dealer, a registered investment adviser, a registered investment company, a commodities company regulated by the CFTC, or a state regulated insurance company. 12 U.S.C. § 1844(c)(5).

<sup>45</sup> See 12 U.S.C. § 1844(c).

<sup>46</sup> See 12 U.S.C. 1848a.

<sup>47</sup> The Dodd-Frank Act does not confer back-up examination authority if the lead insured depository institution is a state Member bank – which is otherwise supervised by the Federal Reserve. Thus, if the Federal Reserve fails to examine the

a written explanation or begin the examination within 60 days after receiving such a written recommendation, the OCC or the FDIC may conduct its own examination to ensure compliance with the law, to determine whether the subsidiary presents safety and soundness risks to any insured depository institution subsidiary, and to determine whether the subsidiary is subject to appropriate risk management systems. Further, the OCC and the FDIC may recommend to the Federal Reserve that it take enforcement action, and if the Federal Reserve does not do so within 60 days, the OCC or the FDIC have the authority to take independent enforcement action against the subsidiary.

Given that the scope of *bank-eligible* activities has greatly expanded in recent years to be nearly as broad as the scope of *holding company-eligible* activities, most holding company subsidiaries – other than those engaged in bank-ineligible securities and insurance activities – would be subject to potential separate back-up examination (and potential enforcement) under Section 605.

*Shared Responsibility for Anti-Tying Regulations.* Section 355 of the Act requires the Federal Reserve to consult with the FDIC and the OCC before promulgating regulations under the anti-tying statute.<sup>48</sup> Existing law requires no such consultation.

*Agency Assessments.* Section 318 of the Act confers on the Federal Reserve, the FDIC, and the OCC the specific authority to impose regulatory assessments. Note, however, that the Federal Reserve's assessment authority under the provision is limited to Large BHCs and SSNFs.

*Investment Bank Holding Company vs. Securities Holding Company.* Section 617 would eliminate the ability of a foreign entity to become an "investment bank holding company" subject to supervision by the SEC. Instead, Section 618 would create an elective "securities holding company" that would be supervised by the Federal Reserve. The purpose of these provisions is to create a framework for foreign securities companies operating in the U.S. to satisfy non-U.S. legal obligations that the foreign securities companies be subject to comprehensive consolidated supervision within the U.S.

To qualify as a "securities holding company," the entity must control one or more broker-dealers registered with the SEC, and must not otherwise be subject to supervision by the Federal Reserve or another federal banking agency. Section 618 directs the Federal Reserve to establish record keeping, reporting, examination, capital, and risk management requirements applicable to securities holding companies. Section 618 further subjects a securities holding company to the provisions of

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nonbank subsidiaries of a BHC in which the lead institution is a state Member bank, no other agency can assert back-up examination or enforcement authority over those nonbank subsidiaries.

<sup>48</sup> 12 U.S.C. § 1972.

the BHC Act as if it were a BHC, with the exclusion of the activity and ownership restrictions of Section 4 of the BHC Act.<sup>49</sup> This provision does not apply to the regulation of any existing broker-dealers; *i.e.*, all of the existing broker-dealers that are subject to consolidated supervision are part of BHCs that are already regulated by the Federal Reserve and not by the SEC.

## V. Changes to the Federal Deposit Insurance System

*Liability-Based Assessments.* Section 331 of the Act requires that the FDIC amend its regulations regarding deposit assessments so that an insured institution's assessments are based not on its deposits but instead on the difference between the insured institution's (i) average consolidated total assets and (ii) average tangible equity (in general, the institution's consolidated liabilities). This change has the effect of shifting the cost of maintaining the Deposit Insurance Fund away from traditional banks that are funded largely by deposits, to larger banks that rely more heavily on non-deposit sources of funds. Coupled with Section 627's repeal of Regulation Q (effectively allowing interest to be paid on transaction accounts held by businesses, as further described below), this will likely diminish the attractiveness of non-insured interest-bearing accounts located offshore.

*Risk Categorization based on Size.* Section 331 also repeals a provision of the Federal Deposit Insurance Act that bars the FDIC from excluding an insured institution from the lowest-risk category based solely on its size.<sup>50</sup> Thus, in theory the FDIC could now charge the highest assessment rate on an insured institution merely because it is big.

*Deposit Insurance Fund Replenishment.* Sections 332 and 334 address the Deposit Insurance Fund's reserve ratio. Section 334 of the Act raises the minimum designated reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35%,<sup>51</sup> eliminates the maximum reserve ratio of 1.50%, and requires the FDIC to achieve the 1.35% minimum designated reserve ratio by 2020. In achieving the new minimum, the FDIC is required to offset the effect of any higher assessments on insured depository institutions with assets of less than \$10 billion – thus effectively shifting the costs of recapitalizing the Fund to depository institutions with assets of \$10 billion or more. Section 332 of the Act eliminates the obligation of the FDIC to pay a dividend equal to half of the amount by which the Deposit Insurance Fund exceeds the designated reserve ratio of 1.35%; in lieu thereof, the FDIC has the authority, in its sole discretion, to suspend or eliminate such a dividend.

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<sup>49</sup> 12 U.S.C. § 1843.

<sup>50</sup> See 12 U.S.C. § 1817(b)(2)(D).

<sup>51</sup> See 12 U.S.C. § 1817(b)(3)(B).

*Permanent Increase in Deposit Insurance Coverage Amount.* Section 335 of the Act makes permanent the May 2009 temporary increase in the deposit (and credit union share) insurance coverage limit from \$100,000 to \$250,000.

*Extension of TAG Program.* Section 343 of the Act extends the October 2008 Transaction Account Guarantee program through December 31, 2012, which program affords deposit insurance coverage without limit on certain non-interest bearing transaction accounts.

*Repeal of Regulation Q.* Section 627 of the Act repeals the provisions of the Federal Reserve Act, the Home Owners' Loan Act, and the Federal Deposit Insurance Act that prohibit the payment of interest on demand deposits (commonly referred to as "Regulation Q"). As a result, banks and thrifts will be permitted to offer interest-bearing demand deposit accounts to business customers, which were previously forbidden under Regulation Q. In addition, banks and thrifts may offer interest-bearing demand deposit accounts to consumer customers without complying with the "NOW account" provisions of the Federal Reserve's Regulation D.<sup>52</sup> The repeal is effective one year after enactment of the Act.

## VI. Limits on Expansionary Activities

The Act contains a number of provisions designed to restrain the growth of certain financial services companies or to restrict their ability to engage in activities deemed to pose more risk to the system and to the Fund.

*Tightening of "Financial Holding Company" Eligibility.* Section 606 of the Act precludes a BHC from electing to become a "financial holding company" – and thereby engage in the broader range of activities permitted under the Gramm-Leach-Bliley Act, such as merchant banking, securities underwriting and dealing, or insurance agency and underwriting – unless the BHC is both "well managed" and "well capitalized."<sup>53</sup> Existing law requires only that the *depository institution subsidiaries* of the BHC – and not the BHC itself – meet these requirements.<sup>54</sup> Section 606 thus raises the bar for BHCs seeking to engage in expanded activities.

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<sup>52</sup> See 12 C.F.R. Part 204.

<sup>53</sup> A "well capitalized" BHC is one that maintains a total risk-based capital ratio of at least 10% and a Tier 1 risk-based capital ratio of at least 6%, and is not subject to a capital-related administrative order from the federal banking agencies. A "well-managed" BHC is one that has a composite rating of "2" or better on the Federal Reserve's RFI(C)/D examination rating and at least a satisfactory rating for management. 12 C.F.R. § 225.2(r), (s).

<sup>54</sup> See 12 U.S.C. § 1843(l); 12 C.F.R. § 225.83. In addition, the depository institution subsidiaries must have a CRA rating of "Satisfactory" or better. *Id.*

Section 606 does not address the implications for existing FHCs that fail to satisfy the new standard. Pre-existing law imposes fairly severe regulatory sanctions on financial holding companies that fail to maintain the statutory requirements for financial holding company status, including entry into a written agreement within 45 days and potential divestiture of expanded activities within 180 days. **Section 606 thus could be construed to place some existing financial holding companies immediately into noncompliance.**<sup>55</sup>

*Limitations on Interstate Acquisitions and Mergers.* Similarly, Section 607 of the Act precludes a BHC from engaging in an interstate acquisition – the acquisition of a bank outside its home state – unless the BHC is both *well* capitalized and *well* managed. Existing law allows such acquisitions provided the holding company is *adequately* capitalized and *adequately* managed.<sup>56</sup> Thus, unless a BHC is both well-capitalized and well-managed, it must confine its ongoing bank acquisitions to its single home state.

A parallel provision in Section 607 precludes a bank from engaging in an interstate merger with another bank headquartered in a separate state unless the surviving bank will be well-capitalized and well-managed following the merger transaction. Existing law requires only that the survivor be adequately managed and adequately capitalized.<sup>57</sup> This parallel provision ensures that banks that are not in a holding company structure are subject to the new heightened requirements.

*No Charter Conversions During Enforcement Actions.* Section 612 of the Act forbids an insured depository institution from converting its charter form (e.g., national bank, state bank, federal thrift, or state thrift) if the insured depository institution is subject to a cease and desist order or other formal order, or an informal memorandum of understanding, with its current regulator “with respect to a significant supervisory matter,” unless the current regulator consents to the conversion. Section 612 does not, by its terms, forbid a change in regulator that doesn’t entail a charter conversion (for example, when a state non-Member bank seeks membership in the Federal Reserve System). However, both charter conversions and changes in regulatory agencies for institutions subject to such administrative action are already discouraged, if not altogether precluded, by an existing interagency policy statement.<sup>58</sup> Thus, Section 612 largely codifies existing regulatory practice.

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<sup>55</sup> See 12 U.S.C. § 1843(m).

<sup>56</sup> See 12 U.S.C. § 1842(d)(1)(A). A BHC’s “home state” is determined by predominance of its banking subsidiary’s(ies’) deposits at the time it first became a BHC or July 1, 1966, whichever occurred later. 12 U.S.C. § 1841(o)(4).

<sup>57</sup> See 12 U.S.C. § 1831u(b)(4).

<sup>58</sup> See *FFIEC Statement on Regulatory Conversions* (July 1, 2009).

*Prior Approval for Large Acquisitions by FHCs.* Section 604 requires that a financial holding company seek Federal Reserve approval before acquiring any company with total consolidated assets in excess of \$10 billion. Existing law requires no prior approval, only after-the-fact notice.<sup>59</sup>

*Thrift Acquisitions Now Subject to Deposit Cap.* The Act expands the nationwide “concentration limits” first introduced upon the enactment of the Riegle-Neal Interstate Banking and Branching Act of 1994. That Act instituted a “nationwide deposit cap,” precluding the Federal Reserve from approving any interstate acquisition of a bank or BHC if the resulting bank or BHC would hold more than 10% of nationwide deposits.<sup>60</sup> Under pre-Act law, a BHC’s acquisition of a *thrift* had not been subject to this limitation. Section 623 closes this loophole, subjecting a BHC’s interstate acquisition of thrift to the same 10% nationwide deposit cap. Section 623 also extends the 10% nationwide deposit cap to interstate depository institution *merger* transactions involving a thrift; pre-Act law applied the deposit cap only to interstate mergers involving two banks.<sup>61</sup>

*New Nationwide Liability-Based Cap.* Section 622 creates an entirely new concentration limit cap, calculated based on total liabilities and imposed on any acquisition (whether or not interstate) and applicable not only to BHCs but also to companies that control a nonbank bank or SSNF. Section 622 prohibits such a financial company from acquiring, acquiring substantially all the assets of, or merging or consolidating with, *any* other company (financial or otherwise) if, as a result of the transaction, the surviving financial company’s total consolidated liabilities will exceed 10% of all of the consolidated liabilities of all financial companies. “Liabilities” is defined as the difference between the entity’s risk-weighted assets and its total regulatory capital, and includes all consolidated liabilities of U.S.-based financial companies (including liabilities abroad) and all consolidated liabilities of foreign-based financial companies’ U.S. operations. Within six months following enactment of the Act, the FSOC is required to conduct a study and render recommendations regarding any modifications to the liability-based concentration limit. The Federal Reserve is required to promulgate regulations implementing the new concentration limit within nine months thereafter.

*Moratorium on Certain Nonbank Banks.* Under existing law, BHCs generally are prohibited from engaging in (or owning more than 5% of a company engaged in) activities that are not “closely related to banking” as defined by the Federal Reserve’s Regulation Y.<sup>62</sup> Although financial holding

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<sup>59</sup> See 12 U.S.C. § 1843(k)(6). Section 163(a) of the Dodd-Frank Act imposes a similar advance notice requirement on SSNFs and on Large BHCs. Under current law, nonbank financial companies have no such prior notice obligation. Traditional BHCs are required to submit an advance notice (in essence, an application) to the Federal Reserve pursuant to Regulation Y.

<sup>60</sup> See 12 U.S.C. § 1842(d)(2).

<sup>61</sup> See 12 U.S.C. § 1828(c); 12 U.S.C. § 1831u.

<sup>62</sup> See 12 U.S.C. § 1843(a), (c), (k).

companies have broader authority, financial holding companies are nonetheless prohibited from engaging in (or owning more than 5% of a company engaged in) activities that are not “financial in nature” as defined by the Federal Reserve. As a result, entities that itself are, or that own subsidiaries that are engaged in commercial activities which are neither “closely related to banking” nor “financial in nature” – with certain exemptions – are prohibited from owning a bank.

Sections 602 and 603 of the Act place a partial moratorium on expansion of one of these exemptions. Existing law allows a company to own a bank, without regard to the activity restrictions outlined above and without being regulated as a BHC, provided the bank is a limited purpose “nonbank bank” (such as an industrial loan company, trust bank, or credit card bank).<sup>63</sup> Section 603 places a three-year moratorium on the FDIC approving insurance applications for any such nonbank banks if the nonbank bank would be controlled by a “commercial firm” – defined as a company less than 15% of the consolidated gross revenues of which are derived from financial-in-nature activities. The moratorium also precludes any change of control of an existing nonbank bank that would result in its acquisition by a commercial firm. Section 603 requires the GAO to conduct a study regarding the appropriateness of continuing the nonbank bank exemptions from the BHC Act (as well as the exemptions afforded for thrifts and thrift holding companies), which GAO study is due eighteen months following the enactment of the Act.

Section 603’s moratorium does not apply to applications for nonbank banks held by companies that are *not* “commercial firms,” *i.e.*, that have 15% or more of their consolidated gross revenues derived from financial-in-nature activities but otherwise do not qualify as a BHC. Thus, a company having, for example, 25% of its consolidated gross revenues derived from financial activities could in theory acquire control of or establish a *de novo* charter for a nonbank bank, subject to FDIC approval.

## VII. Swaps Push-Out Rule

Section 716 of the Act (the “**Swaps Push-Out Rule**” or the “**Lincoln Amendment**”) effectively prohibits an insured depository institution (*i.e.*, a bank or a thrift) from acting as a Swap Dealer.<sup>64</sup> The Rule achieves this result in a somewhat backward fashion, meaning that it prohibits a Swap

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<sup>63</sup> See 12 U.S.C. § 1841(c)(2).

<sup>64</sup> Note that the term “Swap Dealer” is used in this Memorandum generally to refer to “Swap Dealers” and “Security-based Swap Dealers.” For further detail on the distinction between the two categories, please refer to the Title VII summary.

Generally, a “Swap Dealer” is “any person who - (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.” See Dodd-Frank Act § 721(a)(49).

Dealer from obtaining FDIC insurance, rather than by prohibiting a bank that received FDIC insurance from acting as a Swap Dealer.

More specifically, Section 716 prohibits the federal government from providing “federal assistance” to any “swaps entity.” Under the Rule, “federal assistance” includes federal deposit insurance, and “swaps entity” includes a bank registered as a Swap Dealer. The result is that a bank would effectively have its FDIC deposit insurance coverage revoked by reason of Section 716 if the bank were to act as a Swap Dealer. As maintenance of federal deposit insurance is a condition for national banks, federal thrifts, and virtually all state chartered banks and thrifts, this revocation of FDIC deposit insurance coverage would be grounds for appointment of the FDIC as receiver of a bank under the Federal Deposit Insurance Act (“**FDIA**”).<sup>65</sup> The Rule essentially prohibits a bank from *acting* as a Swap Dealer. In this Memorandum, we refer to the prohibition on provision of federal assistance to swaps entities as the “Push-Out requirement.”

The proprietary trading restrictions of the Volcker Rule (discussed below) also act as an overall limitation on the swaps activities of banks and BHCs, and as such the Swaps Push-Out Rule must be read in light of the limits imposed by the Volcker Rule.<sup>66</sup>

*Definitions.* For purposes of the Swaps Push-Out Rule:

“*Federal assistance*” means “any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act, [or] Federal Deposit Insurance Corporation insurance or guarantees for the purpose of

- (A) making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;
- (B) purchasing the assets of any swaps entity;
- (C) guaranteeing any loan or debt issuance of any swaps entity; or
- (D) entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity.”<sup>67</sup>

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<sup>65</sup> See 12 U.S.C. § 1821(c)(5)(J).

<sup>66</sup> See Dodd-Frank Act § 716(m). For more detail on the effect of the Volcker Rule, see Section VIII below.

<sup>67</sup> Dodd-Frank Act § 716(b)(1).

The Rule thus does not prohibit the Federal Reserve from lending to institutions in “unusual and exigent circumstances” (*i.e.*, the emergency lending authority) so long as such lending is part of a program with “broad-based eligibility.”

“*Swaps Entity*” means any entity registered as a Swap Dealer or MSP. Insured depository institutions registered only as a major swap participant (and not as a Swap Dealer) are exempt from the “swaps entity” definition and thus from the Push-Out requirement. Thus, banks and thrifts engaged in activities that do not require registration as a Swap Dealer are not subject to the Push-Out requirement. Note, however, that such banks and thrifts would remain subject to the Volcker Rule’s prohibition against proprietary trading, which would limit the ability of such institutions to engage in swaps transactions for their own account.

*Exempted entities and activities.* The Swaps Push-Out Rule excludes several types of institutions or transactions from its Push-Out requirement:

*FDIC-Operated Institutions.* Bridge banks, “covered financial companies,” and depository institutions that are subject to an FDIC conservatorship or receivership are exempt from the Push-Out requirement.<sup>68</sup>

*Bona Fide Hedging and Traditional Bank Activities.* An insured depository institution (regardless of whether it is registered as a Swap Dealer) that limits its swap activities to any of the following is exempt from the Push-Out requirement:<sup>69</sup>

- swaps hedging “direct” risks;
- swaps on interest rates;
- swaps referencing assets that are permissible for investment by a national bank (except for uncleared credit default swaps or uncleared swaps referencing the credit risk of asset-backed securities).<sup>70</sup>

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<sup>68</sup> Dodd-Frank Act § 716(g). “Covered financial company” is defined in Title II, § 201(a)(8). Note that Title II substantially amends the extent to which a nonbank institution may be subject to an “orderly liquidation” proceeding.

<sup>69</sup> Note again that banks and BHCs may only engage in these activities to the extent permitted under the proprietary trading restrictions of the Volcker Rule.

<sup>70</sup> Generally, national bank-permissible investments include the following instruments: U.S. government and agency securities; certain investment-grade debt securities; certain mutual fund securities; foreign currency; and certain precious metals. See generally 12 U.S.C. § 24(Seventh); 12 C.F.R. Part 1.

*Existing Swaps Exempt.* The Rule does not require wind-down or termination of swaps entered into prior to the date the Rule becomes effective, which generally is 3 years following the date the Act becomes law.<sup>71</sup> Note, however, the Volcker Rule will require “banking entities” to dispose of swaps not held for hedging purposes within 4 years of the date the Act becomes law (subject to possible extensions), unless the swap falls within the narrow exception of instruments allowed by the Volcker Rule (generally, federal or agency securities, GSE securities, and state or state agency securities).<sup>72</sup>

*Pushing Out Swaps Activities.* Institutions subject to the Push-Out requirement must either “push” the relevant activities to an affiliate, subject to regulations that the CFTC, SEC, and Federal Reserve are authorized to issue, or cease the activities altogether.<sup>73</sup> The Rule does not prohibit an FDIC insured institution from affiliating with a Swap Dealer so long as the Swap Dealer affiliate is part of a BHC or savings and loan holding company (“SLHC”).<sup>74</sup> **This safe harbor therefore would not encompass an insured institution that does not have a BHC or SLHC parent.** For example, the safe harbor language of the Swaps Push-Out Rule suggests that a commercial firm that owns an FDIC insured institution, but is not itself a BHC, will be prohibited (i) from registering the FDIC insured institution as a Swap Dealer; and (ii) from having a separate subsidiary registered as a Swap Dealer. **The narrow scope of the safe harbor promises to be particularly problematic for foreign banks and firms that own nonbank banks.**

## VIII. The Volcker Rule

Section 619 of the Act enacts the so-called “Volcker Rule.” The Volcker Rule has two prongs: (i) prohibiting “banking entities” from engaging in proprietary trading in certain securities (the “**Prop Trading Restriction**”); and (ii) prohibiting “banking entities” from sponsoring or investing in a hedge fund or private equity fund (the “**Sponsoring and Investing Restriction**”).

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<sup>71</sup> See Dodd-Frank Act §§ 716(e), (f).

<sup>72</sup> For more detail on the effect of the Volcker Rule, see Section VIII below.

<sup>73</sup> See Dodd-Frank Act §§ 716(c), (j) and (k). The Swaps Push-Out Rule requires the primary federal prudential regulator of banks and BHCs to establish standards for safe and sound conduct of swaps activities (§ 716(k)), but note that Title VII contains duplicative requirements on this point. See, e.g., Dodd-Frank Act § 731 (margin, capital, and business conduct requirements for entities registered as Swap Dealers or MSPs).

<sup>74</sup> See Dodd-Frank Act § 716(c); 12 U.S.C. §§ 371c, 371c-1.

### Key Definitions

“*Banking Entity*” includes insured depository institutions,<sup>75</sup> institutions that control an insured depository institution (*i.e.*, BHCs), entities treated as BHCs for purposes of the Act (such as foreign banks with a U.S. banking presence), holding companies of nonbank banks, and any affiliates of the preceding entities.

“*Proprietary trading*” is defined generally as “engaging as principal for the trading account<sup>76</sup> of the banking entity ... in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that” the federal banking agencies, the SEC, and the CFTC determine by rule to include within the scope of the Prop Trading Restriction.

For purposes of the Sponsoring and Investing Restriction, a “*hedge fund*” or “*private equity fund*” would include any fund exempt from registration as an investment company under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act, or any “similar” fund that the federal banking agencies, the SEC, and the CFTC may, by rule, include within the scope of the Sponsoring and Investing Restriction.

“*Sponsoring*” would include serving as the general partner, managing partner or trustee, selecting or controlling a majority of the directors or trustees or management of the fund, or sharing the same or similar name with the fund for marketing, promotion, or other purposes.

*Exemptions.* There are a number of exemptions to the Volcker Rule restrictions:

- *governments* – the purchase, sale, or disposition of U.S. or agency obligations, GSE obligations, and obligations of any State or political subdivision;<sup>77</sup>

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<sup>75</sup> Banks limited to the exercise of trust or fiduciary powers (“**Trust Banks**”) are deemed not to be a “banking entity” for purposes of the Volcker Rule if the Trust Bank: (i) receives “substantially all” of its deposits in a *bona fide* fiduciary capacity; (ii) does not cross-market its deposit taking activities through affiliates; (iii) does not accept demand deposits, provide checking services, or make commercial loans; (iv) does not utilize payment related services at any Federal Reserve Bank; and (v) does not access the Fed’s discount window.

<sup>76</sup> “Trading account” is defined as “any account used for acquiring or taking positions in the securities or instruments [described in the Volcker Rule] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such accounts” as determined by the federal banking agencies, the SEC, and the CFTC by rule. “Near term” and “short-term price movements” are not defined in the Act.

<sup>77</sup> The exempted securities reflect a small subset of the current bank-eligible securities, and thus the Rule reflects a significant rollback in the investing and trading authority of banks. See generally 12 C.F.R. Part 1. While BHCs (and their affiliates) currently enjoy broader authority to trade in securities (such as equities below the 5% ownership limit afforded to BHCs

- “near term” underwriting and market-making activities – the purchase, sale, acquisition, or disposition of securities and instruments in connection with “underwriting or market-making-related activities, to the extent that any such activities . . . are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties”;
- *hedging direct risks* – risk-mitigating hedging activities (either on an individual transaction basis or on an aggregate portfolio basis) “that are designed to reduce the specific risks of the banking entity”;
- *customer facilitation* – the purchase, sale, acquisition, or disposition of securities or instruments on behalf of customers;
- *public welfare investments* – investments in Small Business Investment Companies, investments designed primarily to promote the public welfare (as defined by Section 24 (Eleventh) of the National Bank Act), and investments relating to qualified rehabilitated buildings or certified historic structures;
- *insurer investments* – the purchase, sale, acquisition, or disposition of securities and instruments by a regulated insurance company, if such transactions are solely for the benefit of the insurance company and are conducted pursuant to insurance company investment laws, regulations, and written guidance provided by the State insurance authority;
- *organizing and sponsoring a fund* – organizing or sponsoring a private equity or hedge fund (including serving as a general partner, managing member, or trustee), and in any matter controlling (or having employees, officers, directors or agents serving as) a majority of the fund’s directors, trustees, or management, provided that a number of additional conditions are satisfied:
  - the banking entity must provide “*bona fide* trust, fiduciary, or investment advisory services” to the fund;
  - the fund may only be offered to trust, fiduciary, or investment advisory customers of the banking entity;

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under Section 4(c)(6) of the BHC Act and unrestricted securities trading authority afforded to securities subsidiaries of financial holding companies), no such latitude is conferred by the Volcker Rule, and holding company trading authority would be no broader than the narrow authority conferred on their subsidiary banks.

- the banking entity may not acquire any ownership interest in the fund except for a *de minimis* investment otherwise authorized by the Act (*see infra* for detail on this limitation);
- the banking entity must comply with the newly imposed Section 23A restrictions applicable to transactions between a banking entity and a fund advised, managed, sponsored, or organized by a banking entity, or in which a banking entity maintains an investment (*see infra* for detail on related party transaction restrictions);
- the banking entity may not assume, guarantee, otherwise insure the obligations of the fund (or any private equity or hedge fund in which the fund in turn has invested);
- the banking entity must disclose in writing to its prospective and actual investors that any losses in the fund are borne solely by the fund investors and not by the banking entity;
- the banking entity and the fund may not share, whether for corporate, marketing, promotional, or other purposes, the same name or a variation thereof; and
- no director or employee of the banking entity may take or retain any ownership interest in the fund, except for those directors or employees that are directly engaged in providing investment advisory or other services to the fund.<sup>78</sup>

*Limitation on Exemptions.* All of the above exemptions are subject to prudential limitations to be defined further by the regulatory agencies. Under Section 619, no transaction, class of transactions, or activity may be deemed permissible (even if otherwise exempted by Section 619) if the transaction(s) or activity would:

- “involve or result in a material conflict of interest”;
- “would result in a material exposure by the banking entity to high-risk assets or high-risk trading strategies”;
- “would pose a threat to the safety and soundness of such banking entity”; or

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<sup>78</sup> In addition, investments in funds pursuant to the *bona fide* services exemption are subject to special Section 23A affiliate transaction restrictions (discussed *infra*). The federal banking agencies, the SEC, and the CFTC have authority to impose additional activity restrictions in the coordinated final regulations to be adopted under the Volcker Rule.

- “would pose a threat to the financial stability of the United States.”

The federal banking agencies, the SEC, and the CFTC are required to adopt coordinated final regulations implementing these limitations (including defining the terms used, such as “material conflict of interest,” “high-risk assets,” and “high-risk trading strategies”).

*De Minimis Investments in Funds.* The Volcker Rule permits a banking entity to “establish[ a] fund and provid[e] the fund with sufficient initial equity capital for investment to permit the fund to attract unaffiliated investors.” Thus, a banking entity (i) may only invest in a fund that the banking entity has itself organized; (ii) may provide “seed money” for one year; (iii) may only retain a “**Permitted Investment**” in a fund beyond the “seed money” period.

The “seed money” rule requires the banking entity to actively seek unaffiliated investors such that, within one year after establishment of the fund, the banking entity’s investment has been reduced (whether by redemption, sale, or dilution) to the level of a Permitted Investment, as described below. Banking entities may seek a two-year extension of the “seed money” period from the Federal Reserve “if consistent with safety and soundness and the public interest.”

A banking entity’s “Permitted Investment” in a fund is subject to the following limitations:

- All fund investments of the banking entity taken together may not exceed, on a consolidated basis, 3% of the Tier 1 capital of the banking entity;
- An investment in an *individual* fund may not exceed 3% of “the total ownership interests” of the fund;
- An investment must be “immaterial to the banking entity.” “Materiality” is to be defined in coordinated final regulations of the banking agencies, the SEC, and the CFTC;
- For purposes of calculating the new capital requirements applicable to fund investments (discussed *infra*), a banking entity’s aggregate investment in funds must be deducted from the banking entity’s assets and tangible equity for purposes of determining compliance with these new capital requirements. The amount of the deduction is required to increase as the fund becomes more leveraged.<sup>79</sup>

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<sup>79</sup> In other words, the deduction is calculated based on the percentage of fund assets deemed “owned” by the banking entity; as a fund become more leveraged, the deduction (and hence the capital charge) will increase.

*Prudential Limits on Exempted Activities.* Section 619 requires the federal banking agencies, the SEC, and the CFTC, as part of the coordinated final regulations, to adopt rules regarding additional capital requirements, diversification, and quantitative limits (including diversification requirements) for banking entities engaged in proprietary trading or sponsoring or investing in private equity or hedge funds, if the agencies determine that such additional capital requirements and quantitative limits are appropriate for safety and soundness reasons.<sup>80</sup>

*SSNFs not Subject to Bar but Subject to Prudential Limits.* An SSNF that is not otherwise a “banking entity” is not subject to the Volcker Rule. However, the Federal Reserve is required to adopt rules regarding capital requirements and quantitative limits with respect to the proprietary trading and fund investment activities of SSNFs. If any divestitures are required in accordance with such rules, an SSNF would have a two-year phase-in period for disposal of the investments (with extensions of up to three years) from the date the firm is designated an SSNF.

*Foreign Entities.* The Volcker Rule would treat U.S. banking entities – *i.e.*, banking entities owned or controlled by an entity organized under U.S. federal or state law – different from their foreign counterparts, allowing a foreign banking entity with affiliates engaged in U.S. operations to engage abroad both in proprietary trading and in sponsoring or investing in funds, provided that the transactions are solely with non-U.S. residents. U.S. banking entities would have no such authority to engage in these activities abroad.

*FSOC Study.* Within six months after the Act’s enactment, the FSOC is required to conduct a study regarding the limits imposed by the Volcker Rule and provide recommendations on implementing the Volcker Rule’s provisions. Within nine months after the FSOC study, the federal banking agencies, the SEC, and the CFTC would be required to adopt coordinated final regulations implementing the Volcker Rule, consistent with the recommendations and modifications of the FSOC.

*Effective Dates.* The provisions of the Volcker Rule become effective twelve months after the adoption of these coordinated final regulations, but in no case later than two years after enactment of the Act.

*Extensions for Existing Investments and Illiquid Funds.* Section 619 confers a grandfather period for any required divestitures, allowing a banking entity to retain any impermissible holdings for an

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<sup>80</sup> The capital and diversification requirements would apply across the board, to any investment, sponsoring, or proprietary trading activity conducted under Section 619. The same is not true regarding the prudential limitations. The prudential limitations regarding conflicts of interest, high-risk-assets or high-risk trading strategies, safety and soundness, and financial stability, which apply to activities falling under one of the statutory exemptions to the Volcker Rule’s general prohibition, do not appear to apply to investments made under the seed money or *de minimis* investing authorities.

additional two years after the effective date, with the possibility of up to three additional one-year extensions granted by the Federal Reserve, either by regulation or by order. In addition, a banking entity may apply for an extension of up to five years for any investment in an “illiquid fund” if “necessary to fulfill a contractual obligation that was in effect on May 1, 2010.”<sup>81</sup> During any transitional period in which impermissible holdings are retained (whether under the initial two-year period, the three one-year extensions, or the one-time five-year extension for investments in illiquid funds), the banking entity is subject to additional capital requirements and other restrictions, to be adopted in the coordinated final regulations.

*Affiliate Transaction Restrictions.* In addition, the Volcker Rule would impose heightened affiliate transaction restrictions on companies subject to the Volcker Rule (discussed *infra*).

## IX. Lending Limits

*Expansion of Lending Limits to Credit Substitutes.* Section 610 of the Act would amend the national bank lending limits to encompass any direct or indirect advance by the bank pursuant to a repurchase arrangement or any credit exposure resulting from a securities lending, securities borrowing, repo, reverse repo, or derivative transaction. In addition, Section 610 authorizes the OCC to include in the lending limit calculation any “contractual commitments” made by the bank.

*State Bank Lending Limits Must Capture Derivatives.* Section 611 of the Act forbids any state-chartered bank from engaging in a derivatives transaction unless the applicable state lending limit encompasses derivative transactions to the same extent as under the National Bank Act.<sup>82</sup>

*Effective Dates.* Sections 610 and 611 would become effective one year and eighteen months, respectively, after the OTS’ responsibilities are transferred to the OCC.

## X. Affiliate Transactions

*Expansion of “Covered Transactions” Definition.* The affiliate transaction restrictions in Sections 23A and 23B of the Federal Reserve Act impose quantitative and qualitative limits on bank’s “covered transactions” (*i.e.*, extensions of credit to, asset purchases, investments in) and other transactions with the bank’s BHC, the bank’s subsidiaries, and other companies under common control (such as other nonbank subsidiaries of the BHC). Section 608 of the Act expands the

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<sup>81</sup> “Illiquid fund” is defined as a fund which, as of May 1, 2010, was principally invested in (or was principally invested in and contractually committed to invest in) illiquid assets “such as portfolio companies, real estate investments, and venture capital investments,” and makes all investment pursuant to a strategy to invest in illiquid assets. Further definition of an “illiquid fund” is left to the Federal Reserve rulemaking process.

<sup>82</sup> See 12 U.S.C. § 84; 12 C.F.R. Part 32 (limiting national bank loans and extensions of credit to any single borrower to 15% of the bank’s capital and surplus, with an additional 10% allowed if appropriately secured).

scope of “covered transactions” subject to the quantitative and qualitative limits of Section 23A.<sup>83</sup> In particular, Section 608 provides that the acceptance of any debt obligation (such as a promissory note or contract) as collateral for a loan with a third party is deemed a covered transaction; current law provides only that accepting “securities” as collateral triggers Section 23A. Section 608 also provides that derivative transactions and transactions involving the borrowing or lending of securities with an affiliate constitute a “covered transaction” if the transaction results in the affiliate having credit exposure to the bank. Currently, only *credit* derivative transactions are deemed to trigger Section 23A.

*Repos as Credit Transactions.* Section 608 changes the characterization of asset repurchase transactions under Section 23A. While such repo transactions have been subject to Section 23A, they have been considered “asset purchases.” Section 608 stipulates that, going forward they are considered “extensions of credit” (rather than asset purchases). As a result, repo transactions will become subject to the collateral requirements of Section 23A, which apply to extensions of credit (but not asset purchases).<sup>84</sup>

*Ongoing Collateral Requirements.* In addition, Section 608 provides that any collateral requirements must be satisfied on an on-going basis. Currently, the collateral requirements imposed by Section 23A on extensions of credit are calculated only at the transaction's inception and additional collateral is not required (unless the original collateral is retired or amortized).

Section 608 expands the scope of “affiliates” to include any investment fund (registered or otherwise) for which the bank or an affiliate of the bank is acting as an investment adviser. This provision expands existing law, which deems an investment fund to be an affiliate subject to Section 23A only if the bank or affiliate *both sponsors and advises* the fund, or if the bank or an affiliate is acting as a *registered* investment adviser.<sup>85</sup>

*Repeal of Partial Fin Sub Exemption.* Existing law provides that transactions between a national bank and a “financial subsidiary” – a firewalled subsidiary engaged in securities, insurance, or other activities impermissible for the bank itself but otherwise deemed “financial in nature” – are exempt

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<sup>83</sup> “Covered transactions” include an insured bank’s loans to an affiliate, purchases of assets from an affiliate, the purchase or investment of securities issued by an affiliate, the acceptance of securities of an affiliate as collateral for a loan to any person, or the issuance of a guarantee, acceptance, or letter of credit to any person on behalf of an affiliate. See 12 U.S.C. § 371c(b)(7).

<sup>84</sup> Under Section 23A, covered transactions in the form of extensions of credit must be collateralized in an amount equal to 100% to 130% of the amount of the extension of credit; the exact percentage is determined based on the nature of the collateral. Certain forms of collateral – such as securities issued by an affiliate or any “low quality asset” – are ineligible as collateral under Section 23A.

<sup>85</sup> 12 U.S.C. § 371c(b)(1)(D).

from Section 23A's 10% individual quantitative limit on affiliate transactions.<sup>86</sup> Section 609 of the Act repeals this exemption (effective one year after enactment), treating a national bank's financial subsidiary as a nonbank affiliate for all purposes under the affiliate transaction rules.

*Section 23A Exemption Orders.* Section 608 repeals the Federal Reserve's authority to grant exemptions from 23A by *order*. Section 608 permits the Federal Reserve to grant exemptions by *regulation* only if it notifies the FDIC in advance, and, within 60 days after notification, the FDIC does not object based on its conclusion that the exemption does not pose an unacceptable risk to the Deposit Insurance Fund. The Federal Reserve's authority to grant exemptions by *order* would be transferred to the respective primary federal regulators for the affected bank:

- The FDIC is given the authority to grant exemptions from Section 23A with respect to state non-Member banks and state thrifts, if, after consultation with the Federal Reserve, the exemption is deemed to be in the public interest and the FDIC determines that the exemption does not pose an unacceptable risk to the Deposit Insurance Fund.
- The Federal Reserve maintains the authority to grant exemptions with respect to state Member banks, provided, after consultation with the FDIC, the agencies concur that the exemption is in the public interest, and the FDIC determines that the exemption does not pose an unacceptable risk to the Deposit Insurance Fund.
- The OCC is given similar authority to grant exemptions with respect to national banks and federal thrifts, provided the OCC consults with the Federal Reserve and the agencies concur that the exemption is in the public interest. In addition, the OCC must provide 60 days' advance notice to the FDIC, and, within 60 days after notification, the FDIC does not object based on its conclusion that the exemption does not pose an unacceptable risk to the Deposit Insurance Fund.

*Netting Agreements.* Section 608 of the Act confers on the Federal Reserve the authority to promulgate regulations or interpretations regarding the treatment of netting agreements under Section 23A. If by interpretation, the Federal Reserve must do so jointly with the appropriate federal banking agency for the impacted bank or affiliate.

*Section 23B Exemption Orders.* Section 23B of the Federal Reserve Act generally requires that all transactions between a bank and its affiliates (not just "covered transactions") be on arms' length terms.<sup>87</sup> Under Section 608, the Federal Reserve retains the authority to grant exemptions from

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<sup>86</sup> See 12 U.S.C. § 371c(e)(3).

<sup>87</sup> 12 U.S.C. § 371c-1.

Section 23B by regulation, but again, only after notifying the FDIC and subject to the condition that the FDIC does not object within 60 days.

*Effective Date.* Section 608 would become effective one year after enactment of the Act.

*The Volcker Rule.* Section 619 – the Volcker Rule – also contains certain affiliate transaction restrictions:

*Fund Relationships Subject to Covered Transactions Bar.* Section 619 would flatly prohibit any “banking entity” that serves as an investment manager, investment adviser, or sponsor of a hedge fund or private equity fund, or any banking entity that organizes or sponsors a hedge fund or private equity fund under the Volcker Rule’s *bona fide* services exemption, or any of such banking entity’s affiliates, from engaging a transaction with the fund if the transaction would be considered a “covered transaction” for purposes of Section 23A. For purposes of applying Section 23A, the banking entity or its affiliate would be treated as if it were a “bank”, and the fund would be treated as if it were an “affiliate.” Thus, Section 619 extends the concept of “covered transactions” to arrangements not involving an insured bank, and applies a flat bar (rather than a quantitative limit, as is the normal situation in the case of Section 23A).

*Exemption for Prime Brokerage Transactions.* Notwithstanding the foregoing, Section 619 allows a banking entity (or its affiliate) to enter into “prime brokerage transactions”<sup>88</sup> with such a hedge fund or private equity fund, provided that the banking entity otherwise is in compliance with the conditions of the *bona fide* services exemption, the CEO of the banking entity annually certifies in writing that the banking entity has not guaranteed the obligations or performance of the fund (as is prohibited by the *bona fide* services exemption), and the Federal Reserve has determined that the provision of prime brokerage services to the fund would be consistent with safety and soundness.<sup>89</sup>

*All Transactions Must be at Arms’ Length.* In addition, under Section 619, *all* transactions between such entities would be subject to the arms’ length requirements of Section 23B,

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<sup>88</sup> “Prime brokerage transaction” is not defined in the Act.

<sup>89</sup> This aspect of the Volcker Rule is somewhat poorly drafted. By its terms, the prime brokerage exemption applies to a variety of arrangements in which the banking entity is an investment adviser, manager, sponsor, or investor, and not just those arrangements in which the fund is organized or sponsored under the *bona fide* services exemption to the Volcker Rule. Thus, it is unclear whether the references were meant to extend certain elements of the *bona fide* services exemption to all arrangements in which prime brokerage services are offered, or instead only to those arrangements in which prime brokerage services are offered to a fund that is organized or sponsored by the banking entity under the *bona fide* services exemption.

including transactions between such entities made under the prime brokerage services exception discussed above.

**XI. Insider Transactions**

*Credit Substitute Transactions Subject to Insider Transaction Restrictions.* The insider restrictions of Section 22 of the Federal Reserve Act regulates a bank’s asset purchases from its directors and a bank’s loans to its insiders – its directors, executive officers, and 10% shareholders.<sup>90</sup> Existing law imposes quantitative and qualitative limits, as well as corporate governance requirements, on bank extensions of credit to insiders – *i.e.*, its directors, executive officers, and 10% shareholders. Section 614 provides that credit exposures resulting from derivative, repo, reverse repo, securities lending, or securities borrowing transactions are considered extension of credit for purposes of these insider lending limits.<sup>91</sup>

*Extension of Section 375 to All Banks.* Section 615 of the Act extends to *all* FDIC-insured banks and thrifts the restriction on asset and security purchases from, and sales to, directors. The current restriction is applicable to only state Member banks and national banks.<sup>92</sup> In addition, Section 615 of the Act expands the restriction to encompass transactions not only with directors but also with executive officers and 10% shareholders.

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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<sup>90</sup> See 12 U.S.C. §§ 375, 375a & ; 12 U.S.C. § 375b.

<sup>91</sup> See 12 U.S.C. §§ 375a & 375b.

<sup>92</sup> See 12 U.S.C. § 375.

# Clients & Friends Memo

## Regulation of Systemically Significant NonBanks Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

July 20, 2010

The focus of this Memorandum is the potential regulation by the Board of Governors of the Federal Reserve System, pursuant to the newly-passed Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act” or the “Dodd-Frank Act”), of nonbank financial companies designated as “systemically significant” as provided by Titles I and VI of the Act, including the Volcker Rule.<sup>1</sup>

### Supervision of Systemically Significant NonBanks

Title I of the Dodd-Frank Act contains sweeping provisions that authorize the Board of Governors of the Federal Reserve System (the “Federal Reserve”) to supervise previously unregulated (or under-regulated) firms--including firms that are neither banks nor affiliated with banks--engaged in various financial activities where those firms’ activities are deemed systemically significant with respect to the U.S. financial system. Firms so designated (the Act refers to them as “Nonbank financial companies supervised by the Board of Governors”<sup>2</sup> – we refer to them as “systemically significant nonbank financial firms,” or “SSNFs” – would be subjected to heightened supervision and prudential regulation by the Federal Reserve, as explained below.

The organization of the memorandum is as follows:

Section I describes the procedure for designating a nonbank as an SSNF.

The principal requirements imposed on SSNFs are described in Section II.

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act’s application to specific industries, entities and transactions. To see these other memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

<sup>1</sup> Reflects those portions of Titles I and VI of the Act as passed by the House of Representatives and the Senate pertaining to certain nonbank companies that may become subject to regulation by the Federal Reserve pursuant to Section 113 of that Act.

<sup>2</sup> See Dodd-Frank Act § 102(a)(4)(D).

Section III sets out the shift in authority over certain investment bank holding companies from the SEC to the Federal Reserve.

Section IV describes the application of “Growth Limits” to SSNFs.

Finally, Section V describes the application of “Volcker Rule” to SSNFs.

#### I. **Creation of the FSOC; Procedure and Criteria for Designation of a Nonbank as an SSNF**

*Creation of the FSOC.* Title I of the Act establishes the Financial Stability Oversight Council (“**FSOC**”), whose voting members include each of the heads of the Federal Reserve, OCC, Bureau of Consumer Financial Protection (“**BCFP**”), CFTC, SEC, FDIC, Federal Housing Finance Agency (“**FHFA**”), and National Credit Union Administration (“**NCUA**”), as well as an independent member appointed by the President.<sup>3</sup> The FSOC has general authority to issue recommendations to the “primary financial regulatory agencies”<sup>4</sup> regarding heightened standards and safeguards as to the conduct of financial activities that “create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies (“**BHCs**”) and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities.”<sup>5</sup> The primary regulatory agencies are generally obligated to implement an FSOC recommendation by rule within ninety days.<sup>6</sup>

*Process for Designation as Systemically Significant.* The most significant power that the FSOC will exercise directly, rather than through “recommendations,” is to designate a nonbank firm an “SSNF.” The FSOC is empowered to impose such a designation if it finds that (i) the nonbank firm is “predominantly engaged” in activities that are “financial in nature” under Section 4(k) of the Bank Holding Company Act (the “**BHC Act**”); and (ii) “material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the

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<sup>3</sup> See Dodd-Frank Act § 111. Title I also establishes the Office of Financial Research (“**OFIR**”), which is generally tasked with facilitating the management of data that the FSOC collects in connection with FSOC reporting requirements imposed on SSNFs under Section 116. See Dodd-Frank Act § 152.

<sup>4</sup> Note that “primary financial regulatory agency” is a defined term referring, generally, to the federal or state regulatory authority having “primary” supervisory jurisdiction over an entity. See Dodd-Frank Act § 2(12). Note also that the various titles of the legislation contain variations on this defined term, and each variation operates to confer jurisdiction with respect to certain activities on one or another “primary” regulatory agency.

<sup>5</sup> See Dodd-Frank Act § 120.

<sup>6</sup> See Dodd-Frank Act § 120(c)(2).

activities of the nonbank financial company, could pose a threat to the financial stability of the United States.”<sup>7</sup>

A nonbank firm is deemed “predominantly engaged” in activities that are “financial in nature”<sup>8</sup> if such activities (i) contribute 85% or more of annual gross revenues of the firm, or (ii) account for 85% or more of the firm’s total consolidated assets.<sup>9</sup> SSNF designation can be applied to foreign firms if such firm’s US operations are deemed significant.<sup>10</sup> Further, a subsidiary may be designated a SSNF even if the parent company is not, which means that the calculation of the 85% test is not required to be made at the ultimate parent level. Thus, the population of entities that could potentially be designated as SSNFs is extremely large.<sup>11</sup>

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<sup>7</sup> See Dodd-Frank Act § 113; *see also Some Concerns with the Regulation of Large Nonbank Holding Companies* (Cadwalader, June 3, 2010), available at [http://www.cadwalader.com/assets/client\\_friend/060310RegLargeNonBankHoldingCos.pdf](http://www.cadwalader.com/assets/client_friend/060310RegLargeNonBankHoldingCos.pdf).

<sup>8</sup> See Dodd-Frank Act § 163(b). The Gramm-Leach-Bliley Act of 1999 established the category of activities that are “financial in nature.” See BHC Act Section 4(k) (12 U.S.C. § 1843(k)). Generally, “financial in nature” activities include such additional activities that are permissible for a bank holding company (“BHC”) that qualifies as and has elected to become a “financial holding company” (“FHC”). “Financial in nature” encompasses a fairly sweeping list of activities, some of which would seem unlikely to be fundamental to the financial stability of the United States, including:

- lending
- trust and safekeeping activities
- securitization of assets
- merchant banking
- underwriting and dealing in securities
- mutual fund activities
- check cashing and money transmitting
- insurance agency and underwriting
- investment advisory services
- “finder” activities
- activities permissible for a BHC outside of the United States and which the Federal Reserve has determined is “usual in connection with the transaction of banking” abroad (such as management consulting, general data processing, and travel agency), and
- activities that are “closely related to banking” under Section 4(c)(8) of the BHC Act, including: servicing loans; real estate and personal property appraising; arranging commercial real estate equity financing; real estate settlement servicing; leasing personal or real property; check guaranty services; credit bureau services; collection agency services; acquiring debt in default; asset management, servicing, and collection activities; management consulting and counseling activities; employee benefits consulting services; career counseling services; courier services; printing and selling certain encoded items; and data processing services.

<sup>9</sup> See Dodd-Frank Act § 102(a)(6).

<sup>10</sup> See Dodd-Frank Act § 113(i). The FSOC must consult with the appropriate foreign regulatory authorities when designating foreign firms SSNFs.

<sup>11</sup> Note that an insurer may be designated an SSNF. For a discussion of the provisions of Title V specifically applicable to insurers, see the Memorandum entitled [Insurance Reforms under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#).

*SSNF Criteria.* When deciding whether to designate a firm as an SSNF, the FSOC must consider a series of factors, including:

- leverage;
- off-balance-sheet exposures;
- transactions and relationships with other significant firms;
- the importance of the firm as a source of credit and liquidity for the United States financial system;
- the importance of the firm as a source of credit for low-income, minority, or underserved communities in the United States;
- whether the firm is a manager rather than owner of assets;
- the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
- whether the firm is subject to prudential standards on a consolidated basis in its home country; or already regulated by a U.S. financial regulatory agency;
- the amount and nature of the firm's U.S. financial assets;
- how the firm funds its operations.

The FSOC must notify a firm of its determination and provide the firm an opportunity for a hearing to contest its findings.<sup>12</sup> In the event of an unsuccessful contest (we assume most firms will contest designation as an SSNF given the substantial burdens that will follow from it), the judicial recourse afforded the designated firm is limited. The firm may appeal the determination in federal district court, but the court may only overturn the FSOC's determination if it finds the determination

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<sup>12</sup> See Dodd-Frank Act § 113(e).

“arbitrary and capricious.”<sup>13</sup> Designated firms must register with the Federal Reserve within 180 days after receiving a final FSOC determination.<sup>14</sup>

## II. Requirements Imposed on Nonbanks Designated as SSNFs

*Mandatory Heightened Prudential Standards.* SSNFs will be required to comply with “prudential standards” that would be stricter than those imposed on existing banks and BHCs. Certain “prudential standards” *must* be adopted by rule, including:

- **Risk-based capital and leverage requirements;**<sup>15</sup>
- **Liquidity requirements;**<sup>16</sup>
- **Risk management requirements,** including the establishment of board-level “risk committees”;<sup>17</sup>

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<sup>13</sup> See Dodd-Frank Act § 113(h). Note that the Act requires the Federal Reserve to issue regulations that provide a “safe harbor” from designation as an SSNF for certain “types or classes” of nonbank financial companies. See Dodd-Frank Act § 170.

<sup>14</sup> See Dodd-Frank Act § 114.

<sup>15</sup> Although the leverage ratio requirement is to be defined in the Federal Reserve rulemaking, the Federal Reserve is required to apply a debt-to-equity ratio limit of 15-to-1 for SSNFs that are found to pose a “grave” threat to U.S. financial stability. In addition, any leverage or risk-based capital provisions adopted by the Federal Reserve must require that certain “off-balance-sheet activities” must be included in the capital computations. “Off-balance-sheet activity” means an existing liability of a company that is not currently a balance sheet liability, but may become one upon the happening of some future event, including the following transactions, to the extent that they may create a liability:

- Direct credit substitutes in which a bank substitutes its own credit for a third party, including standby letters of credit.
- Irrevocable letters of credit that guarantee repayment of commercial paper or tax-exempt securities.
- Risk participations in bankers’ acceptances.
- Sale and repurchase agreements.
- Asset sales with recourse against the seller.
- Interest rate swaps.
- Credit swaps.
- Commodities contracts.
- Forward contracts.
- Securities contracts.
- Such other activities or transactions as the Federal Reserve may, by rule, define.

Dodd-Frank Act § 165(j), (k).

<sup>16</sup> Dodd-Frank Act § 165(b)(1)(A)(ii).

<sup>17</sup> Dodd-Frank Act § 165(b)(1)(A)(iii). The Dodd-Frank Act states that publicly traded SSNFs *must* establish a risk committee within one year after becoming an SSNF. Dodd-Frank Act § 165(h).

- **Resolution plan (or “living will”) requirements**, including the obligation of the SSNF to report periodically to the Federal Reserve, the FSOC, and the FDIC its plan for its own “rapid and orderly resolution in the event of material financial distress or failure”;<sup>18</sup>
- **Periodic credit exposure reporting requirements**, including reports of exposures *to or from* other SSNFs or BHCs with assets of \$50 billion or more (“**Large BHCs**”);<sup>19</sup> and
- **Concentration limits**.<sup>20</sup>

*Potential Heightened Prudential Standards.* In addition, the Federal Reserve *may*, but is not *required* to, adopt prudential standards relating to:

- **Contingent capital requirements**, including the requirement that SSNFs hold a minimum amount of contingent capital that is convertible into equity in times of financial stress;<sup>21</sup>
- **Short-term debt limits**, to be calculated as a percentage of the SSNF's capital and surplus;<sup>22</sup>
- **Enhanced public disclosures**;<sup>23</sup> and

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<sup>18</sup> See Dodd-Frank Act § 165(b)(1)(A)(iv), (d)(1).

<sup>19</sup> Dodd-Frank Act § 165(b)(1)(A)(iv), (d)(2).

<sup>20</sup> Dodd-Frank Act § 165(b)(1)(A)(v). In addition, the Act provides for a hard credit exposure limit of 25% of capital stock and surplus of the SSNF to any “unaffiliated company.” “Credit exposure” is defined as:

- all extensions of credit to the company, including loans, deposits, and lines of credit;
- all repurchase agreements and reverse repurchase agreements with the company, and all securities borrowing and lending transactions with the company, to the extent that such transactions create credit exposure for the SSNF;
- all guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit) issued on behalf of the company;
- all purchases of or investment in securities issued by the company;
- counterparty credit exposure to the company in connection with a derivative transaction between the company and the SSNF; and
- any other similar transactions that the Federal Reserve, by regulation, determines to be a credit exposure.

Section 165(e) also contains an “attribution rule” similar to that found in Section 23A of the Federal Reserve Act (12 U.S.C. § 371c), such that transactions with one party in which the proceeds of the transaction are ultimately transferred to, or that benefit, a second party are treated as a transaction directly with the second party for purposes of the credit concentration limits. The credit concentration limits (including the 25% cap) are not effective until three years after enactment.

<sup>21</sup> See Dodd-Frank Act § 165(b)(1)(B)(i), (c). However, the Federal Reserve may adopt contingent capital requirements only following the FSOC's completion of its study regarding contingent capital.

<sup>22</sup> See Dodd-Frank Act § 165(b)(1)(B)(ii), (g).

<sup>23</sup> See Dodd-Frank Act § 165(b)(1)(B)(iii), (f).

- Other prudential standards recommended by the FSOC or deemed appropriate by the Federal Reserve.

*Early Remediation Regulations.* In addition, the Federal Reserve, after consultation with the FSOC and the FDIC, is required to adopt regulations regarding early remediation requirements, involving a series of specific remedial actions to be taken by a SSNF that is experiencing financial distress.<sup>24</sup>

*Reporting.* SSNFs must submit certain reports to the Federal Reserve and FSOC, which in some cases may be duplicates of reports already provided to foreign authorities or other U.S. federal or state regulatory authorities.<sup>25</sup> The reports are intended to keep the Federal Reserve and FSOC informed as to the reporting entity's financial condition, risk control systems, transactions with depository institution subsidiaries (in the case of a banking organization), and "activities and operations [that] could, under adverse circumstances, have the potential to disrupt financial markets or affect the overall financial stability of the United States."

*Examination and Enforcement.* The Act subjects an SSNF and its subsidiaries to Federal Reserve examination authority with respect to (1) the nature of the operations and financial condition of the SSNF and its subsidiaries; (2) the financial, operational, and other risks of the SSNF and its subsidiaries that may pose a threat to the safety and soundness of the SSNF and its subsidiaries or to the financial stability of the United States; (3) the systems for monitoring and controlling such risks; and (4) compliance by the SSNF and its subsidiaries with the requirements of the Act.<sup>26</sup> The Federal Reserve is also granted authority to issue cease-and-desist orders against an SSNF for engaging in unsafe and unsound practices.<sup>27</sup> In addition, if the Federal Reserve determines that the primary financial regulatory agency having supervisory authority over a functionally regulated subsidiary of an SSNF has not done enough to force the subsidiary to cease the unsafe and unsound practice, the Federal Reserve may initiate enforcement action against the subsidiary as if

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<sup>24</sup> See Dodd-Frank Act § 166 (mandatory and subject to Federal Reserve rulemaking). Early remediation regulations issued by the Federal Reserve are likely to generally resemble the FDIC's "prompt corrective action" requirements. The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") mandated that banking regulators take "prompt corrective action" ("PCA") when an institution's capitalization rating falls below the top two capitalization categories. See 12 U.S.C. § 1831o. PCA may include an increase in the monitoring of the institution, requiring the institution to raise more capital, requiring the institution to merge with a more highly capitalized institution, or closure of the institution. Similarly, the Federal Reserve's early remediation regulations must establish requirements for (i) limits on capital distributions, acquisitions, and asset growth; (ii) capital restoration plan and capital-raising requirements; (iii) limits on transactions with affiliates; (iv) management changes; and (v) asset sales. Dodd-Frank Act § 166(c).

<sup>25</sup> See Dodd-Frank Act §§ 116(b); 161(c).

<sup>26</sup> See Dodd-Frank Act § 161(b) (subjecting SSNFs to Federal Reserve examination).

<sup>27</sup> See Dodd-Frank Act § 162. The SSNF would be treated as if it were a BHC for purposes of FDIA cease-and-desist authority.

the subsidiary were a BHC subject to Federal Reserve supervision.<sup>28</sup> Finally, the Federal Reserve is required to conduct annual “stress tests” of SSNFs to evaluate whether such entities have capital that is adequate on a total consolidated basis to absorb losses resulting from adverse economic conditions.<sup>29</sup>

*Financial Silos for SSNFs.* Bank regulation is largely premised on the concept of “the separation of banking and commerce” – that is, banks are confined to a fairly narrow range of activities, and companies that control banks (*i.e.*, in most cases, Federal Reserve – regulated BHCs) and the other nonbank affiliates of banks are also confined to a limited range of activities permitted under the BHC Act.<sup>30</sup> SSNFs (which, by their nature, are not BHCs and therefore typically engage in a broader range of activities permitted to corporations generally) could not comply with the BHC Act’s activity restrictions without significant divestitures or changes in their activities.

The Act does not require an SSNF (or its parent) to conform its activities to Section 4 of the BHC Act or otherwise shed any activities not permissible for a BHC.<sup>31</sup> The Act does, however, authorize the Federal Reserve to require the “siloeing” of any of the SSNF’s BHC-eligible activities from the remainder of its activities. The Federal Reserve is authorized to issue regulations that would require any SSNF to create an intermediate holding company to “silo” all or a part of the activities of the SSNF that are deemed to be “financial in nature” under BHC Act Section 4(k) – potentially compelling a significant restructuring of the SSNF. The Act further states that such “siloeing” is mandatory where the Federal Reserve determines that, essentially, it would be difficult to properly supervise the “financial in nature” activities of the SSNF if such an intermediate holding company was not created.<sup>32</sup> The Act carves out from the siloeing requirement any “internal financial activities” that are engaged in on behalf of the SSNF or an affiliate (such as the SSNF’s internal treasury or accounts payable functions). Further, the Act extends the Federal Reserve’s “source of strength”

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<sup>28</sup> See Dodd-Frank Act § 162(b)(2).

<sup>29</sup> See Dodd-Frank Act § 165(i). Note that the Act appears to confer very broad discretionary authority on the Federal Reserve to require stress testing of any “nonbank financial company,” which as the term is defined in the act would include any U.S. or non-U.S. company that is engaged “predominantly” in activities that are “financial in nature” under BHC Act § 4(k).

<sup>30</sup> See *Some Concerns with the Regulation of Large Nonbank Holding Companies* (Cadwalader, June 3, 2010), available at [http://www.cadwalader.com/assets/client\\_friend/060310RegLargeNonBankHoldingCos.pdf](http://www.cadwalader.com/assets/client_friend/060310RegLargeNonBankHoldingCos.pdf). This memorandum was published before the Act was adopted and some of the specific concerns raised in the memorandum were addressed in the final version of the Act. Nonetheless, the general policy concern raised by the memorandum; *i.e.*, the absence of a clear policy justification for regulating entities that were neither banks nor controlled banks under a scheme of regulations designed for banks remains an issue.

<sup>31</sup> See Dodd-Frank Act § 167(a).

<sup>32</sup> See Dodd-Frank Act § 167(b)(1)(B).

doctrine to the SSNF's parent company, which would require the SSNF's parent company to provide financial support to the intermediate holding company.<sup>33</sup>

Any forced siloing may have significant burdens associated with it, even beyond the need to undergo a corporate reorganization, and the variety of legal, accounting and tax issues that the reorganization itself may raise. For example, personnel, systems, facilities, licenses, documents, intercompany and third party agreements, expenses, etc. may need to be realigned to be consistent with the newly siloed financial activities.

*Limitation on Certain Acquisitions.* Section 163 of the Act subjects SSNFs to the prior approval requirements of the BHC Act with respect to certain transactions by the SSNF, including acquisition of shares or assets of a bank or BHC.<sup>34</sup> Thus, the Act effectively lowers the maximum ownership interest a SSNF can hold in a bank or thrift, from 24.9% (without filing a Section 3 application under the BHC Act) or 9.9% (without filing a Change-in-Bank Control Act application) to 4.9%. A further limitation that the Act imposes on SSNFs is a requirement that an SSNF give prior notice to the Federal Reserve regarding acquisitions of companies engaged in activities deemed to be "financial in nature," if the company to be acquired has assets in excess of \$10 billion. In short, this gives the Federal Reserve the authority to oversee the acquisition by a nonbank SSNF of another large nonbank financial company, a regulatory hurdle that would have to be accounted for in the accomplishment of virtually any strategic acquisition by an SSNF.

*Cessation of Activities.* The Act grants the Federal Reserve broad authority to require SSNFs to terminate certain activities and divest certain assets if the Federal Reserve determines that the SSNF poses a "grave threat" to U.S. financial stability.<sup>35</sup> Specifically, the Federal Reserve may: (1) limit the ability of the firm to merge with, acquire, consolidate with, or otherwise become affiliated with another company; (2) restrict the ability of the firm to offer a financial product or products; (3) require the company to terminate one or more activities; (4) impose conditions on the manner in which the company conducts one or more activities; or (5) require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities. The exercise of such

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<sup>33</sup> The Act states, "A company that directly or indirectly controls an intermediate holding company established under this section shall serve as a source of strength to its subsidiary intermediate holding company." Dodd-Frank Act § 167(b)(3). "Source of strength" is not defined in Section 167. Prior to the enactment of the Dodd-Frank Act, a "source of strength" doctrine was reflected solely in Federal Reserve Board regulations and not in the banking statutes; the regulations provide that "A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks ...." 12 C.F.R. § 225.4(a)(1). A separate provision of the Dodd-Frank Act codifies source of strength doctrine with respect to traditional bank holding companies, savings and loan holding companies, and holding companies for nonbank banks, but explicitly limits the obligation to serving as a "source of *financial* strength" to its depository institution subsidiaries. Dodd-Frank Act § 616(d).

<sup>34</sup> See Dodd-Frank Act § 163(a).

<sup>35</sup> See Dodd-Frank Act § 121.

powers with respect to nonbank financial companies does not have a precedent and there is no way to know how the procedure by which they may be exercised, how frequently, or the criteria to be used in deciding to exercise the authority.

### III. Securities Holding Companies

*Investment Bank Holding Company vs. Securities Holding Company.* Section 617 would eliminate the ability of a foreign entity to become an “investment bank holding company” subject to supervision by the SEC. Instead, Section 618 would create an elective “securities holding company” that would be supervised by the Federal Reserve. The purpose of these provisions is to create a framework for foreign securities companies operating in the U.S. to satisfy non-U.S. legal obligations that the foreign securities companies be subject to comprehensive consolidated supervision within the U.S.

To qualify as a “securities holding company,” the entity must control one or more broker-dealers registered with the SEC, and must not otherwise be subject to supervision by the Federal Reserve or another federal banking agency. Section 618 directs the Federal Reserve to establish record keeping, reporting, examination, capital, and risk management requirements applicable to securities holding companies. Section 618 further subjects a securities holding company to the provisions of the BHC Act as if it were a BHC, with the exclusion of the activity and ownership restrictions of Section 4 of the BHC Act.<sup>36</sup>

This provision does not constitute a major change in law. Effectively, this provision shifts an authority that would previously have been exercised by the SEC (with respect to regulated broker-dealers that are intended to be subject to consolidated supervision but that are not part of BHCs) to the Federal Reserve, which is better staffed in regard to the supervision of holding companies. This provision does not apply to the regulation of any existing broker-dealers; *i.e.*, all of the existing broker-dealers that are subject to consolidated supervision are part of BHCs that are already regulated by the Federal Reserve and not by the SEC.

### IV. Growth Limits

The Dodd-Frank Act expands the nationwide “concentration limits” first introduced upon the enactment of the Riegle-Neal Interstate Banking and Branching Act of 1994. That Act instituted a “nationwide deposit cap,” precluding the Federal Reserve from approving any interstate acquisition of a bank or BHC if the resulting bank or BHC would hold more than 10% of nationwide deposits.<sup>37</sup>

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<sup>36</sup> 12 U.S.C. § 1843.

<sup>37</sup> See 12 U.S.C. § 1842(d)(2).

*New Nationwide Liability-Based Cap Applicable to SSNFs.* Section 622 creates an entirely new concentration limit cap, calculated based on total liabilities and imposed on any acquisition (whether or not interstate) and applicable not only to BHCs but also to companies that control a nonbank bank and to SSNFs. Section 622 prohibits such a financial company (including an SSNF) from acquiring, acquiring substantially all the assets of, or merging or consolidating with, any other company (financial or otherwise) if, as a result of the transaction, the surviving financial company's total consolidated liabilities will exceed 10% of all of the consolidated liabilities of all financial companies. "Liabilities" is defined as the difference between the entity's risk-weighted assets and its total regulatory capital, and includes all consolidated liabilities of U.S.-based financial companies (including liabilities abroad) and all consolidated liabilities of foreign-based financial companies' U.S. operations. Within six months following enactment of the Dodd-Frank Act, the FSOC is required to conduct a study and render recommendations regarding any modifications to the liability-based concentration limit. The Federal Reserve is required to promulgate regulations implementing the new concentration limit within nine months thereafter.

#### V. The Volcker Rule

Section 619 of the Dodd-Frank Act enacts the so-called "Volcker Rule." The Volcker Rule has two prongs: (i) prohibiting "banking entities" from engaging in proprietary trading in certain securities (the "**Prop Trading Restriction**"); and (ii) prohibiting "banking entities" from sponsoring or investing in a hedge fund or private equity fund (the "**Sponsoring and Investing Restriction**"). These two prohibitions apply to "Banking Entities," which includes insured depository institutions, BHCs, entities treated as BHCs for purposes of the Act (such as foreign banks with a U.S. banking presence), holding companies of nonbank banks, and any affiliates of the preceding entities.

*SSNFs not Subject to Bar but Subject to Prudential Limits.* An SSNF that is not otherwise a banking entity generally is not subject to the two prohibitions of the Volcker Rule because SSNFs are not deemed to be within the definition of "Banking Entity." However, the Federal Reserve is required to adopt rules regarding capital requirements and quantitative limits with respect to the proprietary trading and fund investment activities of SSNFs. If any divestitures are required in accordance with such rules, an SSNF would have a two-year phase-in period for disposal of the investments (with extensions of up to three years) from the date the firm is designated an SSNF.

*Study, Rules and Effectiveness.* Within six months after the Act's enactment, the FSOC is required to conduct a study regarding the limits imposed by the Volcker Rule and provide recommendations on implementing the Volcker Rule's provisions. Within nine months after the FSOC study, the federal banking agencies, the SEC, and the CFTC would be required to adopt coordinated final regulations implementing the Volcker Rule, consistent with the recommendations and modifications of the FSOC. The provisions of the Volcker Rule become effective twelve months after the

adoption of these coordinated final regulations, but in no case later than two years after enactment of the Dodd-Frank Act.

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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# Clients & Friends Memo

## Orderly Liquidation of Financial Companies, Including Executive Compensation Clawback, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

July 20, 2010

Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Act**”) represents Congress’ attempt to address companies considered “too big to fail.” The statute creates a new “orderly liquidation authority” (“**OLA**”), which allows the Federal Deposit Insurance Corporation (“**FDIC**”) to seize control of a financial company<sup>1</sup> whose imminent collapse is determined to threaten the financial system as a whole. Commencement of a receivership under the OLA would preempt any proceedings under the Bankruptcy Code. Thus, lenders, rating agencies, and others seeking to transact business with a company, or an affiliate of a company, that could potentially be considered a systemic risk will have to consider the impact on creditors’ rights of both the Bankruptcy Code and the OLA. Further, the OLA is solely a liquidation remedy. Rehabilitation or reorganization is not an option, and the ability of a debtor to stay in possession is eliminated. The FDIC, in nearly all cases, assumes full control.<sup>2</sup> Insurance companies, which remain subject to state regulation, are not covered by the OLA, but their holding companies and unregulated affiliates and subsidiaries are covered. Insured depository institutions remain subject to the FDIA. However, the ability of the FDIC to seize a bank holding company allows the FDIC to run coordinated proceedings for the bank and its affiliates.

The OLA is modeled after the FDIC’s existing framework for failed insured depository institutions, although there are differences. Among other things, the OLA would maintain safe harbors for qualified financial contracts that mirror those of the Federal Deposit Insurance Act (“**FDIA**”), subject to certain modifications, such as a 1-business day stay period before counterparties can close out

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act’s application to specific industries, entities and transactions. To see these other memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

<sup>1</sup> See § 204.

<sup>2</sup> *But see* discussion, *infra* at 3, regarding SIPC’s responsibility in covered broker or dealer liquidations under the OLA.

their contracts.<sup>3</sup> In addition, the legislation aims to preserve certain priorities of payment, rights to setoff and avoidance action protections that generally follow those established under the Bankruptcy Code.<sup>4</sup> The receiver is required to resolve claims on a fast track (within 180 days of commencement of receivership).<sup>5</sup> The OLA provides some degree of adequate protection to secured creditors by allowing a secured creditor faced with diminution of the value of its collateral to request expedited resolution of its claim (within 90 days).<sup>6</sup>

The law provides a mechanism for recovering the cost of the OLA from other members of the financial industry.<sup>7</sup> It also exposes officers and directors of liquidating financial companies to personal liability, including by creating a right to claw back incentive and other compensation paid during the two year period prior to the commencement of a receivership.<sup>8</sup> If found to have engaged in more serious misconduct (e.g., personal dishonesty or willful disregard of company welfare), a senior executive is subject to being banned from serving any financial company for a minimum of two years.<sup>9</sup>

### **Executive Summary of Title II – Orderly Liquidation Authority**

Certain key elements of the new OLA are highlighted below.

#### **Only “Financial Companies” are Eligible**

The OLA potentially applies to U.S. companies that are bank holding companies, non-bank financial companies supervised by the Federal Reserve Board (“FRB”), companies predominantly engaged in activities that the FRB determines are financial in nature, subsidiaries of such companies (other than insured depository institutions or regulated insurance companies), and brokers or dealers

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<sup>3</sup> See § 210(c)(10)(B)(i).

<sup>4</sup> See § 210(a)(11), (12); see also § 210(b).

<sup>5</sup> See § 210(a)(3). These provisions mirror those of the FDIA. See 12 U.S.C. § 1821(d)(5), (8).

<sup>6</sup> See § 210(a)(5).

<sup>7</sup> See § 210(o)(1) and discussion, *infra* at 11.

<sup>8</sup> See § 210(s)(1). Under Section 210, directors or officers may be held personally liable for monetary damages in actions by or on behalf of the FDIC. See § 210(f)(1). In addition, the FDIC may recover compensation from current or former senior executives or directors that are substantially responsible for the failed condition of the covered financial company. This clawback of executive compensation is limited to the two years preceding the date the FDIC was made receiver, except in the case of fraud. Additional provisions in the Act place executive compensation next to last in priority of unsecured claims and allow regulators to take action if an executive or director violates the law or engages in other explicitly forbidden acts. See § 210(b)(1); see also § 210(f)(2).

<sup>9</sup> See § 213.

registered with the SEC and a member of SIPC.<sup>10</sup> With respect to insurance companies, the OLA contemplates that the insurance company itself would be liquidated under state law once federal regulators determine that it presents systemic risk, but a holding company, other affiliate or subsidiary of an insurance company is eligible for liquidation under the OLA.<sup>11</sup>

The liquidation of insured depository institutions will proceed under existing FDIC procedures.

### **OLA is Exclusive Regime for “Covered Financial Companies”**

According to the Senate Banking Committee’s report on the legislation, “there is a strong presumption that the bankruptcy process will continue to be used to close and unwind failing financial companies, including large, complex ones”.<sup>12</sup> However, where a determination is made that the company’s failure threatens the national economy (as described below), the Bankruptcy Code will be preempted, and an FDIC receivership under Title II of the ACT, presided over by the United States District Court for the District of Columbia, will be the exclusive remedy. Prior commencement of a case under the Bankruptcy Code will not eliminate application of Title II. Where a determination of systemic risk under Title II comes after the commencement of a case under the Bankruptcy Code, the bankruptcy case will be terminated (wherever located) and an OLA receivership in the District of Columbia will be commenced.<sup>13</sup>

### **Continuation of SIPA Protection for Customers of Covered Broker Dealers**

The Securities Investor Protection Corporation (“SIPC”) would continue to be responsible for the liquidation of a registered broker or dealer subjected to the OLA.<sup>14</sup> The FDIC’s involvement would be limited to providing funding and exercising certain powers, including through a newly created bridge financial company.<sup>15</sup> In a covered broker or dealer liquidation, the FDIC would appoint SIPC (without court approval), to act as liquidation trustee under the Securities Investor Protection Act (“SIPA”).<sup>16</sup> SIPC would be obligated to dispense with customer claims on the same priority basis

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<sup>10</sup> See § 201(a)(7)-(9); see also § 201(a)(11). For financial activity to be predominant, 85% or more of its and its affiliates’ consolidated revenues must be derived from activities that are financial in nature. See § 201(b).

<sup>11</sup> See § 203(e). The FDIC has back up authority to commence judicial action in state court if a state regulator fails to act within 60 days after federal authorities determine that a company presents systemic risk. See § 203(e)(3).

<sup>12</sup> See S. Rep. No. 111-176, at 4 (2010).

<sup>13</sup> See §§ 202(a)(1)(A)(i), 208. Pending SIPA proceedings are also subject to termination.

<sup>14</sup> See § 205.

<sup>15</sup> See § 205(b)(2). With respect to a covered broker or dealer, the FDIC may transfer all customer accounts to a bridge financial company, unless the FDIC determines that the accounts likely will be transferred to another covered broker dealer or transfer would materially interfere with FDIC’s ability to avoid systemic risk. See § 210(a)(1)(O)(i).

<sup>16</sup> See § 205(a).

that they now enjoy under SIPA section 8(c).<sup>17</sup> Non-customer claims (other than claims arising under qualified financial contracts) would be subject to the overall priority scheme of the OLA, subject to the elevation of certain administrative priority claims of SIPC.<sup>18</sup> Qualified financial contracts to which a covered broker or dealer is a party would be governed exclusively by the OLA's safe harbor provisions.<sup>19</sup>

SIPC would be entitled to exercise all of its powers under SIPA, but would not have jurisdiction over assets and liabilities transferred by the FDIC to any bridge financial company, and SIPA could not otherwise adversely impact the FDIC in exercising its powers and duties.<sup>20</sup> Any claims against the FDIC arising from asset transfers to a bridge bank would be treated under the OLA and subject to federal district court review.<sup>21</sup>

### **U.S. Initiates the Orderly Liquidation Process**

In order for a receivership under the OLA to be commenced, there must be a formal determination of systemic risk and a recommendation that the company be placed in receivership.<sup>22</sup> The process begins after either a request by the Secretary of the Treasury or at the initiative of either the FRB or the FDIC (or, in the case of a broker or dealer, the SEC) for a formal recommendation that the FDIC be<sup>23</sup> appointed as receiver.<sup>24</sup> To be effective, this written recommendation requires approval by a two-thirds vote of each of the FRB and the board of the FDIC (or, in the case of a registered broker or dealer, a two-thirds vote of the SEC).<sup>25</sup> If the "failure of the financial company would threaten U.S. financial stability" and the foregoing thresholds for recommendation are met, the FDIC will be appointed receiver, and liquidation under the OLA will be "the only option for the company."<sup>26</sup>

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<sup>17</sup> See § 205(g)(1).

<sup>18</sup> See § 205(g)(2).

<sup>19</sup> See § 205(b)(3).

<sup>20</sup> See § 205(b).

<sup>21</sup> See § 205(e).

<sup>22</sup> See § 203(a), (b).

<sup>23</sup> See § 203(a)(1).

<sup>24</sup> See § 203(a).

<sup>25</sup> See §§ 202(a), 203(a).

<sup>26</sup> See S. Rep. No. 111-176, at 4. To protect against adverse consequences resulting from media exposure, the bill contains criminal penalties for persons who recklessly disclose that an emergency petition has been filed with the Court. See § 202(a)(1)(C).

**Twofold Test – Default/Danger of Default and Systemic Risk.**

**Default or Danger of Default.** A company must be in “default or danger of default.” Alternative tests can be met to establish this condition: 1) a pending or threatened commencement of a case under the Bankruptcy Code; 2) the incurrence of or likely incurrence of losses that will deplete all or substantially all of a company’s capital, with no reasonable prospect for the company to avoid such depletion; 3) assets that are or likely will be less than the company’s obligations to creditors and others; or 4) the company is, or likely will be, unable to pay its obligations (other than those in *bona fide* dispute) in the ordinary course of business.<sup>27</sup>

**Determination of Systemic Risk.** If a company is found to be in default or in danger of default, a formal determination of systemic risk must be established by various experts. A covered financial company (“CFC”) would implicate systemic risk if: 1) the company is in default or the danger of default; 2) the failure of the company would have serious effects on the financial stability of the U.S.; 3) no viable private sector alternative is available to prevent default; 4) any effect on creditors, counterparties, shareholders and other market participants is appropriate given the impact actions would have on U.S. financial stability; 5) action taken would avoid or mitigate such adverse effects, taking into account the mitigation of potential adverse effects on the financial system; 6) a federal regulatory agency has ordered the company to convert all its convertible debt instruments that are subject to regulatory order; and 7) a company satisfies the statutory definition of a financial company. The written recommendation voted on by the FRB and FDIC (or SEC in the case of a covered broker or dealer) must evaluate not only these factors, but also why the Bankruptcy Code is inadequate to resolve the company’s condition.<sup>28</sup>

**Federal Insurance Director Initiates OLA with respect to Eligible Insurance Entities.** To initiate the process with respect to an insurance company, or a company whose largest U.S. subsidiary is an insurance company, the Director of the newly created Federal Insurance Office and the FRB, either at the request of the Treasury Secretary or on their own initiative, are to consider whether to recommend subjecting the company to the OLA.<sup>29</sup>

**Only “Arbitrary and Capricious” Petitions are Subject to Court Dismissal.** Upon a recommendation of receivership, the Treasury Secretary would ask a company’s board of directors

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<sup>27</sup> See § 203(c)(4).

<sup>28</sup> See § 203(b).

<sup>29</sup> See § 203(a)(1)(C).

to consent or “acquiesce” to FDIC receivership.<sup>30</sup> In the absence of consent or acquiescence, the Treasury Secretary would petition the Court for authority to appoint the FDIC as receiver and provide notice to the company.<sup>31</sup> The company may oppose the petition, but the Court’s role is limited to determining whether the company constitutes a “financial company” as defined by the statute and has appropriately been found to be in default or in danger of default.<sup>32</sup> The Court can reject the petition only if it finds the government’s determinations to be “arbitrary and capricious”.<sup>33</sup> If the Court disagrees with the Treasury’s finding, the Treasury Secretary has the immediate opportunity to amend and refile the petition.<sup>34</sup> If the Court fails to rule within 24 hours, the petition is deemed granted.<sup>35</sup>

The company and the Treasury Secretary have the right to appeal a decision rejecting a petition to the DC Circuit within 30 days of the lower court’s decision; the decision of the Court of Appeals may be appealed to the Supreme Court within 30 days of the Circuit Court decision.<sup>36</sup> In each case, the scope of appellate review is limited to the definition of the company as a financial company and whether the Treasury has acted arbitrarily and capriciously.<sup>37</sup>

### **Application of FDIC Receivership Powers**

The ACT vests the FDIC with broad power to act as receiver by virtue of its experience in unwinding insured depository institutions. Upon the FDIC’s appointment as receiver, all existing bankruptcy or other insolvency cases are dismissed and no further bankruptcy cases can be filed.<sup>38</sup> Company assets that vested in another entity will revert in the company.<sup>39</sup> However, any order entered by a bankruptcy court prior to the appointment of the OLA receiver will remain in effect.<sup>40</sup>

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<sup>30</sup> See § 202(a)(1)(A)(i). Under Section 207 of the Act, boards of directors are not to be held liable for simply acquiescing or consenting in good faith to the appointment of the FDIC as receiver.

<sup>31</sup> *Id.*

<sup>32</sup> See § 202(a)(1)(A)(iii).

<sup>33</sup> See § 202(a)(1)(A)(iv).

<sup>34</sup> *Id.*

<sup>35</sup> See § 202(a)(1)(A)(v).

<sup>36</sup> See § 202(a)(2).

<sup>37</sup> *Id.*

<sup>38</sup> See § 208(a).

<sup>39</sup> See § 208(b).

<sup>40</sup> See § 208(c).

The FDIC's powers under the OLA mirror its existing receivership powers under the FDIA, with certain modifications intended to address perceived differences between the mandatory liquidation of a company that implicates systemic risk, as opposed to a failed insured depository institution. The scheme reflects the legislative intent that value not be preserved for existing equity, management or unsecured creditors.<sup>41</sup>

As receiver under the OLA, the FDIC succeeds to the rights, title, powers and privileges of the covered company and operates the entity in order to maximize net asset sale value.<sup>42</sup> Among other things, under the OLA the FDIC may engage in:

- creating a bridge financial company to acquire the CFC's assets;<sup>43</sup>
- engaging in financing activities, including funding the liquidation and receiving priority in repayment (but excluding the power to take equity in a CFC or covered subsidiary)<sup>44</sup>, and making additional payments to claimants that are needed to maximize value or limit losses (subject to their being recaptured if the OLF is depleted as discussed below);<sup>45</sup>
- appointing itself as receiver of subsidiaries (other than insured depository institutions, covered broker dealers, and insurance companies) of covered financial companies;<sup>46</sup>
- exercising subpoena powers;<sup>47</sup>
- utilizing private sector services to manage and dispose of assets;<sup>48</sup>

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<sup>41</sup> See generally § 204(a) and S. Rep. No. 111-176, at 4. (Upon being placed into receivership, "The financial company's business operations and assets will be sold off or liquidated, the culpable management of the company will be discharged, shareholders will have their investments wiped out, and unsecured creditors and counterparties will bear losses".) The FDIC may also "provide for the exercise of any function by any member or stockholder, director or officer of any covered financial company for which the FDIC has been appointed as receiver under this title." See § 210(a)(1)(C). Additionally, the Act states that the FDIC "shall terminate all rights and claims [stockholders or creditors] have against the assets of the covered financial company or FDIC arising out of their status as stockholders or creditors." The stockholders' or creditors' rights to payment, resolution or other satisfaction of their claims are excepted. See § 210(a)(1)(M).

<sup>42</sup> See § 210(a)(1)(A), (B).

<sup>43</sup> See § 210(a)(1)(F).

<sup>44</sup> See §§ 204(d), 206(5), 210(b).

<sup>45</sup> See §§ 210(b)(3), 210(d)(4), 210(h)(5)(E).

<sup>46</sup> See § 210(a)(1)(E).

<sup>47</sup> See § 210(a)(1)(J).

<sup>48</sup> See § 210(a)(1)(L).

- terminating rights and claims of creditors (subject to the Act's priority of claims provisions);<sup>49</sup> and
- coordinating with appropriate foreign financial authorities regarding any covered financial company with assets or operations outside the U.S.<sup>50</sup>

*Avoidance/Repudiation Power.* The FDIC has the authority to avoid fraudulent and preferential transfers (with standards similar to those under the Bankruptcy Code; financial contracts enjoy similar carveouts), disaffirm or repudiate any burdensome contract or lease, and enforce any contract notwithstanding any provisions for termination, default, acceleration, or exercise of rights upon insolvency.<sup>51</sup>

*Clawback of Senior Executive Compensation; Potential to be Banned from Financial Companies.* Although directors are insulated from liability for consenting to the regime, the bill requires senior management to be removed<sup>52</sup> and causes payment of their claims to be subordinated to the payment of other creditors.<sup>53</sup> In addition, the FDIC, as receiver, would have the power to recapture incentive and other compensation received two years prior to receivership from current or former senior executives or directors deemed substantially responsible for the company's failure.<sup>54</sup> In cases of fraud, no time limit would apply.<sup>55</sup> Under extreme circumstances, the FDIC could seek to ban a senior executive from the industry.<sup>56</sup>

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<sup>49</sup> See § 210(a)(1)(M). But the FDIC may fail to treat similarly situated creditors in a similar manner if such disparate treatment is deemed necessary to maximize value. See § 210(b)(4).

<sup>50</sup> See § 210(a)(1)(N).

<sup>51</sup> See §§ 210(a)(11)-(12); 210(c). Note, however, that director and officer liability insurance contracts are excepted from the prohibition against the exercise of *ipso facto* termination clauses. See § 210(c)(13)(C)(ii). Other notable powers of the FDIC would include the ability to prevent enforcement of provisions in standstill and confidentiality agreements that limit any person's ability to acquire all or any part of the seized company, see § 210(p), and to prohibit the sale of CFC assets to certain mafeasors. See § 210(r). This section states that the FDIC shall prescribe regulations which, at a minimum, shall prohibit the sale of assets of the covered company to certain people (for example, a person who has defaulted on one or more obligations in excess of \$1 million, or who has been found to have engaged in fraudulent activity in connection with such an obligation). See § 210(r)(1).

<sup>52</sup> See §§ 204(a)(2), 206(4), 207.

<sup>53</sup> See § 210(b)(1). The Act specifies, with respect to the priority of repayment of unsecured claims, executive and director wages, salaries and commissions are seventh (in contrast to wages, salaries and commissions of other individuals, which rank third), followed only by obligations to shareholders. See § 210(b)(1)(G), (C).

<sup>54</sup> See § 210(s)(1).

<sup>55</sup> *Id.*

<sup>56</sup> See § 213. The Act grants the Board of Governors or the FDIC authority to take action if a senior executive or a director, prior to the appointment of the FDIC as receiver, has (A) violated laws, regulations, final cease-and-desist order, or other listed items, (B) engaged or participated in unsafe or unsound practice in connection with a financial company or (C) committed or engaged in any act, omission, or practice which constitutes a breach of fiduciary duty. See § 213(b).

*Liability of Directors and Officers.* The Act also includes provisions that permit a director or officer of a covered financial company to be held personally liable for monetary damages in instances of gross negligence, similar conduct, or conduct that demonstrates a greater disregard of a duty of care than gross negligence. This standard also includes intentional tortious conduct, as defined by state law.<sup>57</sup> Section 210(g) of the Act speaks to damages generally: in any proceeding related to a claim against a director or officer, for example, or other parties employed by or providing services to a covered company, “damages determined to result from the improvident or otherwise improper use or investment of any assets of the covered shall include principal losses and appropriate interest.”<sup>58</sup>

*Stay Protection.* Courts are precluded from taking action to restrain the FDIC as receiver, and, upon request of the FDIC, courts must grant a 90-day stay of any judicial action in which the covered company is or becomes a party (45 days in the case of a bridge financial company that becomes a party to litigation as a result of its assets or assumption of liabilities of a seized company).<sup>59</sup>

*Safe Harbor for Qualified Financial Contracts.* Counterparties to qualified financial contracts are stayed from exercising termination, close out and netting rights for one business day (during which the FDIC may transfer its obligations to a bridge financial company).<sup>60</sup> “Walkaway” clauses (*i.e.*, clauses that cause the contract to be void following a termination due to insolvency) are unenforceable.<sup>61</sup> With respect to financial contracts that are guaranteed by or otherwise receiving credit support from a seized company, the FDIC, as receiver, can enforce obligations of a primary obligor that ordinarily would be subject to termination upon the insolvency of its credit support provider, under certain conditions.<sup>62</sup> These conditions include that the guaranty and related assets and liabilities are transferred to a bridge financial company or other third party, within the same period of time as the FDIC is entitled to transfer the qualified financial contracts of the CFC, or the FDIC otherwise provides adequate protection with respect to the obligations.<sup>63</sup>

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<sup>57</sup> See § 210(f)(2).

<sup>58</sup> See § 210(f)(3).

<sup>59</sup> See §§ 210(a)(8), 210(e), 210(h)(6).

<sup>60</sup> See § 210(c)(10)(B)(i).

<sup>61</sup> See § 210(c)(8)(F).

<sup>62</sup> FDIC can take this action as a receiver of a seized company or its subsidiary (including a subsidiary insured depository institution). See § 210(c)(16).

<sup>63</sup> See § 210(c)(16).

*Proceedings Have Limited Duration.* The term of the FDIC's receivership of a CFC is limited to an initial period of 3 years, subject to two 1-year extensions.<sup>64</sup>

### **Mandatory Terms and Conditions For All Orderly Liquidation Actions**

#### *Senior Management Must be Removed*

The legislation requires the FDIC to, *inter alia*, ensure the removal of management and directors responsible for the failure of the financial institution.<sup>65</sup>

### **Orderly Liquidation Fund**

In an effort to fund the OLA, the ACT creates a segregated fund ("OLF") to be held at the Treasury.<sup>66</sup> The FDIC has authority to issue obligations to the Treasury to fund the OLA.<sup>67</sup> Monies may be borrowed only once the FDIC submits a plan for a CFC's orderly liquidation that is approved by the Treasury Secretary.<sup>68</sup> The law restricts the FDIC from incurring any obligation during the first 30 days of liquidation that would result in total obligations outstanding exceeding the sum of 10% of the total consolidated assets of the covered financial company.<sup>69</sup> Thereafter, the FDIC may become obligated for 90% of the fair value of the total consolidated assets of each covered financial company that are available for repayment.<sup>70</sup>

The law requires the FDIC, in advance of obtaining any funding from the Treasury after the initial 30-day period of the receivership, to provide a repayment plan to the Treasury and to demonstrate that proceeds generated from the liquidation of the seized entity's assets, together with assessments, will suffice to repay outstanding indebtedness over a specified time period.<sup>71</sup> The Treasury Secretary and the FDIC must consult with Congress with respect to such repayment plans.<sup>72</sup> The ACT obligates the FDIC to charge risk-based assessments if necessary to repay obligations to the Treasury within 5 years of issuance (absent an extension from the Treasury in

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<sup>64</sup> See § 202(d) (need for further extension must be certified by the FDIC chairperson).

<sup>65</sup> See § 206.

<sup>66</sup> See § 210(n)(1).

<sup>67</sup> See § 210(n)(5).

<sup>68</sup> See § 210(n)(9).

<sup>69</sup> See § 210(n)(6).

<sup>70</sup> *Id.*

<sup>71</sup> See § 210(n)(9) and (o).

<sup>72</sup> See § 210(n)(9)(B)(ii).

order to avoid serious adverse effect on the U.S. financial system).<sup>73</sup> First, assessments must be imposed on those claimants who received excess payments from the FDIC (*i.e.*, the difference between (1) the aggregate value the claimant received from the FDIC and (2) the value the claimant was entitled to receive from FDIC solely from proceeds of liquidation of the covered financial company).<sup>74</sup> If amounts recovered from such claimants are insufficient to repay outstanding obligations to the Treasury within 5 years, the FDIC can impose special assessments on financial companies with total consolidated assets equal to at least \$50 billion.<sup>75</sup> In imposing these special assessments, the FDIC must take into account various macro- and microeconomic risk factors to avoid further jeopardizing U.S. financial stability.<sup>76</sup> The ACT expressly prohibits the use of taxpayer monies to prevent the liquidation of a financial company under the Act, and mandates that all expenses of liquidation be borne by the financial sector.<sup>77</sup>

#### *Congressional Risk Matrix to be Used to Quantify Assessments*

The legislation requires the new Financial Stability Oversight Council<sup>78</sup> to recommend a risk matrix that the FDIC will use to determine how much to assess financial institutions. That matrix is to take into account the risks presented by the financial company and the extent to which it would benefit from the orderly liquidation of a financial company under Title II, including: asset and liability concentrations, both on- and off-balance sheet; market share; leverage; potential exposure to sudden liquidity calls occasioned by economic distress; the company's financial obligations to others in the financial community; the "amount, maturity, volatility, and stability of the liabilities of the company, including the reliance on short-term funding, taking into account existing systems for measuring its risk based capital", the stability and variety of a company's sources of funding; the importance of a company as a source of credit in the overall economy and liquidity in the marketplace; the extent to which the entity is an asset manager and the diversity of assets under

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<sup>73</sup> See § 210(o)(1)(B).

<sup>74</sup> See § 210(o)(1)(D).

<sup>75</sup> *Id.*

<sup>76</sup> See § 210(o)(4).

<sup>77</sup> See § 214.

<sup>78</sup> This council is comprised of the following voting members (each having one vote): (A) the Secretary of the Treasury (Chairperson); (B) the Chairman of the Board of Governors of the Federal Reserve; (C) the Comptroller of the Currency; (D) the Director of the Bureau of Consumer Financial Protection; (E) the Chairman of the Securities and Exchange Commission; (F) the Chairperson of the FDIC; (G) the Chairperson of the Commodity Futures Trading Commission; (H) the Director of the Federal Housing Finance Agency; (I) the Chairman of the National Credit Union Administration Board; and (J) an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise. In addition, the Director of the Office of Financial Research, the Director of the Federal Insurance Office, a State insurance commissioner, State banking supervisor and State securities commissioner (or similar officer), each to be designated by a special selection process, serves in an advisory capacity, as a nonvoting member. See § 111.

management; and whether the company to be assessed contributed to the failure of the seized company during the ten-year period preceding the seizure.<sup>79</sup>

*Further Studies of Existing Insolvency Regimes/Treatment of Various Constituents*

The final legislation commissions studies of domestic insolvency laws to determine their effectiveness with respect to the orderly resolution or reorganization of systemic financial institutions without “creating moral hazard,” specifically including the treatment of qualified financial contracts.<sup>80</sup> Similarly, the legislation requires international insolvency law and the Bankruptcy Code to be studied in order to better coordinate the resolution of global systemic financial companies.

In addition, the Act requires the Financial Oversight Council to analyze the treatment of fully secured creditors under the OLA. Without being prejudicial to existing law regarding the treatment of secured creditors in a resolution, the Council is obligated to review resolution authority under the Bankruptcy Code, FDIA and OLA regimes, and “examine how a haircut (of various degrees) on secured creditors could improve market discipline and protect taxpayers”. In addition, the Council must compare prudent consumer and small business secured lending practices to those used by depositories with respect to large, interconnected financial firms; consider whether credit differs according to different types of collateral and different terms and timing of the extension of credit; and include an examination of stakeholders who were unsecured or under-collateralized and seek collateral when a firm is failing, and the impact that such behavior has on financial stability and an orderly resolution that protects taxpayers if the firm fails. Each study is required to be completed within one year following the enactment of this legislation.

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<sup>79</sup> See § 210(o).

<sup>80</sup> See §§ 216, 217.

# Clients & Friends Memo

## Hedge Fund Regulation Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

July 20, 2010

The inevitable heightened regulation of the hedge fund industry has come to fruition with the passing of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “**Act**”) by the Senate on July 15, 2010. It now awaits the signature of President Obama. While the Act could be worse – it does not appear to be the operational and expense burden to hedge funds that Sarbanes-Oxley is for corporate America – its ultimate effects remain to be seen, as much of the detailed formulation and implementation of the Act’s largely ambiguous provisions are left to future rulemaking by a wide range of increasingly powerful governmental regulators having tremendous discretionary authority, such as the Securities and Exchange Commission (“**SEC**”), the Commodity Futures Trading Commission (“**CFTC**”), the Board of Governors of the Federal Reserve System (the “**Federal Reserve**”), and the to-be-established Financial Stability Oversight Council<sup>1</sup> (the “**FSOC**”).

What is clear, however, is that the composition of the set of registered investment advisers will change dramatically with the SEC’s regulatory efforts being concentrated on managers with a larger amount of assets under management (“**AUM**”). The Act accomplishes this through changes in the statutory provisions governing the investment advisers that are required to, and indeed are able to, register as investment advisers with the SEC. Larger fund managers that were not previously registered will be required to register, and smaller fund managers that are registered may

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act’s application to specific industries, entities and transactions. To see these other memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

<sup>1</sup> The Act establishes the FSOC, which will consist of the Treasury Secretary, the respective heads of the SEC, CFTC, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Federal Reserve, National Credit Union Administration Board, Federal Housing Finance Agency and (new) Bureau of Consumer Financial Protection, and an independent insurance expert named by the President and confirmed by the Senate.

need to de-register (subjecting them in most instances to a patchwork of state investment adviser regulation).<sup>2</sup>

Coupled with this altered pool of registered advisers is a significantly enhanced disclosure and reporting regime. Important proprietary information on both strategies and portfolios is required to be reported to the government, under the guise of preventing another financial calamity (how so many small snippets of information can be meaningfully analyzed to prevent a future financial crisis will be interesting to see). This, of course, is to say nothing of the remarkable volume of transaction information with respect to swaps that is required to be disclosed under Title VII of the Act.

What is more troubling are the open-ended powers that the Act confers upon the Federal Reserve and the FSOC to regulate systemically significant financial firms, which could include certain large hedge funds. The ultimate effect of these broad powers – which could include the ability to impose capital requirements and even to intercede in the actual business affairs of these financially significant funds – is unknown.

Further, hedge funds that enter into a significant volume of swaps may be required to register with either or both of the SEC and the CFTC as “major swap participants.” Such forced registration could entail regulation of capital as well as other significant requirements that could endanger individual funds’ operating models, to say nothing of the expense of such regulation. Added to this is the substantially increased CFTC regulation to which certain fund managers will be subject, as the Act’s new treatment of many swaps as futures will cause many funds to be considered commodity pools, and thus their managers may be required to register with the CFTC as “commodity pool operators” or “commodity trading advisors” unless an exemption applies.

The following discussion highlights the most noteworthy effects the Act will have on the regulatory regime under which hedge funds and asset managers operate:

## **I. Investment Adviser Registration**

### **A. Elimination of “Fewer than 15 Clients” Exemption**

Until now, many advisers to hedge funds and other investment vehicles have relied upon the exemption contained in Section 203(b)(3) of the Investment Advisers Act

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<sup>2</sup> From the standpoint of national economic policy, this is in fact one aspect of the Act that does seem sensible: to focus on the oversight of advisers having control over greater sums of money and leaving the regulation of smaller advisers to the states, which, in theory, should have the personnel to oversee this larger number of advisers. That said, advisers who are forced to de-register with the SEC and re-register with numerous states are likely to face increased expenses and compliance issues from dealing with numerous local regulators.

of 1940, as amended (the “**Advisers Act**”), as their basis for not registering with the SEC under the Advisers Act. Section 203(b)(3) exempts advisers that have fewer than 15 clients, do not “hold themselves out to the public as investment advisers” and do not provide advice to investment companies registered, or companies electing business development company treatment, under the Investment Company Act of 1940, as amended (the “**Investment Company Act**”). Title IV of the Act eliminates this exemption. Many advisers that relied upon Section 203(b)(3) therefore will be required to register with the SEC as investment advisers, regardless of the number of clients they advise, provided they meet the \$100 million of AUM threshold discussed below (or \$150 million in the case of certain advisers to “private funds”), unless they qualify for a different exemption.

As is the case with most of the provisions of Title IV, the elimination of Section 203(b)(3) becomes effective one year after the date of the Act’s enactment.

#### **B. Increase in AUM Threshold for SEC Registration**

Previously, an investment adviser generally could not register with the SEC unless it had at least \$25 million of AUM, leaving the registration of advisers with less AUM to the individual states. The Act raises this threshold to \$100 million (or such higher amount as the SEC, by rule, may determine) in an effort to permit the SEC to focus its resources on larger managers. As a result, advisers with less than \$100 million of AUM generally will not be permitted to register with the SEC (or, if already registered, will be required to withdraw their registrations) if they are otherwise required to register with and be subject to examination by the state in which their principal office and place of business is located.<sup>3</sup> However, advisers with at least \$25 million of AUM will be permitted to register with the SEC if (1) without such registration, they would be required to register with 15 or more states; or (2) they are not subject to registration or examination in the state where they have their principal office and place of business. Regardless of AUM, registration is still required for advisers to registered investment companies and business development companies.

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<sup>3</sup> Given the manner in which the Act is drafted in relation to state Blue Sky laws, this provision does not apply to advisers with their principal office in either New York State (because New York law does not authorize routine examinations of registered advisers) or Wyoming (because Wyoming has no statutory requirement for adviser registration). Rather, advisers in either of those states will be required to register with the SEC if they have AUM of at least \$30 million and will be permitted to register if they have AUM of at least \$25 million in the case of New York advisers, and AUM of any amount in the case of Wyoming advisers.

**C. Addition or Modification of Other Registration Exemptions**

The Act adds certain new exemptions from Advisers Act registration and pares back on one existing exemption. The newly-added or modified exemptions relate to:

- advisers to “private funds” with aggregate AUM in the U.S. under \$150 million;
- advisers to “venture capital funds”;
- advisers to “small business investment companies”;
- “foreign private advisers”;
- “family office” advisers;
- intrastate advisers with no private fund clients; and
- certain commodity trading advisors.

**D. Definition of “Private Fund”**

The Act defines a “private fund” as any fund that would be an investment company (including foreign entities offering securities in the U.S.) but for the exceptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act. This “private fund” concept is used throughout the Act whenever new regulation is meant to apply to hedge funds, private equity funds and similar investment vehicles. However, the Act is unclear in many instances in distinguishing between investment advisers, on the one hand, and the funds they manage, on the other hand. Clarification of this distinction in related regulations will be important in determining how the Act’s provisions affect the hedge fund industry and to which entities the Act’s provisions apply.

**E. Small Private Fund Advisers**

The Act directs the SEC to provide an exemption for advisers for which the sole clients are “private funds” and which have aggregate AUM in the U.S. of less than \$150 million (“**Small Private Fund Advisers**”), although such advisers will be subject to certain recordkeeping and reporting requirements, to be established by SEC rules.

Note that the Act directs the SEC to consider the systemic risk of “mid-sized private funds” and authorizes the SEC to require registration and examination of advisers to such funds commensurate with their level of systemic risk. However, the Act does not define “mid-sized private funds.”

#### **F. Advisers to Small Business Investment Companies and Venture Capital Funds**

The Act also creates new exemptions for advisers for which the sole clients are: (1) “small business investment companies” (“**SBICs**”) licensed, or applying for a license, under the Small Business Investment Act, provided the client<sup>4</sup> is not a “business development company” under Section 54 of the Investment Company Act; or (2) “venture capital funds.” The Act requires the SEC, by rule issued within one year after enactment, to define the term “venture capital fund.” The SEC is also directed to require venture capital fund advisers to maintain such records and file such reports with the SEC as the SEC determines necessary or appropriate.

Although the exemptions for Small Private Fund Advisers and advisers to SBICs and venture capital funds each use the term “solely,” it is unclear whether the foregoing exemptions will be construed to work in tandem to cover a Small Private Fund Adviser with other clients that are solely SBICs and/or venture capital funds.

#### **G. Offshore Advisers**

The Act creates a new exemption for “foreign private advisers.” The Act defines “foreign private advisers” as investment advisers (1) with no place of business in the U.S.; (2) that do not hold themselves out to the public in the U.S. as investment advisers; (3) that do not advise investment companies registered, or business development companies filing elections, under the Investment Company Act; (4) that have fewer than 15 total U.S. clients, including for this purpose U.S. investors in private funds managed by the adviser; and (5) that have less than \$25 million of AUM attributable to such U.S. clients and investors (or such greater amount as the SEC may provide by rule). Because this exemption is quite narrow,

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<sup>4</sup> Although the Act describes business development status as applying to the adviser itself, we assume this reference was intended to apply to the status of the adviser’s clients.

a large number of offshore advisers will likely be required to either register under the Advisers Act or limit their provision of advisory services to U.S. investors.<sup>5</sup>

Note that the SEC has historically taken the position that a number of the Advisers Act's provisions are generally not applicable to an offshore adviser's relationship with its non-U.S. clients. For example, when the SEC adopted a subsequently- invalidated rule in 2004 requiring both U.S. and offshore advisers to "look through" their fund clients for purposes of determining whether they qualified for the Section 203(b)(3) exemption (the under 15 client exemption), the SEC indicated that, although an offshore adviser might be registered with the SEC on the basis of the number of U.S. investors in one or more of its offshore funds, "because the offshore fund would be a non-U.S. client, the substantive provisions of the [Advisers] Act generally would not apply to the offshore adviser's dealings with the offshore fund."<sup>6</sup> The SEC noted that any U.S. investors in such a fund should not expect the full protection of the U.S. securities laws.

With that premise in mind, the SEC concluded that registered offshore advisers would be required to maintain certain books and records (including records of certain personal securities transactions) and submit to examinations by the SEC staff. However, the SEC also concluded that, at least with respect to its offshore activities, such an adviser would not be subject to the Advisers Act compliance procedures rule (Rule 206(4)-7), custody rule (Rule 206(4)-2), proxy voting rule (Rule 206(4)-6), rule regarding customer solicitations (Rule 206(4)-3), advertising rule (Rule 206(4)-1), or brochure rule (Rule 204-3), and would not be subject to the prohibition on performance fees contained in Section 205 of the Advisers Act, the provisions of Section 205 relating to advisory agreements, or the Section 206(3) restrictions on "principal transactions."

Whether the SEC will take a similar approach with respect to the implementation of the Act in the context of offshore advisers is currently unclear.

#### **H. Family Offices**

The Act adds an exemption for "family offices," to be defined by SEC rule, regulation or order to (1) be construed in a manner that is consistent with the

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<sup>5</sup> It is unclear whether offshore advisers can rely upon the exemption for Small Private Fund Advisers, and if so, whether the exemption's assets under management "in the U.S." test would apply solely to the assets of such adviser's U.S. domiciled funds or would extend to U.S. investors in such adviser's offshore funds. The SEC will need to clarify these issues.

<sup>6</sup> SEC Rel. No. IA-2333 (Dec. 2, 2004) at 69 Fed. Reg. 72054, 72072 at n. 213 (Dec. 10, 2004).

previous exemptive policy of the SEC; (2) recognize a range of organizational, management and employment structures used by family offices; and (3) not exclude certain grandfathered advisers. Based on the foregoing, the term “family office” is likely to include single-family offices that provide a wide range of services in addition to investment advice and to other family offices that operate under the specific requirements of SEC exemptive orders issued before January 1, 2010. It does not appear that multi-family offices will be covered by this exemption.

**I. Intrastate Advisers**

The Act eliminates the existing exemption in Section 203(b)(1) of the Advisers Act for an otherwise intrastate adviser if the adviser advises one or more private funds, even if the private funds and all of their investors are located in the same state as the adviser’s principal office.

**J. Commodity Trading Advisors**

The Act adds a new exemption to Section 203(b)(6) of the Advisers Act for commodity trading advisors registered with the CFTC that advise private funds, but requires such advisors to register with the SEC if, after the Act’s enactment date, their business becomes “predominately” the provision of securities-related advice. The Act does not define “predominately.”

**K. State Blue Sky Regulation**

Investment advisers that are not registered with the SEC, and in certain cases one or more of their employees or other representatives, will be subject to regulation in each state (as well as the District of Columbia and certain U.S. territories and possessions) in which a client may be located or from which the adviser provides investment advice, unless one or more federal or state-specific exemptions apply.

For example, Section 222(d) of the Advisers Act provides a “national de minimis standard,” which preempts states from requiring registration of an adviser with no place of business and fewer than six clients in the state in any 12-month period. While an SEC rule presently prohibits a “look-through” to investors in a private fund or other entity when counting clients in this context, it remains to be seen whether that rule will continue in effect following enactment of the Act.

Notwithstanding Section 222(d), most Blue Sky laws include either exceptions from the definition of “investment adviser,” or exemptions from registration, similar

or identical to Section 222(d), and typically (and more generously than Section 222(d)) exclude from the numerical client limit certain types of institutional investors. However, these exceptions and exemptions are not uniform and must be considered on a state-by-state basis.

If an adviser is required to register with one or more states, Sections 222(b) and (c) of the Advisers Act preempt certain other state requirements, so that a state-registered adviser need only comply with the books and records, capital and bonding requirements of the state in which it has its principal place of business, and not those imposed by other states where it may be registered. However, except as limited by Sections 222(b) and (c), states are free to, and often do, impose disparate requirements on state-registered advisers, so that, for example, an adviser may be subject to different restrictions on its ability to charge performance fees to clients, may be required to file different reports, and may be subject to different custody requirements, in each state in which it is registered, as compared to those permitted or required under the Advisers Act.

In the case of SEC-registered investment advisers, states generally require that advisers offering advice in or from the state make “notice filings,” which may consist of nothing more than a copy of the adviser’s Form ADV and payment of a filing fee. While Section 222(d) of the Advisers Act does not apply to such notice filings, most states have enacted exceptions or exemptions from these filings that track the exceptions and exemptions applicable to state registration (discussed above).

Apart from notice filings, states may not require any other filings from, or impose substantive requirements on, SEC-registered advisers.

Most states also require registration of certain personnel of a state-registered adviser (as well as certain personnel of SEC-registered advisers) as “investment adviser representatives.” In particular, these individuals may be required to pass a qualification exam as a condition of registration.

## **II. Records and Reports**

### **A. Private Fund Records**

The Act contains a number of provisions relating to the maintenance, filing and inspection of records regarding private funds, in each case pursuant to rules to be promulgated by the SEC within 12 months following passage of the Act. In

particular, the Act requires an adviser to maintain, and be subject to SEC inspection with respect to, the following records for each private fund it advises:

- amount of AUM;
- use of leverage (including off-balance sheet leverage);
- counterparty credit risk exposure;
- trading and investment positions;
- valuation policies and practices;
- types of assets held;
- side arrangements or side letters;
- trading practices; and
- other information deemed necessary by the SEC, in consultation with the FSOC.

The Act also requires each adviser to a private fund to file reports containing such information as the SEC deems necessary or appropriate in the public interest or for the assessment of systemic risk.

Furthermore, the Act directs the SEC to conduct periodic inspections of the records of private funds maintained by registered advisers and to conduct such additional examinations as the SEC may deem necessary or appropriate in the public interest or for the assessment of systemic risk. Such advisers must also make available to the SEC, upon request, any copies or extracts of such records “as may be prepared without undue effort, expense or delay.”

Although many hedge fund managers and other asset managers maintain much of this information on a routine basis and disclose some of this information to their investors and counterparties, this information has never before been subject to compulsory disclosure to regulators outside of investigatory or enforcement proceedings.

## **B. Information Sharing and Confidentiality**

The Act requires the SEC to provide the FSOC with any private fund information collected by the SEC and deemed by the FSOC to be necessary to assess the systemic risk posed by such private fund. The SEC and FSOC must generally

maintain the confidentiality of any private fund information they collect, and the Act exempts such information from disclosure under the Freedom of Information Act (“FOIA”).

Notwithstanding the foregoing, the Act provides that such information may be disclosed (1) to Congress, subject to an agreement of confidentiality; (2) to any government agency or self-regulatory organization requesting the information for purposes within the scope of its jurisdiction; or (3) pursuant to a court order in an action brought by the U.S. or the SEC. Information provided to any government agency or self-regulatory organization is also exempt from FOIA disclosure and is subject to the same confidentiality standards applicable to the SEC and FSOC.

Furthermore, “proprietary information” is subject to the same heightened confidentiality standards that apply to facts ascertained by the SEC during examinations. The Act describes “proprietary information” as including sensitive, non-public information regarding (1) the investment or trading strategies of an investment adviser; (2) analytical or research methodologies; (3) trading data; (4) computer hardware or software containing intellectual property; and (5) any additional information that the SEC determines to be proprietary. Investor identity and other investor information is not specifically protected under the Act, the significance of which will depend on whether the SEC can compel disclosure of such information under the information maintenance, filing and disclosure provisions discussed above.

The Act also amends Section 210(c) of the Advisers Act, which generally prohibits the SEC from requiring investment advisers to disclose the identity, investments or affairs of a client, except in an enforcement proceeding or investigation, so as to permit the SEC to require investment advisers to disclose such information for the purpose of assessing potential systemic risk. Although in the registration and exemption context the term “client” generally refers to funds and not to the investors in such funds, the information maintenance, filing and disclosure provisions of the Act are sufficiently vague that it is unclear whether the SEC or another regulator (such as the FSOC) could rely on this provision to require disclosure of private fund investor names and other details that to date have been considered highly confidential by advisers and investors alike.

### **C. Additional Disclosures**

The Act requires each adviser subject to Section 13(f) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), (*i.e.*, advisers with investment

discretion of \$100 million or more of U.S. public company equity and certain other securities) to disclose at least annually its votes cast with respect to U.S. public company say-on-pay proposals and submit a report of the "aggregate amount of the number of short sales" of securities it makes each month. It is not clear whether the report would be of all short sales during the month, which seems to be suggested by the language, or all open positions on the last day of the reporting period, which would be consistent with the current requirements of Section 13(f) as to long positions. Further, it is not clear whether such reports would be required as to all securities or only securities as to which long positions must be reported under Section 13(f).

The Act also makes a number of changes to the reporting requirements for holders of securities subject to Section 13(d) of the Exchange Act, most significantly authorizing the SEC to shorten the time period between a transaction and the required report.

### III. Custody of Client Assets

The Act adds a new Section 223 to the Advisers Act, which requires registered investment advisers to safeguard client assets over which the adviser has custody, including verification of client assets by independent public accountants, as may be prescribed by SEC rule. It is not clear from the Act's text whether any such rule is expected to be in lieu of, or in addition to, the existing "custody rule" (Rule 206(4)-2) under the Advisers Act.

### IV. "Significant Firm" Prudential Safeguards

The Act establishes a new class of systemically significant nonbank financial firms ("SSNFs") that will be subject to new regulations. An SSNF is a firm that directly or indirectly engages in financial activities if the FSOC determines that either (1) material financial distress at the firm could pose a threat to financial stability or the economy; or (2) the nature, scope, size, scale, concentration and interconnectedness or mix of the firm's activities pose such a threat.

Although the SSNF designation is seemingly intended to cover large, traditional financial institutions and certain insurance companies, it is certainly possible that the FSOC will extend SSNF treatment to large hedge funds. It is also unclear how the FSOC will look at hedge funds – is the relevant firm the adviser or the fund? If the latter, will the FSOC use an analysis of similar investment strategies or common control to aggregate a group of smaller private funds?

SSNFs will be subject to Federal Reserve oversight similar to that of banks and bank holding companies, including Federal Reserve examinations, cease and desist orders for unsound practices or business activities deemed by the Federal Reserve to pose a “grave threat” to U.S. financial stability, conditions on the conduct of one or more activities, limits on mergers and acquisitions, forced divestitures of off-balance sheet assets, and forced liquidation by the Federal Deposit Insurance Corporation (“**FDIC**”).

SSNFs will also be subject to new regulation to be promulgated by the Federal Reserve, in consultation with the FSOC. Such new regulation will be more strict than comparable regulation applicable to ordinary banks and bank holding companies and will cover the following:

- Risk-based capital requirements;
- Contingent capital (convertible debt) requirements;
- Risk management requirements;
- Liquidity requirements;
- Credit exposure and other reporting requirements;
- Limits on short-term debt, including margin and repurchase financing;
- Semi-annual stress tests;
- “Living will” plans to facilitate the firm’s rapid, orderly liquidation;
- Restrictions on investment in banks, thrifts and other financial companies;
- Separation of banking activities from other operations; and
- Other prudential standards deemed appropriate by the Federal Reserve.

Of these regulations, the capital requirements, liquidity requirements, debt financing limits and restrictions on investments in financial companies are likely to be the most significant for hedge funds designated as SSNFs, although the particular details of each of these regulations remains unclear.

In addition to these regulations, the Act subjects the officers and directors of SSNFs forcibly liquidated by the FDIC to potential civil liability for gross negligence or similar misconduct leading to such liquidation, and to a potential compensation clawback for the two years leading up to such liquidation.

## V. Large Firm Stress Testing

The Act requires any financial company, including any private fund, with more than \$10 billion in total assets, regardless of SSNF status, to conduct annual stress tests under baseline, adverse, and severely adverse conditions, and to file a report with the Federal Reserve and the company's primary financial regulatory agency. Although not specifically provided in the Act, on the basis of accounting rules for balance sheet consolidation, the SEC or other regulators may seek to apply this requirement to a group of funds which are managed by a single manager and have aggregate assets of more than \$10 billion.

## VI. Volcker Rule

The Act establishes the so-called "Volcker Rule," which, among other things and subject to certain exceptions, prohibits banks, bank holding companies, entities treated as bank holding companies (such as foreign banks with a U.S. presence) and any of their affiliates ("**Covered Banks**") from investing in or sponsoring any private fund or any similar fund that the federal banking agencies, the SEC and the CFTC may, by rule, include within the scope of the prohibition ("**Covered Funds**").

The provisions of the Volcker Rule will become effective twelve months after the adoption of the coordinated final regulations by the federal banking agencies, the SEC and the CFTC, but in no case later than two years after passage of the Act. Covered Banks that currently engage in the prohibited activities will have an additional two years to wind down or divest such activities, subject to three additional one-year extensions granted by the Federal Reserve and an additional five-year extension, also granted by the Federal Reserve, for activities involving illiquid funds or certain currently existing contractual obligations. Thus, it is possible that certain Covered Banks will have as many as seven years to address the Volcker Rule's requirements with respect to certain Covered Funds.

### A. Investing in Private Funds

Despite the Volcker Rule's general prohibition, Covered Banks will be permitted to invest in Covered Funds if the Covered Bank organizes the fund, subject to certain restrictions on the amount of the investment. Under this exemption, a Covered Bank is permitted to establish a Covered Fund and provide the fund with sufficient initial equity capital for investment to permit the fund to attract unaffiliated investors. The Covered Bank is required actively to seek unaffiliated investors, and within one year after the fund is established, the Covered Bank is required to have reduced its investment (whether by redemption, sale, or dilution) as follows:

- the Covered Bank's investment in an individual Covered Fund does not exceed 3% of the total net asset value of the fund (it is unclear how the coordinated final regulations will treat master-feeder structures when making this calculation);
- the Covered Bank's investment in such fund is "immaterial" to the Covered Bank as defined in the coordinated final regulations, and provided further that the aggregate of all such investments by the Covered Bank does not exceed, on a consolidated basis, 3% of its Tier 1 capital; and
- the Covered Bank's total amount of investment in Covered Funds (including the amount of the Covered Funds' leveraged assets) must be deducted from the Covered Bank's assets and tangible equity for purposes of determining compliance with the new capital requirements for Covered Banks (discussed below).

#### **B. Sponsoring Private Funds**

The Volcker Rule prohibits Covered Banks from "sponsoring" a Covered Fund, which includes (1) serving as the general partner, managing member or trustee of the fund; (2) selecting or controlling a majority of the directors or trustees or management of the fund; or (3) sharing the same or similar name with the fund for marketing, promotion, or other purposes.

Despite the Volcker Rule's general prohibition, a Covered Bank will be permitted to sponsor a Covered Fund provided the following conditions are satisfied:

- the Covered Bank provides "bona fide trust, fiduciary, or investment advisory services";
- such fund is organized and offered only in connection with such bona fide services and only to persons that are customers of such services;
- the Covered Bank does not acquire or maintain any ownership interest in the fund except as seed money (discussed above);
- the Covered Bank complies with the newly imposed Section 23A and 23B restrictions on transactions between the Covered Bank and the fund (*i.e.*, certain asset purchases and loans, derivatives and other extensions of credit), other than prime brokerage transactions deemed sound by the Federal Reserve;

- the Covered Bank does not assume, guarantee, or otherwise insure the obligations of the fund (or any private equity or hedge fund in which the fund in turn has invested);
- the Covered Bank discloses in writing to its prospective and actual investors that any losses in the fund are borne solely by the fund's investors and not by the Covered Bank;
- the Covered Bank and the fund do not share, whether for corporate, marketing, promotional, or other purposes, the same name or a variation thereof; and
- no director or employee of the Covered Bank takes or retains any ownership interest in the fund, except for those directors or employees that are directly engaged in providing investment advisory or other services to the fund.

### **C. Prudential Limits on Exempted Activities**

All of the above exemptions are subject to prudential limitations, including that no otherwise exempt transaction or activity may:

- involve or result in a material conflict of interest;
- result in a material exposure by the Covered Bank to high-risk assets or high-risk trading strategies;
- pose a threat to the safety and soundness of the Covered Bank; or
- pose a threat to the financial stability of the U.S.

The federal banking agencies, the SEC and the CFTC are required to adopt coordinated final regulations implementing these limitations (including defining the terms used, such as "material conflict of interest," "high-risk assets," and "high-risk trading strategies").

The Act also requires the federal banking agencies, the SEC and the CFTC, as part of the coordinated final regulations, to adopt rules regarding additional capital requirements, diversification, and quantitative limits (including diversification requirements) for Covered Banks sponsoring or investing in Covered Funds, if the agencies determine that such additional capital requirements and quantitative limits are appropriate for safety and soundness reasons.

**D. Foreign Entities**

The Volcker Rule permits a foreign banking entity with affiliates engaged in U.S. operations to sponsor or invest abroad in hedge funds or private equity funds, provided that the transactions are solely with non-U.S. residents.

**VII. Major Swap Participants**

The Act provides a comprehensive scheme for regulation of “swaps,” including:

- SEC and/or CFTC registration of buy-side participants, including certain hedge funds, as “major swap participants”;<sup>7</sup>
- capital and conduct requirements for major swap participants similar to those applicable to swap dealers;
- mandatory central clearing of certain swaps and margin requirements on many other swaps;
- trade reporting obligations; and
- position limits.

In this context, the term “swap” is defined in an extremely broad manner, including transactions traditionally regarded as swaps and potentially more.

In particular, a “major swap participant” is a legal entity (*i.e.*, not a group of related companies) that, subject to certain exemptions, either (1) maintains a substantial position in swaps in any major swaps category; (2) engages in swaps that create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or (3) is a financial entity that is highly leveraged, is not subject to U.S. bank capital requirements and maintains a substantial position in swaps in any major swaps category. While the Act’s language is subject to regulatory interpretation by the SEC and CFTC, it is likely that at least some hedge funds will satisfy one or more of these three tests.

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<sup>7</sup> More precisely, large users of swaps regulated by the CFTC are defined as “major swap participants” and large users of security based swaps regulated by the SEC are defined as “major security based swap participants.” The Act generally treats both groups in a similar and parallel fashion.

### VIII. Accredited Investor Standard

Currently the test for “accredited investor” status with respect to natural persons under the Securities Act of 1933, as amended (the “**Securities Act**”), is either a net worth of at least \$1 million or an annual income of at least \$200,000 (or \$300,000 joint income with spouse). The Act adjusts the net worth threshold so that, upon enactment and for 4 years thereafter, the value of the investor’s primary residence is not included in such investor’s net worth. The Act importantly does not make any changes to the annual income threshold.

The Act authorizes the SEC to conduct an initial general review of the definition of “accredited investor,” as applied to natural persons, and to promulgate rules adjusting the provisions of the definition that do not relate to the net worth test.

Beginning on the fourth anniversary of the passage of the Act and at least once every four years thereafter, the Act requires the SEC to review the definition of “accredited investor,” as applied to natural persons, and gives the SEC broad authority to modify the definition, including the net worth test, as appropriate for the protection of investors, in the public interest, and in light of the economy.<sup>8</sup>

Although this new standard reduces the number of potential new investors in private funds, the Act does not require existing investors to withdraw from private funds if such investors do not meet the new standard.

### IX. “Bad Boy” Disqualification from Reliance on Rule 506

The Act requires the SEC to issue rules, within one year after enactment, disqualifying from reliance on the private offering safe harbor of Rule 506 under Section 4(2) of the Securities Act offerings by issuers which have been, or which have officers, directors, affiliates or placement agents which have been, the subject of certain civil, criminal or administrative proceedings under federal and state laws. This disqualification may affect hedge funds relying on Rule 506 to satisfy the private offering requirements of the

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<sup>8</sup> Curiously, the Act only requires the SEC to consider modifying the definition of “accredited investor” in Rule 215 under the Securities Act, which defines the term for purposes of Sections 2(15) and 4(6) of the Securities Act, exempting offerings not exceeding \$5 million exclusively to “accredited investors.” Since the definitions of “accredited investor” in Rule 215 and in Rule 501(a) of SEC Regulation D (applicable to private offerings complying with Rule 506 under Section 4(2) of the Securities Act) are identical, it is anticipated that any modification to Rule 215 would be accompanied by a conforming change to Rule 501(a).

investment company registration exceptions contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act.<sup>9</sup>

#### **X. Qualified Client Standard**

The Act requires that the various dollar amount tests for “qualified client” status for purposes of Section 205(e) of the Advisers Act, permitting payment of performance fees to investment advisers with regard to such clients, such as the \$1.5 million net worth threshold, be indexed for inflation within one year following enactment and every five years thereafter. Any inflation adjustment that is not a multiple of \$100,000 will be rounded up to the nearest multiple of \$100,000.

Although investors in private funds need not be qualified clients by reason of Section 3(c)(1) or 3(c)(7) of the Investment Company Act, a private fund may not pay a performance fee with respect to investors that do not satisfy the test.<sup>10</sup> There does not appear to be any grandfathering provision for existing investors in private funds, likely making it necessary for some private funds to amend their investment terms to either exclude non-qualified clients or apply a different fee structure to such clients.

#### **XI. Other Potentially Relevant Provisions**

The Act contains other financial market regulatory provisions that may directly or indirectly affect various aspects of the investment management industry. These provisions include the following:

- SEC and CFTC regulation of over-the-counter derivatives and pre-approval of contracts before they can be cleared by a clearing house;
- a requirement that a “securitizer” retain 5% of the credit risk of any asset, and increased disclosure about the underlying assets;
- increased supervision of banks and bank holding companies;
- supervision by the Federal Reserve of holding company subsidiaries;
- the possible imposition of fiduciary duties for broker-dealers;

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<sup>9</sup> Hedge fund offerings to natural persons in the U.S. generally seek to comply with Rule 506 so as to qualify the offering as “covered securities” under Section 18(b)(4)(D) of the Securities Act, which preempts securities registration requirements under Blue Sky laws.

<sup>10</sup> This requirement is most relevant for 3(c)(1) funds because the “qualified purchaser” requirement for 3(c)(7) funds by definition satisfies the “qualified client” test.

- potential restrictions on mandatory predispute arbitration agreements between any investment adviser and its customers or clients;
- creation of a Federal Insurance Office; and
- provisions relating to trade reporting and mortgage loans, among others.

In particular, the provisions relating to swaps and other derivatives will likely have a significant impact on hedge fund trading operations and compliance costs.

## **XII. Studies for Future Regulatory Changes**

The Act mandates the following government studies that could lead to changes in the regulatory framework applicable to private funds and investment advisers:

- a Government Accountability Office (“GAO”) study regarding the compliance costs associated with SEC Rules 204-2 and 206(4)-2 under the Advisers Act with respect to custody of funds or securities of clients by investment advisers and the additional costs if subsection (b)(6) of Rule 206(4)-2 were eliminated (this subsection provides an exemption to the “independent verification” rule when an adviser has “custody” because client assets are held by an “operationally independent” person related to an adviser);
- a GAO study regarding the feasibility of forming a self-regulatory organization to oversee private funds;
- an SEC study regarding the standards of conduct applicable to all broker-dealers and investment advisers when providing personalized investment advice regarding securities to retail customers and whether there are any regulatory gaps or shortcomings;
- an SEC study regarding the need for enhanced examination and enforcement resources with respect to investment advisers;
- an SEC study regarding improved investor access to information on investment advisers and broker-dealers; and
- an SEC study regarding the state of short selling on national securities exchanges and in over-the-counter markets, with particular attention to the impact of recent rule changes and the incidence of the failure to deliver shares sold short and the delivery of shares on the fourth day following a short sale transaction.

While it is clear that the Act will have significant consequences for the regulation of investment managers and their clients – hedge funds in particular – the scope and depth

of these consequences remain uncertain as many provisions await clarification and implementation by various regulatory agencies.

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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# Clients & Friends Memo

## Insurance Reforms Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

July 20, 2010

On July 15, 2010, the Senate voted in favor of adopting the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). The Act is far-reaching in scope and represents the culmination of months of debate and intense lobbying. The Act was precipitated by the financial crisis that began in 2007 and, therefore, its primary goal is to prevent a recurrence. The focus of this Memorandum is Title V – “Insurance” – of the Act.

### I. Subtitle A of Title V of the Act — Federal Insurance Office

Subtitle A (“Subtitle A”) of Title V of the Act, referred to as the “*Federal Insurance Office Act of 2010*”, establishes the Federal Insurance Office (the “FIO”) within the Department of the Treasury. The FIO is the first federal office created that focuses solely on insurance and will be headed by a director (the “Director”) appointed by the Secretary of the Treasury. Historically, the federal government has left the regulation of the insurance industry to the states. The creation of the FIO and the other provisions of Subtitle A of the Act described below may be an indication that the federal government intends to play a larger role in the regulation of the U.S. insurance industry.<sup>1</sup>

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

<sup>1</sup> Companies engaged in insurance activities are potentially subject to Federal Reserve regulation under Title I of the Act as well. Under Title I, the Financial Stability Oversight Council (FSOC) may designate nonbank companies engaged in financial-in-nature activities (which would include an insurance company) as subject to heightened supervision by the Federal Reserve if the FSOC determines that the insurance company's activities are sufficiently economically significant to warrant such heightened supervision. For a discussion of the provisions of Title I, see the memorandum entitled [Regulation of Systemically Significant NonBanks Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#).

The FIO is tasked with overseeing all lines of insurance except for (i) health insurance,<sup>2</sup> (ii) long-term care insurance (except long-term care insurance that is included with life or annuity insurance components)<sup>3</sup> and (iii) crop insurance.<sup>4</sup> The FIO has the authority to:

- monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system;
- monitor the extent to which traditionally underserved communities and consumers, minorities and low- and moderate-income persons have access to affordable insurance products (except health insurance);
- recommend that the Financial Stability Oversight Council (“FSOC”) designate an insurer (including its affiliates) as an entity that should be subject to regulation as a nonbank financial company supervised by the Board of Governors of the Federal Reserve System pursuant to Title I of the Act on the basis that such insurer (or affiliate) presents a potential risk to the U.S. financial system;<sup>5</sup>
- assist the Secretary of the Treasury in administering the terrorism insurance program established pursuant to the Terrorism Risk Insurance Act;
- coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters, including representing the U.S. in the International Association of Insurance Supervisors;
- assist the Secretary of the Treasury in negotiating “covered agreements” between the U.S. and foreign governments or regulatory authorities (as discussed below); also, determine whether state insurance measures are preempted by any such covered agreements;
- consult with the states (and their insurance regulators) regarding insurance matters of national and international importance; and
- perform such other related duties and authorities as may be assigned to the FIO.

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<sup>2</sup> As determined by the Secretary of the Treasury in coordination with the Secretary of Health and Human Services based on section 2791 of the Public Health Service Act (42 U.S.C. 300gg-91).

<sup>3</sup> As determined by the Secretary of the Treasury in coordination with the Secretary of Health and Human Services.

<sup>4</sup> As established by the Federal Crop Insurance Act (7 U.S.C. 1501 *et seq.*).

<sup>5</sup> See footnote 1.

The FIO will also advise the Secretary of the Treasury on both domestic and international insurance policy issues and the Director will serve in an advisory capacity on the FSOC. In order to carry out the foregoing tasks, the FIO is empowered to, among other things, collect and gather data from insurers and the insurance industry, analyze and disseminate such data and issue reports on all lines of insurance (except health insurance overseen by the FIO).

**A. Information Gathering**

The FIO may require an insurer (or its affiliate) to submit information or data to it in order to carry out its prescribed functions; *provided, however*, certain “small” insurers that meet a minimum size threshold to be established by the FIO will be exempt from having to comply with any such information requests. Prior to requesting information directly from insurers, the FIO is required to coordinate with federal agencies and state insurance regulators (and any publically available sources) to determine whether the information that is the subject of the request can be obtained in another manner from another source. If such information is available from another source in a timely manner, the FIO will collect the information from such source instead of from the insurer. In the event that that nonpublic information is submitted by an insurer to the FIO, such submission (a) will not constitute a waiver of any privilege under federal or state law to which the information is otherwise subject and (b) will continue to be protected by any prior confidentiality agreements entered into that covers such information. Information that is gathered by the FIO may be shared with state insurance regulators through an information sharing agreement. Significantly, subject to certain requirements, the Director is granted the power to require by subpoena the production of any data that it requests as part of its information-gathering function.

**B. Preemption of State Insurance Measures**

The FIO may preempt state insurance measures,<sup>6</sup> but only if the Director determines that the measure (A) results in less favorable treatment of a non-U.S. insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a U.S. insurer domiciled, licensed, or otherwise admitted in that state; and (B) is inconsistent with a covered agreement. Prior to making any determination to preempt a state insurance measure, the Director must notify and consult with the applicable state and the United States Trade Representative, publish in the Federal Register notice of the potential inconsistency with a covered agreement (including a description thereof), provide a reasonable opportunity for interested parties to comment and consider such comments. If the Director concludes that

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<sup>6</sup> State insurance measures are defined as any state law, regulation, administrative ruling, bulletin, guideline or practice relating to or affecting prudential measures applicable to insurance or reinsurance.

there is an inconsistency, the Director will then notify the state, establish a reasonable period of time (not less than 30 days) before the determination becomes effective, notify certain committees of Congress and publish a notice in the Federal Register. No state could then enforce insurance measures that were preempted by these provisions (although the decision to preempt could be appealed to a federal court). Subtitle A does not preempt, however, (A) any state insurance measure that governs any insurer's rates, premiums, underwriting, or sales practices, (B) any state coverage requirements for insurance, (C) the application of the antitrust laws of any state to the business of insurance, or (D) any state insurance measure governing the capital or solvency of an insurer, except to the extent that such state insurance measure results in less favorable treatment of a non-U.S. insurer than a U.S. insurer.

**Note:** *Despite the preemption power, the Act is clear that nothing therein should be construed to provide the FIO or the Department of the Treasury with general supervisory or regulatory authority over the business of insurance, which authority is intended to remain with state insurance regulators.*

**C. Reports**

Under the Act, the Director is tasked with providing certain reports on the U.S. and global reinsurance markets, including the following:

- Beginning on September 30, 2011 (and on an annual basis thereafter), the Director must submit to the President and to Congress a report on any actions taken by the FIO to preempt inconsistent state insurance measures.
- Beginning September 30, 2011 (and on an annual basis thereafter), the Director must submit to the President and Congress a report on the insurance industry and any other information the Director deems relevant or that is requested by certain committees of Congress.
- No later than September 30, 2012, the Director must submit to Congress a report describing the breadth and scope of the global reinsurance market and the critical role such market plays in supporting insurance in the U.S.
- No later than January 1, 2013 (and updated not later than January 1, 2015), the Director must submit to Congress a report regarding the ability

of state regulators to access reinsurance information for regulating companies in their jurisdictions.

- No later than 18 months after enactment, the Director must submit to Congress a report on how to modernize and improve the system of insurance regulation in the United States. This report is to be based on the following considerations, as well as any other considerations the Director determines are necessary and appropriate:
  - systemic risk regulation with respect to insurance;
  - capital standards and the relationship between capital allocation and liabilities, including standards relating to liquidity and duration risk;
  - consumer protection for insurance products and practices, including gaps in state regulation;
  - the degree of national uniformity of state insurance regulation;
  - the regulation of insurance companies and affiliates on a consolidated basis;
  - international coordination of insurance regulation;
  - the costs and benefits of potential federal regulation of insurance across various lines of insurance (except health insurance);
  - the feasibility of regulating only certain lines of insurance at the federal level, while leaving other lines of insurance to be regulated at the state level;
  - the ability of any potential federal regulation or federal regulators to eliminate or minimize regulatory arbitrage;
  - the impact that developments in the regulation of insurance in foreign jurisdictions might have on the potential federal regulation of insurance;
  - the ability of any potential federal regulation or federal regulator to provide robust consumer protection for policyholders; and
  - the potential consequences of subjecting insurance companies to a federal resolution authority, including the effects of any federal resolution authority: (i) on the operation of state insurance

guaranty fund systems, including the loss of guaranty fund coverage if an insurance company is subject to a federal resolution authority; (ii) on policyholder protection, including the loss of the priority status of policyholder claims over other unsecured general creditor claims; (iii) in the case of life insurance companies, on the loss of the special status of separate account assets and separate account liabilities; and (iv) on the international competitiveness of insurance companies.

**D. Covered Agreements**

Subtitle A authorizes the Secretary of the Treasury and the United States Trade Representative to jointly negotiate and enter into covered agreements on behalf of the U.S. A “*covered agreement*” is defined generally as an agreement regarding prudential measures with respect to the business of insurance or reinsurance entered into between the U.S. and a foreign government, authority or regulatory entity that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under state insurance or reinsurance regulation. Before entering into a covered agreement, certain technical requirements must be followed, including a consultation with Congress regarding (a) the nature of the agreement, (b) how and to what extent such agreement would achieve the purposes, policies, priorities and objectives of Subtitle A and (c) the implementation of the agreement, including the general effect of the agreement on existing state laws.

**II. Subtitle B of Title V of the Act — State-Based Insurance Reform**

**A. Nonadmitted Insurance**

Part I of Subtitle B (“**Subtitle B**”) of Title V of the Act is referred to as the “*Nonadmitted and Reinsurance Reform Act of 2010*.” Subtitle B reforms the regulation of the nonadmitted property/casualty insurance markets and the reinsurance markets. Nonadmitted insurance refers to casualty insurance permitted to be placed directly or through a surplus lines broker with a nonadmitted insurer<sup>7</sup> eligible to accept such insurance. The term “*surplus lines broker*” means an individual, firm, or corporation which is licensed in a state to sell, solicit, or negotiate insurance on properties, risks, or exposures located or to be performed in a state with nonadmitted insurers.

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<sup>7</sup> A “nonadmitted insurer” is defined as “with respect to a state, an insurer not licensed to engage in the business of insurance in such state but does not include a risk retention group, as that term is defined in section 2(a)(4) of the Liability Risk Retention Act of 1986.”

Subtitle B provides certain consumer protections to policyholders by prohibiting a state, other than the home state of the insured, to require any premium tax be paid for nonadmitted insurance (although the states may establish procedures to allocate among the states the premium taxes paid by an insured to an insured's home state). The term "home state" generally means (i) the state in which an insured maintains its principal place of business or, in the case of an individual, the individual's principal residence or (ii) if 100% of the insured risk is located out of the state referred to in clause (i), the state to which the greatest percentage of the insured's taxable premium for that insurance contract is allocated. Congress expressed its intent in Subtitle B of the Act that each state adopt nationwide uniform requirements, forms and procedures that provide for the reporting, payment, collection and allocation of premium taxes for nonadmitted insurance. The states are authorized to require surplus lines brokers and insurers to annually file tax allocation reports with the insured's home state detailing the portion of the nonadmitted insurance policy premium attributable to properties, risks, or exposures located in each state.

Subtitle B also provides that, except as otherwise stated therein, the placement of nonadmitted insurance is subject to the statutory and regulatory requirements solely of the insured's home state. Also, no state, other than the insured's home state, may require a surplus lines broker to be licensed in order to sell, solicit or negotiate nonadmitted insurance with respect to such insured. In connection with the foregoing, any law, regulation, provision or action of any state that applies to nonadmitted insurance sold to, solicited by, or negotiated with an insured whose home state is another state is preempted; *provided, however*, that there is a workers' compensation exception to this preemption for any law, rule or regulation that restricts the placement of workers' compensation insurance or excess insurance for self-funded workers' compensation plans with a nonadmitted insurer.

1. *Uniform Standards*

In order to promote uniform laws and regulations regarding the licensure of surplus lines brokers, Subtitle B prohibits a state from collecting any fees relating to licensing of a surplus lines broker unless such state has in effect within two years after the enactment of Subtitle B, laws and regulations that provide for participation by the state in the national insurance producer database of the National Association of Insurance Commissioners ("NAIC") or another equivalent uniform database. Also, in an attempt to provide for uniformity, a state is prohibited from imposing eligibility criteria for nonadmitted insurers domiciled in the U.S. except in

conformance with the requirements and criteria in Sections 5A(2) and 5C(2)(a) of the Non-Admitted Insurance Model Act (which provides for certain minimum capital and surplus requirements), unless the state adopts “nationwide uniform requirements, forms and procedures.” In addition, a state may not prohibit a surplus lines broker from placing nonadmitted insurance with a nonadmitted insurer domiciled outside the U.S. that is listed on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC.

2. *Streamlined Application for Commercial Purchasers*

States are prohibited from requiring a surplus line broker that is placing nonadmitted insurance for an “exempt commercial purchaser” from making a due diligence search to determine whether the full amount or type of insurance sought by such commercial purchaser can be obtained from admitted insurers if (a) the broker producing it has disclosed to the purchaser that such insurance may or may not be available from an admitted market that may provide greater protection with more regulatory oversight and (b) the commercial purchaser has requested in writing thereafter that the broker produce or place such insurance from a nonadmitted insurer. For purposes of above, an exempt commercial purchaser is defined as follows:

- (a) a purchaser of insurance who employs or retains a qualified risk manager to negotiate insurance coverage;
- (b) has paid aggregate nationwide commercial property and casualty insurance premiums in excess of \$100,000 in the immediately preceding 12 months; and
- (c) (i) meets at least one of the following criteria:
  - (I) possesses a net worth in excess of \$20,000,000;
  - (II) generates annual revenues in excess of \$50,000,000;
  - (III) employs more than 500 full-time or full-time equivalent employees per individual insured or is a member of an affiliated group employing more than 1,000 employees in the aggregate;

- (IV) is a not-for-profit organization or public entity generating annual budgeted expenditures of at least \$30,000,000; or
  - (V) is a municipality with a population in excess of 50,000 persons.
- (ii) Effective on the fifth January 1 occurring after the date of the enactment of the Act and each fifth January 1 occurring thereafter, the amounts noted in subclauses (I), (II), and (IV) of clause (c)(i) above will be adjusted to reflect the percentage change for such five-year period in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics of the Department of Labor.
3. *Study of NonAdmitted Insurance Market*

The Comptroller General, in consultation with the NAIC, is required to conduct a study of the impact of Subtitle B of the Act on the size and market share of the nonadmitted insurance market for providing coverage typically provided by the admitted insurance market. In particular, the study will address:

- the change in size and market of the nonadmitted insurance market and in the number of insurance companies and insurance holding companies providing such business;
- the extent to which insurance coverage typically provided by the admitted insurance market has shifted to the nonadmitted insurance market;
- the consequences of any change in the size and market share of the nonadmitted insurance market, including differences in the price and availability of coverage available in both the admitted and nonadmitted insurance markets;
- the extent to which insurance companies and insurance holding companies that provide both admitted and nonadmitted insurance have experienced shifts in the volume of business between admitted and nonadmitted insurance; and

- the extent to which there has been a change in the number of individuals who have nonadmitted insurance policies, the type of coverage provided under such policies, and whether such coverage is available in the admitted insurance market.

## B. Reinsurance

### 1. *Regulatory Reform*

Part II of Subtitle B (“**Part II**”) of the Act contains certain provisions preempting state law governing reinsurance arrangements. Part II provides that if the state of domicile of the ceding insurer (*i.e.*, the insurer purchasing reinsurance) is an NAIC-accredited state (or has financial solvency requirements substantially similar to those imposed by the NAIC) and recognizes credit for reinsurance, then no other state may deny such credit for reinsurance. Furthermore, Part II preempts laws, regulations, provisions or other actions of a state that is not the domiciliary state of the ceding insurer (other than those with respect to taxes and assessments on insurance companies or insurance income) to the extent that they:

- restrict or eliminate the rights of the ceding insurer or the assuming insurer to resolve disputes pursuant to contractual arbitration to the extent such contractual provision is not inconsistent with the provisions of Title 9, United States Code;
- require that a certain state’s law shall govern the reinsurance contract, disputes arising from the reinsurance contract, or requirements of the reinsurance contract;
- attempt to enforce a reinsurance contract on terms different than those set forth in the reinsurance contract itself, to the extent that the terms are not inconsistent with this part; or
- otherwise apply the laws of the state to reinsurance agreements of ceding insurers not domiciled in that state.

### 2. *Regulation of Reinsurer Solvency*

Part II provides that if the state of domicile of a reinsurer is an NAIC-accredited state or has financial solvency requirements substantially

similar to those imposed by the NAIC), (i) such state is then the only state responsible for regulating the solvency of such reinsurer and (ii) no other state may require that the reinsurer provide any additional financial information other than the information the reinsurer is required to file in its domiciliary state (although nothing precludes a state from receiving a copy of the financial information filed with the domiciliary state).

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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# Clients & Friends Memo

## The New Scheme for the Regulation of Swaps, with Appendices on Retroactivity, Special Entities and Tax, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

July 20, 2010

Title VII (the “**Derivatives Legislation**” or the “**Legislation**”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Act**”) is among the most far-reaching and controversial sets of statutory changes included within the Act. The Derivatives Legislation will give primary authority to the Commodity Futures Trading Commission (the “**CFTC**”) and the Securities Exchange Commission (the “**SEC**” and, together with the CFTC, the “**Commissions**”) to regulate the swaps market, both as to transactions and participants, although the various banking regulators (the “**Bank Regulators**” and, together with the Commissions, the “**Regulators**”) will retain substantial authority with respect to banks.

Among other things, the Derivatives Legislation will (i) require that certain “swaps” be traded on exchanges, centrally cleared and publicly reported; (ii) require the registration of both dealers in swaps and large end users with one or both of the Commissions; (iii) authorize the Commissions to establish a comprehensive regulatory system applicable to these registered dealers and end users; (iv) require the establishment of new swap market mechanisms, including exchanges, clearing organizations and swap information “repositories”; and (v) give the Commissions broad and often overlapping powers that they would, in many instances, be required to use jointly, sometimes in conjunction with, or under the direction of, the Bank Regulators. The impact of the Derivatives Legislation reaches far beyond the swaps markets, having at least indirect application to spot or cash market trading.

Many of the key terms in the Derivatives Legislation are either undefined or are left for the Regulators to fill in. Further, there are provisions of the Legislation that may not be readily feasible to implement, such as the authority given the Regulators over the capital requirements of end users,

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

or that may require substantial clarification or amendment, including the definition of the term “swap,” which is, of course, fundamental to the scope of the Legislation. We also note that the manner in which the Derivatives Legislation will be applied to international transactions, which are a large component of the swaps markets, is not apparent.

This Memorandum is broken into 7 parts as follows:

Part I. Sets out in the **overall structure** of the Legislation and certain issues of **regulatory jurisdiction**.

Part II. Discusses the various definitions in the Derivatives Legislation relating to the terms “**swap**,” “**security-based swap**,” and “**security-based swap agreement**” and the new definition of “**security**.”

Part III. Discusses new mandatory central clearing, trade execution and reporting requirements for swaps.

Part IV. Discusses collateral segregation requirements in connection with regulated swaps and bankruptcy reforms intended to protect counterparties of swap intermediaries.

Part V. Defines which **parties (both dealers and end users) to swaps must register** with the CFTC or SEC.

Part VI. Describes the **regulations applicable to parties that have registered**, including the obligations that they owe to their counterparties. Appendix A to this memorandum provides more detail as to the particular requirements that are owed by swap dealers and major swap participants when entering into swaps with “special entities” (a term that includes many governmental entities and plans).

Part VII. Describes certain of the **new trading rules** that would apply to swaps, such as the prohibition on non-exchange traded swaps being sold to non-eligible contract participants (“**ECPs**”) and the regulators’ new authority to establish **position limits** and **large trader reporting**.

One of the major concerns that the Act has raised is with respect to its retroactive impact on existing swaps. This issue is discussed in Appendix B of the memorandum.

Title XVI of the Act, which is discussed in Appendix C to this memorandum, makes certain amendments to section 1256 of the tax code so as to preserve the existing tax treatment of certain swaps. In addition, the Act effectively mandates the standardization of many swaps. Standardized

swaps will require upfront payments. Significant upfront payments on swaps may give rise to tax consequences for end users and dealers.

We have also provided two other memoranda that are particularly significant to the Derivatives Legislation. The effect of the Derivatives Legislation on end users is the particular topic of our memorandum titled [Regulation of End Users of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#). New limitations on banks' authority to enter into swaps are discussed in our memorandum titled [Changes to the Regulation of Banks, Thrifts, and Holding Companies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#).

## Part I. Structure of the Legislation; Who Makes the Rules

### A. Three Parts to Title VII, Split into Two Subtitles

The Derivatives Legislation is divided into two Subtitles (A and B), but effectively is in three parts. Part I of Subtitle A is largely concerned with the division of regulatory authority between the various regulators, and particularly as to how the CFTC and the SEC may resolve any differences between them as to the scope of their respective regulatory jurisdictions. Part II of Title A describes the authority of the CFTC over those transactions that it regulates, defined as “swaps” and “security-based swap agreements”; Subtitle B describes the authority of the SEC over “security-based swaps.” Part II of Subtitle A and Subtitle B run roughly parallel, so we will discuss similar provisions together in each part of this memo, while identifying where there are material differences between them.

### B. CFTC, SEC and Prudential Regulators; Limitations on State Insurance Regulators.

Generally, the Derivatives Legislation amends the Commodity Exchange Act (the “**CEA**”) to provide authority to the CFTC to regulate transactions defined as “swaps” and persons who participate in the swaps market, and amends the Securities Exchange Act of 1934 (the “**Exchange Act**”) to give the SEC jurisdiction over “security-based swaps” and persons who participate in the security-based swaps market. In addition, the Derivatives Legislation provides for (i) joint jurisdiction over “mixed swaps,” which could prove to be a point of contention between the Commissions and (ii) sets out procedures by which the Commissions may determine which of them (if not both) has jurisdiction over “novel derivative products.”<sup>1</sup> Where a banking entity is required to be registered under the Derivatives Legislation, certain of the regulatory requirements would be established by the bank’s primary federal regulator, referred to as its “prudential regulator.”<sup>2</sup>

One interesting feature of the Act (at Section 722 and Section 767) is that it specifically provides that swaps and security-based swaps may not be considered to be insurance and may not be regulated as insurance under the law of any state. While this provision was likely adopted to clarify that state insurance regulators do not have jurisdiction over credit default swaps (“**CDS**”), the provision is not limited to CDS. Given the very broad definition of the term “swap” (as discussed below), questions may arise as to the boundaries between the jurisdiction of the Commissions and the state insurance regulators.

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<sup>1</sup> Derivatives Legislation Sec. 718.

<sup>2</sup> Derivatives Legislation Sec. 721 (defining “prudential regulator”).

### C. Overlapping Regulation.

It is a clear theme of the Derivatives Legislation that there is a preference for a considerable degree of regulation, often regulation of the same matter, such as capital, and in many cases regulation of the same legal entity, by two agencies (the CFTC and the SEC) or by three agencies (the Commissions and the relevant Bank Regulator). While the various regulators are directed to cooperate and adopt similar rules governing similar subject matters, it remains to be seen how this sharing of jurisdiction will work and whether it will prove collegial and efficient.

### D. Limited Exemptive Authority.

Another feature of the Derivatives Legislation relevant to the establishment of the rules thereunder is that the exemptive authorities of the CFTC and the SEC are limited, rather than absolute (*see, e.g.*, Section 772 of the Act). This means that if there are portions of the Derivatives Legislation which, for one reason or another, simply do not work, the Commissions may not be able to “exempt” around the problems—a legislative fix will be required.

## Part II. Definitions

### A. Before the Road Map, an Overview.

The Derivatives Legislation turns on the meaning of the term “swap” and on certain related definitions. These definitions are often complex, and convoluted, and rely on cross-references and incorporation by reference. In brief, the key defined terms around swaps are structured as follows:

**“Swap”**: This term is defined in Subtitle A of the Derivatives Legislation, and is effectively used to mean a derivatives transaction (other than a listed future) that is governed by the CFTC under the CEA. The term “swap” carves out a “security-based swap,” so that, as a general matter, a transaction would not be both a “swap” and a “security-based swap”—unless of course it is a “mixed swap.”

**“Security-based swap”**: This term “security-based swap” is used to mean those trades regulated by the SEC under the Exchange Act. This definition works by carving out a portion of the transactions that would otherwise fit within the definition of the term swap.

**“Security-based swap agreement”**: Note that this is a **different term than** “security-based swap” immediately above and it is used differently for Subtitles A and B. For purposes of Subtitle A, the term applies to a transaction that is (i) a “swap agreement” for purposes of Gramm-Leach-Bliley (*e.g.*, what we currently think of generically as swaps) and (ii) that relates to securities, *but (x)* is primarily regulated by the CFTC, *(y)* while the two Commissions are required to issue joint rules

regarding books and records and to share information and (z) the two Commissions will share anti-manipulation enforcement authority. For purposes of Subtitle B, the term is also used to describe swap agreements that relate to securities, but it is limited to those as to which the CFTC has primary authority (e.g., a swap on a broad-based securities index) and excludes “security-based swaps.” This definition is used where necessary in the securities laws to give the SEC anti-fraud authority with respect to swaps that relate to securities, but that are primarily regulated by the CFTC.

**“Mixed swap”:** This term is used to mean those transactions that have elements of both (i) “swaps” that are regulated by the CFTC and (ii) “security-based swaps” that are regulated by the SEC. Both Commissions will have authority over trades meeting this definition.

**“Security”:** The scopes of the Exchange Act and several of the other securities laws are expanded by adding the term “security-based swap” to the list of instruments within the definition of a “security.” This generally has the effect of making the securities laws, including the registration and regulatory requirements applicable to registrants, applicable to transactions in security-based swaps.

**Other Definitions.** Most of the other definitions in the Derivatives Legislation effectively turn on the definitions above. For example, Subtitle A of the Derivatives Legislation provides for the registration and regulation of “swap dealers” and “major swap participants,” entities whose activities involve “swaps” regulated by the CFTC; Subtitle B of the Legislation provides for the registration and regulation of “security-based swap dealers” and “major security-based swap participants,” entities whose activities involve “security-based swaps” regulated by the SEC.

**A Word on CFTC Jurisdiction and CEA Amended Definitions:** While the CEA is not amended to bring “swaps” into the definition of the term “future,” the CFTC is given broad general authority to regulate swaps and persons who trade swaps, just as it has jurisdiction over persons that trade futures. (In fact, the CFTC’s new jurisdiction over end users of swaps is actually broader in many respects than its jurisdiction over end users of futures.) This means, for example, that corporations, funds and advisers that are participants in the swaps market must consider whether they are now within the amended definitions of a commodity trading advisor (because of giving advice with respect to swaps) or as a commodity pool operator (because of operating a fund or other entity that transacts in swaps).

## B. A Closer Look at “Swaps.”

Understanding of the Derivatives Legislation necessarily begins with the definition of the term “swap” and the various exclusions.

i. *Swap—Starting Definition.* A “swap” is defined in Section 721 of the Act to include (albeit subject to exclusions that will follow) a contract that is (i) one of a laundry list of swap transactions familiar to readers of the Bankruptcy Code; e.g., equity swaps, interest rate swaps, currency swaps, energy swaps, and so on; (ii) an option on virtually anything;<sup>3</sup> (iii) a CDS; (iv) an agreement that provides for the exchange of payments based on the value or level of any property, rate or quantitative measure and that transfers financial risk associated with a future change in any such value or level without also conveying a current or future ownership interest in the underlier; (v) an agreement that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence; and (vi) any combination or permutation of the above.

ii. *Swap—General Exclusions.* From the above broad definition, there are then excluded: (i) listed futures, security futures and other transaction types already regulated by the CFTC; (ii) any sale of a **nonfinancial commodity** for deferred shipment or delivery, so long as such transaction is **intended to be physically settled** (what we would commonly call a “**forward**”); (iii) an option on a security that is “subject to” the Securities Act or the Exchange Act; (iv) foreign currency options listed on U.S. securities exchanges; (v) an agreement as to the sale of one or more securities on a “fixed basis” and that is “subject to” the Securities Act and the Exchange Act; (vi) an agreement as to the sale of one or more securities on a contingent basis and that is “subject to” the Securities Act and the Exchange Act, but not a CDS (a CDS is a swap or a security-based swap); (vii) a note or other evidence of indebtedness that is a “security” as defined in the Securities Act (be aware that the definition of the term “security” includes other types of instruments that are not within this exclusion and which, if they have contingencies associated with them, might be “swaps”); (viii) any agreement that is based on a security and entered into directly or through an “underwriter” (as defined in the Securities Act), by the issuer of the security for the purposes of managing a risk associated with capital raising (which we understand to be a reference to the “greenshoe” portion of an underwriting); (ix) an agreement with the U.S. government, a Federal Reserve Bank or a federal agency that is fully backed by the full faith and credit of the United States; or (x) a “security-based swap” (a term which is further discussed below) other than a “mixed swap.”<sup>4</sup>

iii. *Some Uncertainties and Oddities as to the Definition of Swap.* We mention below a few of the prongs of the swap definition and exclusionary language that are likely to raise

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<sup>3</sup> More specifically, an option may be on, among other things, securities, commodities, instruments of indebtedness, and quantitative measures. As defined in the CEA, the term “commodity” is completely open-ended; it means any tangible or intangible item that may be traded in a market.

<sup>4</sup> For example a swap based on both a single equity security and a broad-based securities index would be both a security-based swap (because of the equity) and a swap (because of the index).

the greatest uncertainty. **The legal uncertainties around two of these issues (forwards and contingent contracts) are discussed in more detail in our related memorandum titled [“Regulation of End Users of Swaps Under the Dodd Frank Wall Street Reform and Consumer Protection Act.”](#)**

(a) *“Intent to Settle by Physical Delivery: Forwards.”* Since its adoption in 1922, the CEA has made a distinction between “futures contracts” and contracts for “deferred delivery” (more commonly known as forward contracts). Speaking generally, a forward contract is one where there is, to quote the Act, an “intent” of physical delivery. That said, historically there was great uncertainty and substantial litigation over what it meant to have an “intent” to settle by physical delivery. We are concerned that the adoption of the Act is likely to re-create the legal uncertainty that was prevalent in the commodity market prior to the adoption of the CMFA.

(b) *Contracts Involving a “Contingency.”* Under the Act, the term “swap” includes **“any agreement, contract, or transaction . . . that provides for any . . . payment or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence.”**<sup>5</sup>

This definition includes a wide variety of non-purchase contracts which include contingencies such as most credit agreements and certainly all floating rate commercial loans, success fee contracts and similar arrangements, and **most forms of insurance**. While this expansive reading of the term “swap” may seem unlikely,<sup>6</sup> in fact prior to the promulgation of a variety of statutory interpretations by the CEA and the eventual adoption of the CMFA, there had been substantial legal uncertainty as to transactions that the CEA might regulate as “futures.” Now that the Act has expanded the CFTC’s jurisdiction so that it is significantly broader than it was before the adoption of the CMFA, questions as to the scope of the CFTC’s jurisdiction over “contingent” contracts will likely move again to the forefront of legal worries, as they were before the adoption of the CMFA.

(c) *Contracts on Foreign Exchange.* Under the Act, the term “swap” includes not only any foreign exchange swap, but also any foreign exchange forward (generally a foreign exchange forward is one that settles by delivery in more than 2 business days); *provided, however*, the Secretary of the Treasury may take certain steps, including making a report to various Congressional committees, carving out such trades from the definition of swap. (The carve out

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<sup>5</sup> Derivatives Legislation Sec. 721 (defining “swap”).

<sup>6</sup> In some respects, it may be worrisome that Congress thought it necessary to carve out the “greenshoe” of a securities underwriting from the definition of the term “swap” - as that is a type of contingent right that would not have come to mind readily as within the common understanding of a “swap.”

would not apply to trades on futures exchange or with retail investors.) However, even if the Secretary of the Treasury takes the required actions—and we assume that he will given the potential for disruption to the economic system if parties could not transact freely cross-border in currencies—foreign exchange swaps and forwards will remain subject to reporting requirements under the Act. Given the volume of trades in currency that will now have to be reported, this is a surprising requirement, particularly as we are not aware of any suggestion that currency trading, which is a traditional banking activity, contributed to the economic crisis.

iv. *Security-Based Swap.* The term “swap” carves out a “security-based swap,” which are those swap-type transactions regulated by the SEC. The term “security-based swap” is limited to the following types of trades that would otherwise be swaps: (i) those referencing a narrow-based security index, (ii) those referencing a single security or a loan, and (iii) CDSs relating to single issuers or the components of a narrow-based security index. Agreements, contracts or transactions that would otherwise satisfy the definition of “security-based swap” only because they reference government securities are “swaps” excluded from the definition of “security-based swaps,” though options on government securities appear to fall outside of both definitions (and thus would continue to be “securities” regulated by the SEC).

The effect of this relatively narrow definition of “security-based swap” is that the CFTC has jurisdiction over swaps referencing a broad index of securities (a broad index is generally an index composed of ten or more securities) or CDS relating to a broad index—that is, since a swap on a broad index is not a “security-based swap,” it remains within the definition of a “swap.” The Act’s definitions leave open the question of whether a swap on a basket of securities is (i) a swap on numerous individual securities (subject to SEC jurisdiction), (ii) a swap on a broad index (subject to CFTC jurisdiction) or (iii) either, depending on the specifics of the documentation. Further, the market will have to revisit the difficult question of when, for example, an in-the-money option on a broad index of securities is an option regulated by the SEC and when it is a swap regulated by the CFTC. In any case, one effect of this split in jurisdiction over transactions that relate to securities is that most entities that enter into swaps with respect to securities are likely to be regulated by both the SEC and the CFTC.

We also note that transactions having components of both “swaps” and “security-based swaps” are subject to regulation as “mixed swaps” by both the CFTC and the SEC. Many, if not most, security-based swaps have an interest rate component to them; for example, one party receives an equity-related return, and the other party receives a return based on LIBOR or another floating rate of interest. Since a transaction involving a rate of interest may be a swap regulated by the CFTC, under the literal words of the Act, such a trade could be a mixed swap regulated by both Commissions, which will hopefully not prove to be the case as regulations are adopted.

### Part III. Mandatory Clearing, Trade Execution and Reporting

As finally passed by both houses of Congress, the mandatory clearing and trade execution portions of the Derivatives Legislation are based on the original House version of the legislation, but include significant compromises with the Senate conferees that were hammered out in the conference committee. The mandatory reporting and collateral segregation requirements are based on the Senate version of the legislation.

For purposes of the following discussion, we will use the term “swap” to refer to both “swaps” regulated by the CFTC and “security-based swaps” regulated by the SEC, unless otherwise indicated. Also, we will use the term “swap dealer” and “major swap participant” generically to refer to entities regulated by the CFTC or the SEC.

*Mandatory Clearing.* Swaps are subject to mandatory clearing only if a derivatives clearing organization or clearing agency has been approved to clear the swap, **and** the relevant Commission has determined, after at least a 30-day notice and comment period,<sup>7</sup> that the relevant “swap, or group, category, type, or class of swaps” described in the submission is required to be cleared. Swaps entered into before application of the clearing requirement will not need to be cleared if they are reported within the Act’s specified time frames.

In determining whether a swap is to be subject to mandatory clearing, the relevant Commission is required to consider whether the “derivatives clearing organization” (for “swaps”) or “clearing agency” (for “security-based swaps”) has adequate risk management policies and procedures and take into account the following factors:

- the existence of significant outstanding notional exposures, trading liquidity and adequate pricing data;
- the availability of infrastructure to clear the swap on terms that are consistent with the material terms and trading conventions on which the contract is then traded;
- the expected mitigation of systemic risk, taking into account the size of the market and the resources of the clearing house;
- the effect on competition, including appropriate fees; and

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<sup>7</sup> The notice and comment period may not be longer than 90 days unless the derivatives clearing organization or clearing agency submitting the application for clearing consents to a longer period.

- the existence of reasonable legal certainty in the event of the insolvency of the clearing house or one or more of its members with respect to the treatment of counterparty positions and collateral.<sup>8</sup>

As we noted in our August 20, 2009 memorandum on an earlier version of the legislation, Congress' decision to establish a mandatory clearing requirement for certain swaps (rather than, for example, encouraging clearing primarily through capital regulation of financial institutions), creates difficult issues of line drawing for regulators and swap counterparties. Namely, since swaps and bilaterally negotiated contracts and the clearing houses will necessarily need to specify many, if not all of the contractual terms of the swaps that they will clear, a question will arise as to when a bespoke contract is sufficiently dissimilar from a clearable swap (or a combination of clearable swaps) to be permissible without clearing. Similarly, what happens in situations where a clearing house is available to clear all swaps with certain basic structural characteristics and terms, but the consequence of such clearing is the forced use of terms specified by the clearing house in place of terms that may be preferred by the parties?

The Derivatives Legislation does not directly address these issues, but includes an attempt to minimize the difficulty by providing that the Commissions must consider the extent to which a clearing house is proposing to clear transactions on terms that are consistent with existing OTC contracts. While this may be useful as a basis to prevent offerings from clearing houses that are unduly narrow, the line between swaps that will be required to be cleared and those that will not is likely to be uncertain. Parties to swaps that are not intended to be cleared will need to consider how they can demonstrate that such swaps are sufficiently dissimilar to cleared swaps to avoid the mandatory clearing requirement.

*The Commercial End User Exemption.* The Derivatives Legislation provides an optional exception from mandatory clearing to any person that (i) is not a "financial entity," (ii) is using the swap to "hedge or mitigate commercial risk" and (iii) notifies the relevant Commission as to how it generally meets its financial obligations associated with entering into uncleared swaps. For the purpose of the optional exemption, the term "financial entity" means a swap dealer, a major swap participant, a commodity pool, a "private fund" as defined in the Investment Adviser's Act (e.g., a hedge fund), an employee benefit plan, or a person predominantly engaged in the business of banking, or in activities that are financial in nature. The definition excludes certain captive finance companies and the Commissions are authorized to exempt small banks and certain other entities.

One oddity of the mandatory clearing requirement and the commercial end user exception is the extent to which they interfere with the normal process of contracting. Where one party to the

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<sup>8</sup> Pursuant to Title VIII of the Act, the relevant Commission is also required to consult with the Board of Governors prior to making a mandatory clearing determination. See Section 812 of the Act.

transaction is not a swap dealer or major swap participant, the Derivatives Legislation provides that party with the **sole** right to elect clearing (where the swap is clearable but not subject to mandatory clearing) and to select the clearing house at which the swap will be cleared. The implications of this aspect of the Derivatives Legislation for swap dealers and major swap participants is currently uncertain. For example, what happens when a swap dealer is not a member of a particular clearing house? Is it permissible to clear swaps for customers in this circumstance? What happens if the parties have agreed to terms for a swap that is not cleared and the non-swap dealer subsequently demands clearing? Can the swap dealer re-price the swap to reflect its change in costs? As discussed further below, the ability of a swap dealer to hold and use collateral posted in connection with a swap also depends on whether the swap is cleared, and only certain swap dealers may hold collateral for customers in connection with cleared swaps.

For further discussion of the commercial end user exception and the challenges it poses to commercial institutions that use swaps, see our accompanying memorandum titled "[Regulation of End Users of Swaps Under the Dodd Frank Wall Street Reform and Consumer Protection Act.](#)"

*(Partially) Open Access in Clearing.* The Derivatives Legislation requires derivatives clearing organizations and clearing agencies to clear swaps executed over-the-counter or at an unaffiliated trading platform on a nondiscriminatory basis. However, the Derivatives Legislation does not require swap trading platforms to have the capacity to clear swaps traded on their markets with multiple clearing houses, nor does the Derivatives Legislation require fungible clearing of swaps across clearing houses or for clearing houses to provide for transferability. Thus it remains to be seen whether, and the extent to which, market structure will facilitate competition in clearing.

*Trade Execution Requirements.* Transactions that are subject to mandatory clearing are also required to be traded on a designated contract market or "swap execution facility" (for "swaps") or a national securities exchange or "security-based swap execution facility" (for "security-based swaps"), unless no such venue accepts the transaction. Where an end user opts to exercise the end user exception for clearing, the trade execution requirements do not apply. Conversely, where a counterparty to a swap is not an eligible contract participant, the swap must be traded on designated contract market or a national securities exchange (trading on swap execution facilities is not permitted).

Notably, mandatory trade execution does not require a considered determination of the CFTC or SEC comparable to the required mandatory clearing determination. That is, the mandatory trade execution requirement is effectively self-executing once a swap is subject to mandatory clearing. While the listing rules of the various trade execution facilities are subject to Commission review, the Derivatives Legislation gives significant power to the trade execution facilities to control the manner in which swaps must be traded. For additional discussion of the new "swap execution facilities" see below.

*Trade Reporting Requirements.* All swaps, including those that are exempt from mandatory clearing, are subject to reporting requirements. With respect to swaps that are cleared, regulatory reporting and public dissemination of swap information is handled by the relevant clearing house and/or trade execution facility. Swaps that are not accepted for clearing at a clearing house must be reported to a “registered swap data repository” or a “registered securities-based swap data repository” (together, “**swap data repositories**”) or, if no swap data repository will accept the report, directly to the relevant Commission.

To a large extent, swap reporting requirements are the obligations of swap intermediaries rather than end users. For swaps where only one of the parties is a swap dealer or major swap participant, the swap dealer or major swap participant is required to report. Where one of the parties is a swap dealer and the other is a major swap participant, the swap dealer is required to report. However, where neither party is a swap dealer nor major swap participant (or where both parties are swap dealers or major swap participants), then parties must decide between themselves which party will report.<sup>9</sup> Therefore, all parties to swaps will be required to develop and implement compliance procedures to satisfy reporting requirements and to provide for the timely submission of reports when they are required.

Swaps counterparties will need to consider several questions when developing these reporting procedures. First and foremost, swap counterparties will need to assess the scope of the reporting requirement and identify contracts to which it applies; *i.e.*, they must determine which contracts are “swaps.” As noted in Part III above, the scope of the definition for “swap” is deceptively broad.<sup>10</sup> Accordingly, swap counterparties must develop the capacity to identify contracts that may be deemed to be swaps and/or manage the risk of unintentional reporting failures.

Additionally, market participants may be required to deal with difficult issues relating to what information is required to be reported and when. While both the timing and content of regulated swap reports is largely in the discretion of the Commissions, the Derivatives Legislation does require the Commissions to promulgate rules to provide for the “real time public reporting” of swap data, including for swaps that are exempt from clearing. For this purpose, the Derivatives Legislation defines “real time public reporting” as public dissemination of data, including price and volume, “as soon as technologically practicable after the time at which swap transaction has been **executed.**” As to swaps subject to clearing, this may mean pressure from the Commissions to

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<sup>9</sup> The Derivatives Legislation does not make clear whether the parties are jointly liable for a failure to report under this circumstance, or whether the parties can rely on an agreement that one of the parties will report to limit potential liability for a compliance failure to one of the parties.

<sup>10</sup> For a fuller discussion of this topic, see our separate memo titled [Regulation of End Users of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#).

effectuate give-ups and submission for clearing as quickly as possible. As to uncleared swaps, it is likely that the parties will be required to report more or less immediately upon “execution.”

Lastly, we note that market participants should be mindful to monitor for announcements as to start dates for reporting. Overlapping transition rules in the Derivatives Legislation create ambiguity as to when reporting of pre-enactment swaps will be required. Sections 723 and 763 of the Derivatives Legislation provide for the reporting of swaps (i) entered into before enactment of the Derivatives Legislation within 180 days of the general effective date of the legislation (*i.e.*, 540 days after enactment) and (ii) entered into after enactment but prior to the effective date within 90 days of the general effective date or by such other time as the relevant Commission prescribes by rule. However, Sections 729 and 766 require the Commissions to adopt reporting rules for pre-enactment swaps within 90 days of enactment, and require reporting of such swaps within 30 days of enacting the rules, unless the Commissions determine another period to be appropriate.

#### **Part IV. Collateral Segregation and Bankruptcy**

While the mandatory clearing requirement is the headline item in the Derivatives Legislation, the provisions of the Derivatives Legislation relating to collateral segregation and bankruptcy will also have a profound restructuring effect on the derivatives market.

*Collateral Segregation for Cleared Swaps.* With respect to cleared swaps, the Derivatives Legislation provides that **only a registered futures commission merchant** is permitted to accept collateral of a swaps customer that requires the use of an intermediary in order to effectuate clearing (*e.g.*, because the customer is not a direct member of a clearing house). That is, Congress has effectively mandated that the FCM model for clearing swaps is the only acceptable way to provide intermediated clearing. Other models that provide for intermediation by banks or other financial institutions are effectively prohibited. Given that many common swaps will be required to be cleared, this means that most swap dealers will be required to be CFTC-registered FCMs. Moreover, this requirement will also likely affect the choice of entities that sell-side financial conglomerates will use to deal in security-based swaps, as there will be significant efficiencies in selecting an entity that can be dual-registered as an FCM in order to clear swaps.

Substantively, the segregation requirements for cleared swaps are generally modeled after current CEA requirements for futures contracts and related collateral. FCMs are required to segregate customer collateral from proprietary assets and treat them as belonging to customers, provided that assets of multiple customers can be segregated in a single custody account with a third-party custodian for convenience. Customer funds and property may be withdrawn from segregation to the extent necessary to margin or settle the customer's cleared swaps with the relevant derivatives clearing organization, and customer cash may be invested in government securities, municipal securities or other assets prescribed by the CFTC. Under these rules, it would be possible for

customers who wish to satisfy margin requirements imposed by a swap dealer (or the CFTC) with assets that would not qualify as margin at the relevant derivatives clearing organization to do so, but it would effectively require the swap dealer to provide financing to the customer. To avoid this result, the parties will likely need to make separate arrangements for the swap dealer or an affiliate to provide eligible margin against the margin provided by the customer in a repurchase or lending transaction.

*Bankruptcy Reform Relating to FCMs.* Special rules under the U.S. Bankruptcy Code and the CEA that are applicable to FCMs provide protection to “customers” of FCMs with respect to their “commodity contracts.” Specifically, these rules protect the “net equity” claims of customers from the general creditors of the FCM and require the bankruptcy trustee for an insolvent FCM to use “best efforts” to effectuate a bulk transfer of open commodity contracts and related collateral to a solvent FCM.

Section 724 of the Derivatives Legislation amends both the CEA and the Bankruptcy Code to provide that cleared swaps will be considered “commodity contracts” subject to these special bankruptcy rules. This reform is intended to resolve uncertainty as to whether cleared CDS would qualify for the special bankruptcy protection available to FCM customers, as there is currently some uncertainty as to whether CDS would qualify as contract of sale of a “commodity” for future delivery under the CEA.<sup>11</sup>

*Collateral Segregation for Cleared Security-Based Swaps.* With respect to cleared securities-based swaps, the Derivatives Legislation provides that only a broker-dealer or security-based swap dealer may accept collateral from a security-based swap counterparty. As only such persons may deal in security-based swaps, this requirement is not particularly restrictive, though it does limit the options of buy-side institutions for avoiding intermediation by swap dealers. In other respects, the segregation requirements applicable to security-based swaps mirror those applicable to swaps.

*Bankruptcy Reform Relating to Stockbrokers.* The Derivatives Legislation is intended to provide bankruptcy protections for security-based swaps that are equivalent to the “customer” protections for counterparties clearing swaps through an FCM. The Bankruptcy Code provides special bankruptcy rules for “stockbrokers” and their “customers” that are similar (though not identical) to the bankruptcy rules for FCMs. Section 763 of the Derivatives Legislation inserts language in the

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<sup>11</sup> We note one technical drafting error in the Derivatives Legislation regarding this amendment. The Derivatives Legislation amends the text of the CEA to provide that all swaps cleared with “derivatives clearing organization” shall be considered protected “commodity contracts” as used in the Bankruptcy Code with regard to collateral of a swaps customer received by an FCM. However, the amendments made to the Bankruptcy Code itself may technically only treat swaps that are cleared on a **registered** derivatives clearing organization as “commodity contracts.” As a result, some uncertainty may remain as to the bankruptcy treatment of swaps cleared with exempt derivatives clearing organizations (e.g., non-U.S. clearing houses).

Exchange Act that provides that a security-based swap will be “considered to be” a “security” for purposes of the Bankruptcy Code and an account that “holds” a security-based swap (other than a portfolio margin account subject to FCM regulation) will be “considered to be” a “securities account” for purposes of Section 741 of the Bankruptcy Code. Putting aside the puzzling choice to amend the Bankruptcy Code through the Exchange Act, the point of this amendment appears to be to establish that (i) a security-based swap dealer would qualify as a “stockbroker” for purposes of the Bankruptcy Code and (ii) a security-based swap counterparty would qualify as a “customer.”<sup>12</sup>

By establishing that a securities-based swap is a customer position of a stockbroker, the Derivatives Legislation would provide that the claim of each such customer with respect to such swap and related collateral is protected from the general creditors of the security-based swap dealer as a “net equity” claim under the Bankruptcy Code. Generally, this would mean that a counterparty’s claim with respect to a security-based swap would be valued as of the filing date, and that any in-the-money amount would be a protected cash claim. It is somewhat less clear however, to what extent the Derivatives Legislation provides for the bulk transfer of cleared security-based swaps in a manner equivalent to the bulk transfer of customer positions of an FCM. While the CFTC has issued regulations pursuant to bankruptcy authority granted under the CEA which require the bankruptcy trustee for an insolvent FCM to use its best efforts to effect a bulk transfer of open commodities contracts, no similar regulation (or specific grant of authority to the SEC) exists with respect to stockbrokers.<sup>13</sup>

Additionally, we note that while the Derivatives Legislation provides for the bankruptcy of a security-based swap dealer as a “stockbroker” under the Bankruptcy Code, it does not amend the Security Investor Protection Act of 1970 (“SIPA”). SIPA effectively overrides the Bankruptcy Code with respect to broker-dealers that are members of the Securities Investor Protection Corporation (“SIPC”) and contains its own definitions of “security” and “customer.” Thus, the Derivatives Legislation does not appear to provide special bankruptcy protections to persons who clear their security-based swaps through SIPC members, other than mandatory segregation of collateral.

*A Note About Liquidation Under Title II.* While the Derivatives Legislation provides for the applicability of special customer protection rules under the Bankruptcy Code to the counterparties of swap dealers as discussed above, it is also possible that an insolvent swap intermediary could be liquidated under the “orderly liquidation authority” for systemically significant institutions

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<sup>12</sup> The Derivatives Legislation explicitly excludes the claims of security-based swap counterparties with respect to uncleared security-based swaps from this special bankruptcy protection, except to the extent that such a counterparty has a claim for the return of margin for which the SEC has established a customer protection or segregation requirement.

<sup>13</sup> Where a security-based swap dealer is subject to the special regime for resolution of systemically significant entities by the FDIC under Title II of the Act, the FDIC would have separate transfer authority with respect to security-based swaps.

provided in Title II of the Act. Title II includes a provision preserving the special status of “customer” claims against FCMs and stockbrokers (at least insofar as customers receive distributions of customer property held by the intermediary prior to distributions to general creditors). However, in addition to providing special powers to the FDIC, Title II also imposes obligations particular to cleared swaps and to “qualified financial contracts,” which, among other things, limit the FDIC’s general power to transfer assets to a bridge-bank or solvent institution.<sup>14</sup> Thus, swap counterparties will need to assess their intermediary risk in light of each bankruptcy regime which may apply. For additional discussion of Title II, see our accompanying memorandum titled [“Orderly Liquidation of Financial Companies, Including Executive Compensation Clawback, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act”](#).

*Optional Collateral Segregation for Swaps that are Not Cleared.* Swap dealers and major swap participants are required to segregate collateral received with respect to uncleared swaps at the sole discretion of their counterparties, provided that variation margin is not subject to this requirement. Where both parties to a swap are either swap dealers or major swap participants, each may be required to segregate at the option of the other. Each swap dealer and major swap participant is required at the outset of a swap transaction to notify its counterparty of the option to segregate, and to “report . . . on a quarterly basis . . . that [its] back office procedures...are in compliance with the agreement of the counterparties” in cases where the counterparty does not opt for segregation. Segregated collateral is required to be carried by an “independent” third-party custodian in an account designated as a segregated account for the counterparty.

## Part V. Registration Requirements

In reviewing the requirements below, note that many institutions may become subject to registration with both the CFTC as a result of activities in regard to swaps and with the SEC as a result of activities in regard to security-based swaps.

### A. Registration Requirements for Swap Dealers.

The Derivatives Legislation contains two sets of registration requirements, one applicable to those involved with “swaps” (who must register with the CFTC as “swap dealers”) and one applicable to those involved with “security-based swaps” (who must register with the SEC as “security-based swap dealers”). As these two sets of registration requirements run in parallel, they are discussed in parallel below. In this part of the memorandum, we will refer to both types of registrants as “swap dealers” and we will refer to both “swaps” and “security-based swaps” as “swaps.”

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<sup>14</sup> See Section 210(c) of the Act. For example, to prevent “cherry picking” of contracts by the FDIC, Title II requires the FDIC to transfer **all** of a creditor’s “qualified financial contracts” with the seized company to an alternative financial institution (including swaps and non-swaps) if it transfers any of such contracts to such institution.

*Definition of Swap Dealer.* The definition of a “swap dealer” is based upon the definition of a “[securities] dealer” in Section 3(a)(5) of the Exchange Act. Generally speaking, a “swap dealer” is a person (i) engaged “in the business” of buying and selling swaps as principal, including through a broker, (ii) but not a person who does not do so as part of a “regular business.”

The exclusion for those entering into transactions “not as part of a regular business” is, in the securities laws, commonly known as the “trader” exemption.” If the phrase is interpreted in the Derivatives Legislation in a manner consistent with the Exchange Act, it would serve to exclude from the swap dealer definition most end users. Of course all market participants should conduct an analysis of their activities to determine whether they might fall within the swap dealer definition. However, even if these “traders” are excluded under this definition, they may be required to register under the end user registration categories (discussed further below).

i. *No Bank Exemption.* The Derivatives Legislation does not provide a bank exemption from registration. In fact, Section 716 of the Act effectively prohibits an insured depository institution from acting as a swap dealer. The prohibition on a U.S. bank acting as a swap dealer is discussed in significant detail in our related memorandum titled “[Changes to the Regulation of Banks, Thrifts and Holding Companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act.](#)”

ii. *Offshore Exemption?* Notably, the registration requirements that apply to swap dealers do **not** contain the standard jurisdictional limitation to persons and activities in “interstate commerce.” Read literally, this could mean that the Act is intended to have extra-territorial reach.

Section 772 generally excludes from the regulation of security-based swaps by the SEC those persons who transact a business “without the jurisdictions of the United States.” While this should serve to protect persons outside the United States who do not trade with persons inside the United States, it does not protect foreign persons who transact using “interstate commerce” with U.S. persons. The jurisdictional limitation on the CFTC under Section 722 is even less comforting: activities outside the United States may be regulated by the CFTC if they have a direct and significant connection with activities in the United States.

In short, we are not certain as to how the Commission will apply the requirements of the Act to non-U.S. persons. It is far from certain that the exemptions that currently apply to, for example, securities transactions pursuant to Rule 15a-6 under the Exchange Act, will be available with respect to security-based swaps.

iii. *Securities Broker Registration.* The Derivatives Legislation requires the registration of brokers in security-based swaps by virtue of its expansion of the definition of the term

“security” to include a security-based swap. This would make Section 3(a)(4) of the Exchange Act apply as to brokers in security-based swaps.

#### B. Registration Requirements for Major Swap Participants.

The Derivatives Legislation provides very extensive registration requirements for certain end users, referred to as (i) “major swap participants” as to swaps who must register with the CFTC, and (ii) as “major security-based swap participants” (as to security-based swaps who must register with the SEC). For purposes of this section, we refer to both categories of registrants as “major swap participants.”<sup>15</sup>

*Major Swap Participant.* The term “major swap participant” is defined as an entity that fits one of three tests:<sup>16</sup>

- The **first test** covers an entity that maintains a “**substantial position**” in swaps in any “**major swaps category.**”
- The **second test** covers an entity whose “**swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.**”
- The **third test** covers a “**financial entity**” that is “**highly leveraged relative to the amount of capital that it holds,**” that is not an entity subject to U.S. bank capital requirements, and that maintains a “substantial position” in swaps in any “major swaps category.”

For purposes of the first test only, swaps held “for hedging or mitigating commercial risk”; are not included in the determination of a substantial position.<sup>17</sup> The first test also excludes positions held by any employee benefit plan as defined in Section 3(3) and 3(32) of ERISA “for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.”<sup>18</sup>

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<sup>15</sup> By contrast, the “dealer” definition in Section 3(a)(6) of the Exchange Act is amended to carve out security-based swap agreements with eligible contract participants. As a result, a “dealer” in such agreements would not fit within that definition, but rather would fit within the definition of a security-based swap dealer in the Legislation.

<sup>16</sup> Derivatives Legislation Sec. 721; Sec. 761.

<sup>17</sup> The term “hedging or mitigating commercial risk” is not defined in the Derivatives Legislation. There is a somewhat similar term—bona fide hedge—which is used in the provisions regarding position limits, which are discussed in Section V of this memorandum.

<sup>18</sup> It should be noted that the hedging exclusion for plans may not apply, absent clarification, to certain employee benefit plans that use swaps for more than just, for example, mitigating interest rate risk or currency risk of cash market investments made by the plan. In this regard, some employee benefit plans use swaps for what could be characterized as investment purposes; e.g., to gain exposure to an asset class.

i. Note that **all of the key terms** (“substantial position;” “major swaps category;” “substantial counterparty exposure;” “highly leveraged”) in the three tests are **undefined by the Act** and await rulemaking action by the Commissions. Further, as to corporate groups that enter into swaps for the purpose of hedging commercial risk, the Act contains some fairly complicated provisions that may effectively limit the benefit of one member of the group entering into swaps to hedge the commercial risk of another member of the corporate group. For a fuller discussion of the scope of this definition, see our related memorandum titled “[Regulation of End Users of Swaps Under the Dodd Frank Wall Street Reform and Consumer Protection Act.](#)”

ii. *Bank Activities as End Users.* The Derivatives Legislation limits, but does not prohibit, a bank from acting as an end user of swaps, or even from registering as a major swap participant. Nonetheless, banks are significantly limited in their swaps activities. For a fuller discussion of these limitations, see our related memorandum titled “[Changes to the Regulation of Banks, Thrifts and Holding Companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act.](#)”

iii. *Jurisdiction.* As discussed above, the extent of the Commissions’ jurisdiction over non-U.S. entities and activities is very unclear. That said, end users will not want to be subject to registration as a major swap participant and therefore the Act may provide a significant inducement to move financial activities offshore.

iv. *Commodity Pool, Commodity Pool Operators, Commodity Trading Advisors.* Users of CFTC-regulated swaps should also be mindful that, even if they are not major swap participants, the Act adds a new definition of “commodity pool” and amends the existing definitions of “commodity pool operator” and “commodity trading advisor” to take account of activity involving swaps, so that funds and advisors may become subject to registration or regulation on account of these expanded definitions even if they escape regulation as a major swap participant.

## **Part VI. Regulatory Requirements Applicable to Swap Dealers and Major Swap Participants**

The rules that are to be adopted by the Commissions, pursuant to Sections 731 and 764 of the Act, as to swap dealers, security swap dealers, and major swap participants and major security-based swap participants (collectively, “**Registrants**”) do not, in many respects, make a significant distinction between being a financial intermediary (swap dealer) and an end user (major swap participant). The particular areas that are to be governed include (i) registration procedures; (ii) associated persons; (iii) capital; (iv) margin; (v) reporting and recordkeeping; (vi) trading records; (vii) business conduct; (viii) documentation; (ix) back office procedures; (x) supervisory requirements; and (xi) the monitoring of conflicts.

The following discussion briefly summarizes the different types of regulations that are required to be adopted. The Derivatives Legislation does not provide much detail in this regard, leaving that to the CFTC, SEC and Bank Regulators. Registration procedures are also left to the discretion of the CFTC and the SEC, respectively, as is the case generally now.

A. Capital Requirements.

i. The capital requirements are the most problematic, and perhaps counter-intuitive, part of the whole swaps registration scheme. In short, both swap dealers and major swap participants would be subject to capital regulations that would be based on the capital rules that generally apply to banks. As most entities, and certainly most end users, would find it difficult if not impossible to comply with bank capital rules (not so much because of the limitations on leverage, but because of their complexity and the fact that they are intended for banks), organizations subject to capital requirements as to their swap activities will likely have to isolate these activities in a specific legal entity so as not to have the swap capital rules apply to their business generally.

ii. It appears that Congress was somewhat mindful of the difficulty of applying capital regulations to end users. For example, the Act provides that, in setting capital requirements, the Regulators may take into account, “the risks associated with . . . the other activities conducted by the person that are not otherwise subject to regulation by virtue of the status of that person” as a Registrant under the Act. This implies that, to some extent, the Regulators could set individual capital transactions for every firm—a task that would seem difficult to accomplish.

iii. It is unclear what would happen if a Registrant, particularly a major swap participant as opposed to a swap dealer, were to fail to comply with the various regulations, particularly the capital regulations. Would it be put out of business? Would it be required to close out all of its swap positions? Would it be prohibited from entering into new trades? How would this work for overseas entities? How would it work for governmental entities, insurance companies, plans?

B. Margin Requirements.

Generally, the expectation is that cleared swaps will be subject to margin requirements imposed by central clearing counterparties in the first instance. The Derivatives Legislation requires the Regulators to impose mandatory *initial and variation* margin requirements on all swaps that are not cleared.

The Bank Regulators, in consultation with the Commissions, will jointly set the initial and variation margin requirements as to Registrants that are banks. The relevant Commission will set the initial and variation margin requirements for all other Registrants. Margin rules are required to “be

appropriate for the risk associated with non-cleared swaps.” In setting such rules, the Regulators are required to periodically consult with each other and to set comparable margin requirements to the extent practicable (the Bank Regulators are also required to consult with the Commissions before jointly promulgating any rules).

*Applicability to End Users.* One of the principal purposes of exempting end users from mandatory clearing with respect to swaps used to hedge commercial risk was to allow these end users to avoid margin requirements set by central clearing counterparties. However, the Derivatives Legislation does not include a carve-out from the mandatory margin requirements that will be imposed on Registrants for non-cleared swaps. As of today, this contradiction is not fully resolved. Senators Dodd and Lincoln have stated in an open letter that the intent of the Legislation is not to require end users to post initial margin with respect to their exempt swaps. However, it may be difficult for regulators required to be responsible for the safety and soundness of Registrants to provide the effective equivalent of a blanket exception for trades with end users.

*Swaps Between Registrants.* Where both parties to a non-cleared swap are Registrants, the Derivatives Legislation appears to require each to post initial and variation margin to the other. It is not clear how the requirements with respect to initial margin will work in practice, particularly as each party will have the sole option to require segregation of initial margin received by the other.

### C. Books and Records, Recordkeeping, Reports.

The CFTC and the SEC each have authority to establish books and records requirements as to those Registrants over which they have authority. We think it likely that, as a practical matter, the CFTC and the SEC could adopt regulations governing books and records that would go beyond matters relating to swaps, which would likely be necessary if they are to regulate a Registrant’s capital.

The CFTC and the SEC must require a Registrant to maintain daily records of its swaps and of related cash market and forward trades. Registrants would also be required to maintain “recorded communications,” including e-mails, instant messages and “recordings of phone conversations.”<sup>19</sup> These records would have to be broken down by counterparty or customer and would have to constitute a “complete audit trail for conducting comprehensive and accurate trade reconstructions.”

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<sup>19</sup> We believe this means that Registrants would be required to maintain records relating to phone calls if such recordings were created, but the Legislation does not appear to mandate the recording of telephone conversations.

Each of the CFTC and the SEC would have authority to require such reports of its Registrants as the agency requires of the Registrant's transactions, positions and financial condition.

D. Business Conduct and Special Rules Applying to Trades with Special Entities.

As to Registrants within their respective jurisdictions, the CFTC and the SEC would be required to adopt "business conduct" rules relating to (i) fraud prevention, (ii) general supervision of its business, (iii) compliance with position limits, (iv) verifying the regulatory status of any counterparty, (v) disclosures of risks to counterparties, and (vi) anything else that the agencies believe appropriate.

A variety of additional conduct requirements applies to transactions in which one of the parties is a "special entity"—a term that includes federal agencies, states and their instrumentalities, endowments and various pension plans. For a fuller discussion of these special requirements, see Appendix A to this memorandum.

E. Documentation and Back Office Standards.

As to Registrants within their respective jurisdictions (but consulting with the Bank Regulators as to banks), the CFTC and the SEC would be required to adopt rules governing "confirmation[s], processing, netting, documentation and valuation" of swaps. Although this sounds reasonable, it is in fact quite unclear as to what it would mean for the CFTC and the SEC to adopt rules governing "netting," or even documentation (would certain types of trade documentation be made mandatory?).

F. Research (Conflicts of Interest).

Registrants (**plus** futures commission merchants and introducing brokers otherwise regulated under the CEA) would be required to establish "structural and information safeguards" between, at a minimum, those within the firm engaged in (i) "activities relating to research or analysis of the price or market" for any asset underlying a transaction, on the one hand, and (ii) those involved with clearing or trading activities on the other. Some of the statutory language is oddly drafted, requiring that persons involved in "providing clearing activities" are required to be "separated by appropriate information partitions" from persons involved in "clearing activities." The meaning of this will have to await explanation by the Commissions.

G. Associated Persons, Chief of Compliance.

Registrants would be generally barred from permitting the involvement in a swap of any individual who is subject to a "statutory disqualification."

Registrants would be required to appoint a chief compliance officer (“**CCO**”) who shall report directly to the Registrant’s board or senior officer. The CCO has substantial responsibilities for establishing compliance procedures, for conducting reviews of those procedures and for providing a related certification. These responsibilities, particularly the required certification, add the potential for personal liability.

#### **Part VII. Regulatory Requirements Applicable to all Persons entering into Swaps**

This Section of the Memorandum describes a variety of additional requirements that apply to persons that enter into, or might seek to enter into, swaps or security-based swaps. This discussion is thus relevant both to Registrants, and also to other persons that might enter into regulated transactions.

##### **A. Retail Regulated Swaps, Eligible Contract Participant Definition.**

The Act makes it unlawful for any person other than an “eligible contract participant” (as defined in the CEA and now in the Exchange Act) to enter into (i) a swap unless the swap is entered into on or subject to the rules of a fully regulated futures exchange (ii) or a security-based swap unless the trade is entered into on a national securities exchange. Further, it would be illegal to sell a security-based swap to a non-ECP unless the trade was registered under the Securities Act.

The Act somewhat tightens the financial standards applicable to certain categories of persons within the ECP definition.

##### **B. Position Limits and Large Trade Reporting Requirements.**

The Act would apply in a variety of ways to persons (and their affiliates) that may have large positions with respect to swaps.

i. *Position Limits.* The CFTC and the SEC would have authority to establish position limits as to swaps. More specifically, the CFTC would have authority to establish aggregate position limits for (i) listed commodities contracts, (ii) contracts traded by U.S. participants on foreign boards of trade and (iii) swaps that perform or affect “a significant price discovery function” with respect to regulated markets, while the SEC would have authority to establish aggregate position limits to with respect to (i) securities traded on a U.S. exchange, and (ii) security-based swaps that perform “a significant price discovery function” in regulated markets.<sup>20</sup>

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<sup>20</sup> In addition, the Act (at Section 719) requires the CFTC (in consultation with the exchanges) to conduct a study of effects of position limits “on excessive speculation and on the movement of transactions from exchanges in the United States to

We read these provisions to mean that the CFTC and SEC would have the power to establish position limits on specified swaps grouped together with the securities and commodities contracts to which they relate, rather than just setting an overall limit on a person's aggregate investment in the U.S. markets.

For purposes of these limits and the large trader reporting requirements described below, the CFTC and the SEC are intended to perform a determination as to whether a category of swaps performs or affects a "significant price discovery function" by reference to a series of factors. These factors include (i) whether the swaps use or rely on a daily or final settlement price linked to related commodities contracts/securities, (ii) whether the swaps are sufficiently linked to their related contracts/securities to permit arbitrage, (iii) the extent to which prices in the related markets reference the swaps, (iv) the extent to which the swaps trade in sufficient volume to effect the prices of the related contracts/securities and (v) such other factors as the CFTC and SEC shall determine.

The SEC could also delegate to any self-regulatory organization ("**SRO**") the authority to adopt position limits as to any security-based swap and any security on which such security-based swap is based. In addition, every CFTC and SEC-regulated exchange would have to have power to establish position limits.

ii. *Large Trader Reporting.* The CFTC would have authority to establish quantitative levels at which positions held in swaps become reportable. As with the large trader reporting system currently in place for futures, it would be unlawful for any person to hold a position that equals or exceeds quantities specified by the CFTC unless such person files reports of those positions in accordance with CFTC rules. Persons subject to such requirements would also be required to maintain books and records of such swap transactions open for inspection and examination by either the CFTC or SEC (in the case of security-based swap agreements). Similar authority to establish large trader reporting levels and requirements is granted the SEC in the case of security-based swaps.

### C. Reporting Requirements Applicable to Persons Generally.

Any person who enters into a swap that is not centrally cleared and not reported to a swap Repository would be (i) required to make such reports as may be required by the relevant regulator

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trading venues outside the United States." This requirement appears to be in response to concerns expressed by some CFTC commissioners and others that the imposition of strict limits in the United States could have the effect of pushing trade to offshore markets.

and (ii) **be open to inspection** by the relevant regulator, a banking agency, the Financial Services Oversight Counsel and the Department of Justice.<sup>21</sup>

How would these inspection rights be implemented? Would the Department of Justice require a subpoena? What are the extra-territorial effects of this?

D. Potential Expansion of Existing Exchange Act Reporting Requirements for Beneficial Owners and Institutional Investment Managers and the Section 16 Provisions.

The SEC is given authority to amend the existing reporting requirements that apply under Sections 13(d) and (g) of the Exchange Act and Section 13(f) of the Exchange Act to treat persons that have a position in security-based swaps as the beneficial owner of the underlying security if the SEC determines that the security-based swap "provides incidence of ownership comparable to direct ownership of the security . . ." A person aimed to be a beneficial owner for purposes of Section 13 would also be deemed a beneficial owner for purposes of Section 16.

E. Bad Trades and Actors.

The Commissions are directed to collect such information as they may need to issue a report concerning any swaps that may be "detrimental" to the "stability of a financial market" or "participants in a financial market." See Section 714 of the Act (called "Abusive Swaps"). Presumably, this is directed at CDS or other swaps that go "short" an entity or the market. Notably, under the revisions to Title IX of the Act, the SEC is given increased authority over securities borrowing and lending, as well as over short sale transactions, likely on the view that the regulators may stop market declines by inhibiting trading.

The Commissions are given the authority to prohibit an entity from doing business in the United States if it is located in a foreign country where the regulation of swaps activity is sufficiently liberal as to "undermine the stability of the United States." See Section 715 of the Act.

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<sup>21</sup> See Derivatives Legislation Sec. 729; Sec. 766.

Appendix A**Special Entities Appendix to the New Scheme for the Regulation of Swaps**

This Appendix highlights provisions of the Act that are unique to a Swap Dealer or Major Swap Participant regarding Swaps with governmental entities (at the federal, state or local level), endowments, ERISA plans and public pension plans (such entities being defined as “Special Entities” in the Act).<sup>1</sup>

**Special Entity**

The term Special Entity includes, among other things, a federal agency; a state, state agency, city, county, municipality, or other political subdivision of a state; any employee benefit plan, as defined in Section 3 of ERISA; any governmental plan, as defined in Section 3 of ERISA; or any endowment. It is unclear whether “employee benefit plan” includes funds or other entities that are deemed to hold “plan assets” under ERISA. Such deeming can occur when 25% or more of the value of one or more classes of equity in the fund or entity is beneficially owned by an employee benefit plan or plans. A similar question exists for entities that hold the assets of governmental plans, with the added ambiguity that, because there is no 25% rule for governmental plans, it is not clear as to what rule would be applied to funds that may have significant investment by governmental plans. The inclusion of such entities within the definition of “Special Entity” could complicate compliance. Given the complexities involved in dealing with plan asset and/or governmental plan entities, this ambiguity requires expedited clarification.

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<sup>1</sup> Provisions specifically addressing Swaps are contained in Title VII of the Act and the provisions discussed in this memorandum, unless otherwise indicated, are set forth under substantially identical subsections entitled “Business Conduct Standards” set forth in Sections 731 (relating to “Swaps” and adding Subsection 4s(h) to the Commodity Exchange Act) and 764 (relating to “Security-based Swaps” and adding Subsection 15F(h) to the Securities Exchange Act of 1934). The significance of the existence of two such sections is primarily jurisdictional – which regulatory entity will have primary responsibility for promulgating regulations and monitoring compliance for the related categories of derivatives – and, for ease of reference, unless otherwise required by the context each reference to a Swap, Swap Dealer or Major Swap Participant is equally applicable to, respectively, a Security-based Swap, Security-based Swap Dealer or Major Security-based Swap Participant. Accordingly, references to Subsection (h) in this memorandum are applicable to that subsection of the amendments effected by each of Sections 731 and 764, and references to the Commission are to the CFTC with respect to Swaps or the SEC with respect to Security-based Swaps. Provisions affecting Swap Dealers would affect Major Swap Participants in substantially the same manner.

## Changes in Treatment of Special Entities Effected by the Act

### *General*

In comparison to the base text of the legislation initially considered by the conference committee convened by the House of Representatives and the Senate to reconcile the legislation enacted by each house of Congress, the Special Entity provisions contained in Subsection (h) of the Act vary in several significant respects.

### *Fiduciary Duty*

The Act does not impose a “fiduciary duty” on a Swap Dealer entering into an arm’s length Swap involving a Special Entity.

### *Fee Disclosure*

The Act does not require that a Swap Dealer disclose the source and amount of any fees or other material remuneration it directly or indirectly expects to receive in connection with a Swap.

### *Eligible Contract Participant*

The clause of the definition of “Eligible Contract Participant” in the Commodity Exchange Act that currently includes governmental entities that invest at least \$25 million is revised by the Act to include only those governments that invest at least \$50 million (Section 721(a)(9) of the Act), but does not exclude investments of bonds proceeds, as had been proposed in the House bill. The Act also leaves in place the existing “Eligible Contract Participant” alternative to the investment of a specified dollar amount for governmental entities entering into a Swap with specified types of financial institutions.

### *Clearing Exception*

The Act excludes from the clearing requirements of the Act certain end user Swaps, which may include many Swaps with Special Entities. The Act provides that, at the option of the counterparty that is not a “Financial Entity,” the requirements that a swap be centrally cleared will not apply if one of the counterparties:

- is not a Financial Entity,
- is using Swaps to “hedge or mitigate commercial risk”, and
- notifies the Commission, in a manner prescribed by the Commission, how it generally meets its non-cleared-Swap financial obligations.

“Financial Entities” are defined to include Swap Dealers, Major Swap Participants, a “commodity pool,” a “private fund,” an employee benefit plan as defined in paragraphs (3) and (32) of Section 3 of ERISA and certain other financial institutions (subject to the Commission’s right to exempt certain of those other financial institutions).

The Act leaves unclear whether Swaps to “hedge or mitigate commercial risk” include Swaps that “manage” risk. Would a governmental end user, for example, be engaging in a transaction excepted from the clearing requirements if it creates synthetic variable rate exposure through issuance of fixed rate debt and entry into a fixed-to-floating interest rate Swap? Similarly, would an endowment be able to create synthetic exposure to equities through the use of equity derivatives without being subject to the clearing requirements? In a letter to Congressmen Frank and Peterson dated June 30, 2010, Senators Dodd and Lincoln expressed their view that, among other things, the Act does not authorize regulators to impose margin or capital requirements on certain end users and used the phrases “hedge or mitigate” and “hedge or manage” interchangeably; this may be an indication to the regulators of Congressional intent. Moreover, would risks being hedged or mitigated by a Special Entity be considered “commercial risks” since such entities generally are not considered to be engaged in commercial activities? If the regulators view the phrases “hedge or mitigate” or “commercial risk” narrowly, they may deny Special Entity end users access to effective and noncontroversial tools for managing risk.

### **Rulemaking Requirements**

Clauses (3) and (6) of Subsection (h) require the Commission to prescribe business conduct standards that establish a duty for Swap Dealers (i) to verify that any counterparty meets the eligibility standards for an Eligible Contract Participant, (ii) to disclose to any counterparty that is not a Swap Dealer (A) material risks and characteristics of the Swap, (B) material incentives or conflicts of interest, and (C) the daily mark of the Swap transaction, and (iii) communicate in a fair and balanced manner based on principles of fair dealing and good faith. Each Commission is also authorized to promulgate additional rules that it determines to be appropriate. Each Commission is required by the terms of the Act to promulgate the rules and regulations required by Subsection (h) within 360 days after the date of enactment.

### **Requirements Imposed Upon Swap Dealers**

#### *General*

The Act requires each Swap Dealer to conform with the business conduct standards established by the Commission, including those that relate to (i) fraud, manipulation and other abusive practices involving Swaps (either offered or entered into), (ii) diligent supervision of the business of the Swap Dealer or Major Swap Participant, (iii) adherence to position limits, and (iv) the matters enumerated

above under "Rulemaking Requirements". These requirements apply regardless of whether the counterparty is a Special Entity.

#### *Arm's Length Transactions*

Any Swap Dealer or Major Swap Participant that enters into (or offers to enter into) a Swap with a Special Entity must, in addition to the above requirements, (i) before initiation of the transaction, disclose to the Special Entity in writing the capacity in which the Swap Dealer or Major Swap Participant is acting and (ii) comply with any duty imposed upon it by the Commission to have a reasonable basis to believe that the Special Entity has an independent representative that:

- has sufficient knowledge to evaluate the transaction and risks,
- is not subject to a statutory disqualification,
- is independent of the Swap Dealer or Major Swap Participant,
- undertakes a duty to act in the best interests of the Special Entity,
- makes appropriate disclosures,
- will provide representations to the Special Entity regarding fair pricing and the appropriateness of the transaction, and
- in the case of ERISA plans, is a fiduciary as defined in Section 3 of ERISA.

Because of the ambiguities of clause (ii), the Commission must establish what constitutes an *independent advisor*, as well as set out appropriate means of demonstrating a reasonable basis to believe that each applicable qualification has been met. Moreover, it will be important to many end users to have input as to whether they should be required to retain an independent representative.

#### *Advisory Roles*

Subsection (h) imposes parameters for any Swap Dealer acting as an advisor to a Special Entity, including prohibitions against (i) fraudulent devices, schemes or artifices, (ii) fraudulent or deceitful transactions, practices or courses of dealing, and (iii) fraudulent deceptive or manipulative acts, practices or courses of business. Any such Swap Dealer acting in such a capacity also has a duty to act in the best interests of the Special Entity and to make reasonable efforts to obtain sufficient information to make a reasonable determination that any Swap recommended by the Swap Dealer is in the best interests of the Special Entity, including information relating to:

- the financial status of the Special Entity,
- the tax status of the Special Entity,
- the investment or financing objectives of the Special Entity, and
- any other information prescribed by the Commission.

Section 975 of the Act sets forth discrete requirements under the Securities Exchange Act of 1934 for Municipal Advisors (a term which is defined separately from, but does not expressly exclude, Swap Dealers or Major Swap Participants).<sup>2</sup> One important issue for consideration by the regulators is whether the parameters imposed upon Swap Dealers serving in advisory roles to Special Entities will (or should) be uniform with the requirements imposed upon Municipal Advisors.

### **Stable Value Contracts**

With respect to Stable Value Contracts, which are used in connection with stable value options offered in many participant-directed defined contribution plans (e.g., participant-directed 401(k) plans), the Act mandates that the Commissions conduct a joint study within 15 months of the enactment of the Act to determine whether such contracts fall within the definition of a "Swap". In making the required determination, the Commissions shall consult with the U.S. Department of Labor, the Department of Treasury and State entities that regulate stable value contract issuers. The Act provides that if it is determined that a Stable Value Contract meets the definition of a "Swap", the Commissions must determine whether any exemption for these contracts is appropriate and in the public interest, and issue regulations implementing the Commissions' determinations. Until the effective date of any regulations, Stable Value Contracts will not be subject to the requirements applicable to "Swaps". Further, Stable Value Contracts in effect before the date of any such regulations will not be considered "Swaps". For these purposes, "Stable Value Contract" means any contract, agreement or transaction that provides for a crediting interest rate and guaranty or financial assurance of liquidity at contract or book value prior to maturity that is offered by a bank, insurance company or other State or federally regulated financial institution for the benefit of any individual or commingled fund available as an investment in an employee benefit plan (as defined in Section 3(3) of ERISA, including "governmental plans" described in Section 3(32) of ERISA) subject to participant direction, an eligible deferred compensation program described in Section 457 of the Internal Revenue Code that is maintained by an eligible employer described in Section 457(e)(1)(A) of the Internal Revenue Code, an arrangement described in Section 403(b) of the Internal Revenue Code or a qualified tuition program under Section 529 of the Internal Revenue Code.

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<sup>2</sup> A Municipal Advisor is a person (including a financial advisor, guaranteed investment contract broker, third-party marketers, placement agents, solicitors, finders, and Swap advisors) who is not a municipal entity or an employee of a municipal entity who provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to structure, timing, terms or other similar matters concerning such financial products, or undertakes the solicitation of a municipal entity. The definition excludes, among others, brokers, dealers or municipal securities dealers serving as an underwriter, any registered investment adviser or commodity trading advisor who is providing advice related to Swaps.

**Timing of Implementation**

As with many other provisions of the Act, a meaningful understanding of the Special Entity requirements cannot be reached until each Commission provides regulations detailing the implications for each party when a Major Swap Participant or Swap Dealer interacts with a Special Entity as a counterparty or advisory client. The Act provides that rules and regulations must be finalized and published no later than 360 days after enactment of the Act. The Act will become effective on the later of 360 days after the date of enactment or, in the event a provision requires a rulemaking, 60 days after publication of the rule or regulation implementing such provision.

Appendix B**Retroactivity Appendix to the New Scheme for the Regulation of Swaps**

This Appendix highlights provisions of the Act that may be applied to existing transactions on a retroactive basis.

**Potentially Retroactive Provisions**

Certain provisions of the Act are expressly to be applied on a prospective basis only<sup>1</sup> and certain provisions are expressly to be applied on both a retroactive and prospective basis.<sup>2</sup> However, with respect to certain other requirements – specifically, the margin requirements contained in Sections 724, 731, 763 and 764 – the Act is silent as to retroactivity.<sup>3</sup>

- Sections 731 and 764 require, in part, that registered swap dealers and major swap participants satisfy minimum initial and variation margin requirements to be established by the applicable Commission<sup>4</sup> or prudential regulator with respect to non-cleared swaps.
- Sections 724 and 763 provide, in part, that the counterparty to any non-cleared swap with a swap dealer or major swap participant may request that any initial margin it provides be segregated for the benefit of the counterparty.

This silence may or may not be intentional and, therefore, creates uncertainty as to whether retroactivity is intended. Additionally, Section 739<sup>5</sup> appears to expressly prohibit using the passage of the Act as grounds for terminating or renegotiating the terms of existing swaps, unless the right

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<sup>1</sup> For example, the clearing requirements of Sections 723 and 763 do not apply to existing swaps whose terms are reported to the applicable Commission pursuant to other provisions of the Act, and the push-out provisions of Section 716 will not apply to existing swaps. Additionally, Section 739 expressly excludes, under certain circumstances, existing swaps from the position limits established under Section 737. We note, however, that the Act does not provide a similar exclusion in respect of position limits for security-based swaps.

<sup>2</sup> For example, Sections 729 and 766 expressly require that all existing swaps be reported to the applicable Commission or a registered swap data repository within a prescribed time period.

<sup>3</sup> Generally, as a matter of statutory interpretation, for a law to be applied retroactively, Congress must show its clear intent; absent express language to the contrary, the presumption is that a law only applies on a going-forward basis. However, in certain circumstances, legislative intent can be inferred from the absence of language.

<sup>4</sup> “Commission”, as used herein, shall mean either the U.S. Securities Exchange and Commission or the U.S. Commodity Futures Trading Commission, as applicable.

<sup>5</sup> We note that Section 739 does not govern security-based swaps and a parallel provision covering security-based swaps is absent under the Act.

to do so is provided for under an existing swap. The existence of such a provision may imply that retroactive effect is intended.<sup>6</sup>

### **Some Problems with Margin Retroactivity**

If the margining requirements are applied retroactively, practical difficulties may result. For example, retroactive margining will likely result in a liquidity drain on providers required to post, as it could unreasonably increase costs without permitting parties to renegotiate pricing. The liquidity drain - or simply even the perception of it - could result in rating downgrades, which could trigger even more stringent posting requirements. As a result, in the event a party does not possess the required collateral, it may be unable or unwilling to perform under its existing swaps. In addition, it may be impossible for certain parties to comply with their governing corporate documents and the requirements of the Act. For example, credit derivative product companies, or "CDPCs," are generally prohibited from posting collateral by the terms of their charters, and special purpose entities typically used in securitizations do not own treasuries or hold excess cash capable of being posted. At this point, it is unclear how affected parties will navigate through such conflicting mandates.

### **Termination of Existing Swaps**

Retroactive requirements could also lead to the early termination of existing swaps. Parties to an existing swap that contains a termination event, illegality provision or similar event that is triggered by enactment of the Act may have the option to exercise their rights to terminate or renegotiate the

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<sup>6</sup> We note that on June 30, 2010, Senators Dodd and Lincoln co-authored a letter (the "Letter") addressed to Representatives Frank and Peterson, which, in part, discusses the retroactivity of the margin and capital requirements contained in the Act. The Letter states, in relevant part, as follows:

"Congress recognized that the capital and margin requirements in this bill could have an impact on swaps contracts currently in existence. For this reason, we provided legal certainty to those contracts currently in existence, providing that no contract could be terminated, renegotiated, modified, amended or supplemented (unless otherwise specified in the contract) based on the implementation of any requirement in this Act . . . It is imperative that we provide certainty to these existing contracts for the sake of our economy and financial system."

While the Letter was intended to provide clarity as to retroactivity, we believe that Congressional intent remains unclear. One reading of the provision above is that margin provisions are to be applied retroactively and that parties are prohibited from terminating based upon those new requirements. However, another interpretation is that margin requirements are retroactive, but that parties are not required to amend their contracts (whether those documents already require the posting of collateral or not) to comply with the Act, which would seem to have the effect of making margining requirements non-retroactive. In the absence of further interpretation by the regulators, it is difficult to confidently determine Congressional intent with respect to Section 739.

swap.<sup>7</sup> However, termination may also result from a swap party's failure to perform under the economic burden of retroactive margin requirements or from a ratings downgrade that may result.

### **Constitutional Challenge**

The Supreme Court has defined retroactivity in terms of the nature of the effect it has on parties. Generally, a provision's retroactivity turns on whether it would impair rights a party possessed when it acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed.<sup>8</sup> Further, the Supreme Court has held that the rule against retroactive application of laws should only be applied to "substantive" laws and not necessarily to "procedural" laws or laws that merely provide for "prospective relief."<sup>9</sup> Accordingly, retroactivity of the Act may be impermissible based upon the substantive effect it has upon parties to existing contractual agreements.

### **Conclusion**

The ability to clarify the retroactivity of the Act now rests with the applicable Commission, which must promulgate applicable rules and regulations within 360 days of enactment of the Act. As discussed above, the retroactive application of the Act's margin requirements has the potential to disrupt the financial markets and impair existing swaps.

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<sup>7</sup> Standard ISDA documentation and other derivatives contracts give parties the right to terminate the agreement when certain events occur that materially undermine the contract. For example, under the ISDA Master Agreement's illegality provision, a contract is terminable if any material aspect of either party's performance under the contract (including payment and delivery) becomes illegal after the contract is entered into. Additionally, other existing swaps may contain terms allowing the parties thereto to take certain actions – including increasing fees or terminating – upon the incurrence of increased costs due to a change in law.

<sup>8</sup> *Landgraf v. USI Film Products*, 511 U.S. 244 (1994).

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

Appendix C**Federal Income Tax Appendix to the New Scheme for the Regulation of Swaps**

This Appendix highlights certain provisions of the Act that were required in order to prevent the Act from having negative unintended tax consequences for dealers and investors.

**Federal Income Tax Issues****I. Section 1256 of the Internal Revenue Code**

Section 1601 of the Act amends section 1256 of the Internal Revenue Code (the “Code”) to provide that “section 1256 contracts” do not include:

any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.<sup>1</sup>

If these swaps had been treated as section 1256 contracts, they would have been required to be marked-to-market annually, and any gain or loss would have been 60% long-term capital gain or loss and 40% short-term capital gain or loss. This would have created serious character mismatch issues for dealers that are parties to cleared swaps and timing issues for investors who use cleared swaps to hedge capital assets.<sup>2</sup>

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- <sup>1</sup> Note that the list of the various financial instruments that are excluded from section 1256 treatment is not the same as the list of financial instruments that are “swaps” or “security-based swaps” under Title VII of the Act. Further, the financial instruments excluded from section 1256 treatment are generally not defined for federal income tax purposes and, in fact, may be subject to different federal income tax treatment depending on the economic terms of the instrument. For example, an equity swap may be constructed as either a “notional principal contract”, a forward contract, or an option, each of which is treated differently for federal tax purposes, and a credit default swap may be constructed as an option, a notional principal contract, or possibly insurance, each of which is treated differently for federal tax purposes. In addition, the open-ended category of “or similar agreement” certainly appears to include a variety of financial instruments. Thus, exclusion from section 1256 treatment does not appear to depend on the tax characterization of a financial instrument. Regulatory guidance will be necessary to clarify the scope of the exclusion from section 1256.
- <sup>2</sup> For example, although dealers generally mark-to-market their securities and treat all gains and losses as ordinary gains and losses under section 475 of the Code, section 1256 contracts are not treated as securities for these purposes and therefore give rise to capital gains and losses. Since capital losses cannot be used to offset ordinary income, a dealer that uses a section 1256 contract to hedge a security will not generally be able to use a capital loss generated by a section 1256 contract to offset the ordinary gain on the hedged security. Dealers may elect to treat section 1256 contracts as securities for purposes of section 475 of the Code, but the election is available only if the dealer clearly identifies the section 1256 contract in its records before the close of the day on which the section 1256 contract is acquired or entered into. In certain circumstances, making this identification may not be practical.

The Act, by unambiguously amending section 1256 of the Code to provide that most swaps and “similar agreements” are not section 1256 contracts, avoids this issue. Accordingly, swaps will not be treated as section 1256 contracts by reason of being cleared and traded.

## II. The Federal Income Tax Issues Associated with Upfront Payments on Cleared Swaps

The Act does not resolve a second issue that exists today for standardized swaps and will become more important as cleared swaps are standardized.

Under existing Treasury regulations, a swap or other notional principal contract that provides for a “significant non-periodic payment” is bifurcated into an “on-market” swap and a deemed loan.<sup>3</sup> The Treasury regulations do not define “significant” for this purpose, although one example in the regulations provides that an upfront payment on an interest-rate swap equal on a present value basis to approximately 9.1% of the total fixed rate payments due under the contract is not treated as significant, while another example indicates that an upfront payment equal on a present value basis to 66.7% of the total fixed rate payments due under the swap, or 40% of the present value of the total fixed payments on an on-market swap, is treated as significant.<sup>4</sup>

If a standardized swap that provides for an upfront payment is bifurcated into an on-market swap and deemed loan, the following issues will arise:

- An offshore fund with a U.S. manager that is deemed to make this loan could be treated as engaged in origination activity, and therefore as being “engaged in a U.S. trade or business” and potentially subject to U.S. federal income tax on a net income basis.<sup>5</sup>

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Second, periodic payments on swaps are generally treated as ordinary income; however, gain or loss on a section 1256 contract is generally treated as capital gain or loss. Thus, a character mismatch would have arisen to the extent that periodic payments reduce the fair market value of a section 1256 contract.

Third, if an investor uses a section 1256 contract to hedge a capital asset that is not itself required to be marked-to-market, the investor will be required to mark-to-market the section 1256 contract but generally not the hedged asset. In this case, a timing issue will arise. (If the hedged asset is a capital asset, the taxpayer will not be permitted to treat the hedged asset as a hedging transaction under section 1256(e) of the Code or Treasury regulations section 1.1221-2(b)(2).)

<sup>3</sup> Treasury regulations section 1.446-3(g)(4).

<sup>4</sup> Compare Treasury regulations section 1.446-3(g)(6), Example (2) (9.1%) with Example (3) (40; 66.7%).

<sup>5</sup> Section 864(b)(2)(A)(ii) provides a safe harbor under which a foreign person with a U.S. investment manager is not treated as engaged in a trade or business in the United States if it limits its activities to “trading in stocks and securities” for its own account. However, the IRS takes the position that the safe harbor is not available to a foreign corporation that originates loans. See IRS Office of Chief Counsel Memorandum, PRENO-119800-09 (September 22, 2009). Therefore, if the deemed loans are treated as giving rise to origination activity, the foreign person could fail to qualify for the section

- A U.S. tax-exempt organization that is deemed to have received a loan as a result of having received a significant upfront payment on a swap may be treated as having “unrelated debt-financed income,” and may be subject to federal income tax.<sup>6</sup>
- A “controlled foreign subsidiary” (a “CFC”) that is deemed to have made a loan to one of its 10% United States shareholders as a result of having made a significant non-periodic payment on a swap may be treated as having invested in “United States property” and, therefore, under section 956 of the Internal Revenue Code, the 10% United States shareholders of the controlled foreign corporation may be deemed to have received a taxable dividend.<sup>7</sup>
- If a 10% foreign shareholder of a U.S. corporation is deemed to have made a loan to the U.S. corporation as a result of having made a significant non-periodic payment on a swap, to with the U.S. corporation, the foreign shareholder may be subject to a 30% withholding tax on the deemed interest income.<sup>8</sup>

Although there are no evident tax policies that would support these counterintuitive results in the context of upfront payments on standardized swaps, published guidance from the IRS will be necessary to resolve the issues definitively.

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864(b)(2) safe harbor, in which case the foreign person could be treated as engaged in a trade or business in the United States and subject to U.S. federal income tax on a net income basis.

<sup>6</sup> Tax-exempt organizations are generally subject to tax on income or gain from investment property that is financed with indebtedness. This income or gain is generally referred to as “unrelated debt-financed income.” See generally section 514(a).

<sup>7</sup> Section 956 provides, generally, that the 10% United States shareholders of a CFC are taxed on the CFC’s investment in “United States property” to the extent of the CFC’s untaxed earnings and profits. United States property includes an obligation of a United States shareholder. See sections 956(c)(1)(C) and (c)(2)(F). Thus, if a CFC is deemed to make a loan to a United States shareholder, the CFC will generally be treated as having invested in United States property.

<sup>8</sup> Interest paid by a U.S. corporation to a 10% foreign shareholder generally does not qualify for the “portfolio interest” exemption from withholding tax and therefore is generally subject to a 30% U.S. withholding tax. Sections 881(c)(1) and (c)(3)(B).

We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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# Clients & Friends Memo

## Regulation of End Users of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

July 20, 2010

The purpose of this memorandum is to provide an overview of the application of Title VII (the “**Derivatives Legislation**” or the “**Legislation**”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Act**”) to end users, particularly (i) operating corporations (“**Corporates**”), such as manufacturing companies, insurance companies and airlines (all of which may be impacted somewhat differently), (ii) state and other municipal entities (“**Munis**”), and (iii) public and private benefit plans (“**Plans**”; and collectively with Corporates and Munis, “**end users**”).

In General, the Derivatives Legislation establishes a separate but parallel scheme of regulation for “security-based swaps” regulated by the Securities and Exchange Commission (the “**SEC**”) and for “swaps” on non-securities such as interest rates, currencies, energy and agricultural products (and certain securities) regulated by the Commodity Futures Trading Commission (the “**CFTC**”; and together with the SEC, the “**Commissions**”).<sup>1</sup>

The memorandum focuses on seven aspects of the Derivatives Legislation relevant to end users, as well as a number of topics that arise with respect to each of these issues.

- The **first issue** is the scope of the term “**swap**”; and the related topics include the application of that term to **forwards, commercial loans and insurance**.

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

<sup>1</sup> For purposes of simplicity, unless the distinction is particularly important, this memorandum refers to both “swaps” and “security-based swaps” as “swaps” and makes similar simplifying uses of terminology. For a more detailed description of the swap regulatory scheme, see our related memorandum titled “[The New Scheme for the Regulation of Swaps Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#).” That memorandum also contains additional Appendices relating to (i) the tax treatment of swaps, (ii) the retroactivity provisions of the Derivatives Legislation and (iii) certain additional obligations that apply to swap dealers in entering into transactions involving Munis and Plans.

- The **second issue** is the application of the “**major swap participant**” definition to each of Corporates, Munis and Plans.
- The **third issue** is the ability of these three types of entities to rely on the “**commercial user**” exemption from clearing and margin requirements.
- The **fourth issue** is the reporting requirements that apply to persons that enter into swaps.
- The **fifth issue** is the imposition of position limits on swaps and related assets and contracts.
- The **sixth issue** is the application of the “**legal certainty**” provision of the Derivatives Legislation as applied to **pre-existing swaps**.
- The **seventh issue** is the ability of end users to plan for compliance with the Derivatives Legislation so as to minimize the impact of the legislation.

Notwithstanding the length of the Derivatives Legislation, it is unclear (and there is no guidance in the legislative history) whether the number of end users required to register as a major swap participant, and thus be subject to the attendant regulatory burdens, will be 10,000 or 10: it is left to the regulators. Nonetheless, it is possible to identify issues of concern, and actions that end users may take to maximize flexibility once rules are implemented.

## I. Definition of the Term “Swap”

The Derivatives Legislation provides a comprehensive scheme for regulating “swaps,” including (i) mandatory registration of swaps dealers and certain large users of swaps (referred to as “major swap participants”<sup>2</sup>); (ii) capital and conduct requirements on entities required to register; (iii) mandatory central clearing of certain swaps and imposing margin requirements on many swaps not required to be cleared; (iv) trade reporting obligations; and (v) position limits. The impact of these requirements depends upon the definition of the term “swap” and how that term will ultimately be interpreted.

The Derivatives Legislation defines “swap” in an **extremely expansive** manner.<sup>3</sup> In this regard, the first part of the discussion below focuses on the application of the swap definition to “forward” transactions. In addition, in Sections I.C and D, we discuss the breadth of the definition, including the potential application to commercial loans and insurance contracts.

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<sup>2</sup> More precisely, larger users of swaps regulated by the CFTC are defined as “major swap participants” and large users of security based swaps regulated by the SEC are defined as “major security-based swap participants.” This memo generally combines both terms under the rubric of “major swap participants.”

<sup>3</sup> See Derivatives Legislation Sec. 721 (defining the term “swap”).

### A. Forwards.

“Swaps” generally include any contract that provides, on an executory basis, for the exchange of payments based on the value of one or more underlying rates or assets.<sup>4</sup> “Forwards” involving physical commodities are **excluded** from the definition of a “swap,” **provided** the parties enter into the transaction with an **“intent” to make delivery**. Put differently, a transaction would not be a forward, even if the parties are hedging, if the parties do not intend delivery. Further, the term “forward” in the Derivatives Legislation is limited to transactions in physical commodities; *i.e.*, it does not include transactions in financial commodities.<sup>5</sup>

*Example of a Hedging Swap.* Assume an airline holding company with various operating subsidiaries is concerned about the price of oil rising. The airline wishes to enter into purchase contracts to lock in the price of oil for the next three years. The first question for the airline is whether those purchase contracts are “forwards” (outside the scope of the Derivatives Legislation) or “swaps” (subject to the requirements of the Derivatives Legislation).

Assume that to support its fleet, the airline will require oil deliveries in various locations throughout the world (assume the United States and Europe by way of example). To rationalize its hedging, the airline only enters into purchase contracts in Houston, based on the assumption that (i) if the price of oil rises in Europe, (ii) the price of oil will also increase in Houston and (iii) the airline will close out the Houston oil contracts at a profit, offsetting its cost increases in Europe. In any case, the airline **does not intend all the oil it purchased in Houston to be delivered**, although the contracts are intended as hedges against rising oil prices.

Under the literal words of the Derivatives Legislation, the purchase contracts would be “swaps” inasmuch as they do not fit within the definition of “forwards” given the absence of intent to take delivery. (While this may not in and of itself be problematic, it does bring the trades within the scope of the Derivatives Legislation.) For purposes of this memorandum, we will refer to such contracts for hedging where delivery is not actually “intended,” as “Hedging Swaps.”

*Intent and Forwards.* Assume that the airline prefers that the oil purchase contracts be treated as forwards (outside the scope of the Derivatives Legislation), and not as swaps. It must then consider a difficult question raised by the forward contract definition: what is “intent” (*i.e.*, state of mind) to deliver?

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<sup>4</sup> See *Id.*

<sup>5</sup> Derivatives Legislation Sec. 721. One of exclusions for a “swap” includes “any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.”

Assume the airline's oil contracts were with three different oil producers in Houston and that, over time, the airline takes delivery of all of the oil contracts from one of the three producers, but not the other two. In that case, a question arises as to whether the airline had the requisite "intent" of taking delivery of the contracts, inasmuch as the airline took delivery of less than half of the oil.

Another difficult question is whether the intent of the airline is the same as the intent of the seller of the oil. That is, what if the seller of the oil has the "intent" to deliver, but the airline does not have the "intent" to receive, but rather expects to close out the contract by delivery. Whose intent governs? Can the parties agree on a mutual intent by contract? If an oil producer learns from experience that an airline consistently declines to take delivery, is that producer on notice that the airline does not have the requisite intent?

*Litigation and Interpretation.* Prior to the adoption of the Commodity Futures Modernization Act (the "CFMA"), whether parties to a forward had the requisite "intent" to make or take delivery in connection with forward contracts was the subject of both court disputes and regulatory actions.<sup>6</sup>

To eliminate these conflicts with respect to sophisticated institutional participants, the CFTC had begun to move away from an interpretation of the term "forward" that depended on whether the parties actually intended to settle by delivery. Rather, the CFTC moved (i) to a position that a contract would be deemed a forward based on a party's ability to make or take delivery, regardless of intent; and (ii) more generally to a sophistication standard, where so long as the parties were sophisticated, they would be deemed to have entered into a legal "forward" contract, regardless of intent or expectation of taking delivery.<sup>7</sup> These positions were controversial, since they were not

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<sup>6</sup> See, e.g., *CFTC v. Co Petro Mktg. Group*, 680 F.2d 573 (9th Cir. 1982); *In re Stovall*, Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,775 (Dec. 6, 1979). The statutory exclusion for forward contracts in the Commodity Exchange Act ("CEA") reflects a judgment that notwithstanding the CEA's application to contracts involving delivery in the future, the regulatory scheme for futures trading "should simply not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity." *Statutory Interpretation Concerning Forward Transactions*, 55 Fed. Reg. 39188, 39190 (Sep. 25, 1990).

In an opinion written by Judge Frank Easterbrook, the 7<sup>th</sup> Circuit held that the relevant inquiry was whether the transaction involved, on the one hand, "a sale **of the commodity**," in which case it would be deemed to be a forward; or the contract was, on the other hand, "a sale **of the contract**," in which case it would be considered a futures contract. *CFTC v. Zelener*, 373 F.3d 861, 865 (7th Cir. 2004) *reh'g and reh'g en banc denied*, 387 F.3d 624 (7th Cir. 2004). As a proxy for this inquiry, Judge Easterbrook focused on whether the contract was fungible or absent that, whether the seller promised to allow the buyer to enter into an offsetting contract on demand. If either condition applied, the contract would be regarded as a futures contract. *Id.* at 868.

<sup>7</sup> See, e.g., *Regulation of Hybrid and Related Instruments ("Hybrids Interpretation")*, Comm. Fut. L. Rep. (CCH) ¶ 23,995 at 34,491 (Dec. 11, 1987) (refraining from exercising regulatory jurisdiction over swap transactions "which contemplate cash settlement rather than delivery of the physical commodity"); *Statutory Interpretation Concerning Forward Transactions ("Brent Interpretation")*, Comm. Fut. L. Rep. (CCH) ¶ 24,925 at 37,368 (Sept. 25, 1990) (holding that 15-day Brent oil contracts were forward contracts notwithstanding the fact that such transactions "may ultimately result in performance through the payment of cash as an alternative to actual physical transfer or delivery of the commodity").

based on statutory interpretations, but on a view that sophisticated parties should be able to determine for themselves whether to trade or not.<sup>8</sup>

The issue of intent with respect to many transactions between institutional parties largely became moot after Congress adopted the CFMA, which provided that, so long as the parties met certain financial status requirements, such parties could enter into off-exchange forwards or swaps, regardless of their specific “intent.”<sup>9</sup> The Derivatives Legislation undoes the CFMA and thus returns the law to the difficult issue of determining intent. The question then becomes how will the courts and the regulators, particularly the CFTC, interpret “intent.”

For purposes of this memorandum, we assume that the courts and the CFTC will take the Derivatives Legislation at its plain meaning, and thus require intent (and not merely ability) to deliver as a prerequisite to a trade being a forward. Accordingly, parties need to consider how they can **demonstrate—both as to themselves and as to their counterparties—“intent,”** and what documentation can survive both potential litigation and regulatory challenge. At a minimum, market participants should be aware that the law in this area was unsettled prior to the adoption of the CFMA and this uncertainty will again return.<sup>10</sup>

#### B. Commodity Options.

Under the plain language of the Derivatives Legislation, it is possible that a commodity option will be treated as a “swap,” rather than a forward, even if the option calls for settlement by physical delivery. As a practical matter, this question is left for determination by the CFTC.

#### C. Floating Rate Loans as Swaps.

As noted above, the definition of “swap” in the Derivatives Legislation is very broad. In addition to payment contracts based on the value of an underlying asset, the definition also includes “**any agreement, contract, or transaction . . . that provides for any . . . payment or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial,**

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<sup>8</sup> Mark D. Young, *Should the Supreme Court Review Zelener? ABA Committee on Regulation of Futures and Derivative Instruments, Winter Meeting, Key West, Florida, February 5, 2005.*

<sup>9</sup> Nevertheless, this issue of intent continued to create uncertainty in certain foreign currency and commercial agricultural transactions outside the scope of the CFMA. See Robert Zwirb, *The CFTC and Foreign Currency—From A to Zelener, Futures & Derivatives Law Report, Feb. 2009, Vol. 29, Issue 2.*

<sup>10</sup> See Christina A. Barone, *The Hedge-To-Arrive Controversy: Conflicting Outcomes in Administrative and Judicial Proceedings*, 52 Admin. L. Rev. 1423, 1426 (2000) (noting that CFTC and federal courts analyzing HTA contracts according to the traditional case law multi-factor approach reach “opposing outcomes”). This dichotomy between the courts and the CFTC continues to this day.

**economic, or commercial consequence.**<sup>11</sup> While we read the definition of “swap” to carve out physically settled purchase contracts of nonfinancial commodities and securities (without regard to whether they are contingent contracts), the definition includes a wide variety of non-purchase contracts which include contingencies such as most credit agreements, success-fee contracts and similar arrangements, and most forms of insurance.

For example, this provision could be read to include, among other contracts, commercial loans having floating rates of interest, since these loans have payment terms dependent on the “occurrence of an event” (a rise or fall in interest rates) with a financial, economic or commercial consequence. Commercial loans having interest or payment triggers tied to other commodity prices (such as oil), currency values or the like could similarly be read to be included within the broad definition of “swap” set forth in the Derivatives Legislation, as could commercial loans with conditions precedent such as material adverse-change clauses.

We assume that Congress did not intend the term “swap” to cover commercial loans. Nonetheless, the scope of the definition of “swap” creates an interpretative problem. One potential solution is simply to conclude that the regulation of commercial loans is not what Congress intended. However, there are uncertainties associated with this position. *First*, being wrong could result in a violation of the law. *Second*, the CFTC has historically—pre-CFMA—asserted authority over private transactions linked to interest rates, currencies and other commodities. A body of regulatory practice developed at that time as to whether various loan and debt instruments were in fact disguised futures contracts subject to regulation under the Commodity Exchange Act.<sup>12</sup> *Third*, the Derivatives Legislation specifically excludes “securities” that have payment terms linked to commodity values, but it does not provide a similar carve-out for commercial loans.

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<sup>11</sup> Derivatives Legislation Sec. 721 (defining “Swap”).

<sup>12</sup> For examples of pre-CFMA regulatory debates over the scope of the CEA’s authority, see *e.g.*, (i) Advance Notice of Proposed Rulemaking, 52 Fed. Reg. 47022 (Dec. 11, 1987); (ii) Statutory Interpretation Concerning Certain Hybrid Instruments, 54 Fed. Reg. 1139 (Jan. 11, 1989); and (iii) Statutory Interpretation Concerning Hybrid Instruments, 55 Fed. Reg. 13582 (April 11, 1990) (the “Reissued Interpretation”). In the Reissued Interpretation, the CFTC expressed the view that “commercial loans, that is bank loans directly to a commercial customer for the purpose of providing funds for use by the customer in its business . . . as well as loans to foreign governments, or political subdivisions thereof, would be beyond the purview of the CEA. . . .” Assuming that the Reissued Interpretation would again become “good law,” is it limited to loans by banks? And query why loans to foreign governments are carved out from the CFTC’s jurisdiction, but not loans to municipalities?

It is unclear whether Congress or the CFTC considered these documents in the course of the debate over the Derivatives Legislation, as well as whether the old interpretations have any continuing authority in light of the adoption of the CFMA and now the impending repeal of the CFMA and adoption of the Derivatives Legislation. In short, how much of the old statutory interpretation survives?

#### D. Insurance Contracts as Swaps.

The definition of “swap” is also broad enough to include many, if not all, types of insurance contracts. Read literally, even contracts such as corporate life insurance, theft insurance, or fire insurance could be “swaps,” since these contracts have payment terms linked to the occurrence of an event with a financial consequence.

Can we assume that Congress simply did not mean to include contracts that are commonly thought of as insurance as “swaps?” One possible “interpretation” is that Congress only intended to clarify that credit default swaps were not “insurance”—as the characterization of such swaps as insurance was publicly debated before the adoption of the Act. This approach raises not only the problem of the literal words of the Derivatives Legislation, but also the problem that Congress was explicitly considering the issue of insurance as it adopted the Derivatives Legislation. For example, sections of the Derivatives Legislation provide that no state insurance authority will have authority over any swap agreement<sup>13</sup>—which raises difficult questions given the broad definition of “swap.” Further, the regulatory history of the CEA demonstrates that the CFTC has historically taken the position that it should have authority over certain classes of contracts sold as insurance. For example, in the Reissued Interpretation cited in footnote 12 above, the CFTC conceded that it would not have jurisdiction over “non-transferable life insurance contracts,” but left open the question of its jurisdiction over other insurance contracts. The issue of the CFTC’s authority over insurance is potentially more difficult now than it was in 1990 because the scope of CFTC jurisdiction under the Derivatives Legislation is much broader than it was in 1990.

In short, while Congress **likely did not intend** the words of the Derivatives Legislation to include all insurance, **it is not safe to assume** how the courts or regulators will determine this issue as to various types of insurance. As a practical matter, of course, insurance companies and buyers of insurance will likely have to reach a judgment as to the scope of the definition of the term “swap” before it is ultimately clarified.

#### E. Purposes of Swaps: Hedging and “Investment.”

In the first section of this memorandum, we discussed the breadth of the term “swap.” In the next parts of the memorandum, we discuss certain aspects of the regulation of swaps applicable to end users.

For end users, very significant aspects of the regulation under the Derivatives Legislation turn on the purpose for which swaps are entered. The purpose of a particular swap may determine, for

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<sup>13</sup> See Derivatives Legislation Sec. 722 (Jurisdiction); Sec. 767 (State Gaming and Bucket Shop Laws).

example, whether an end user (i) is required to register as a “major swap participant” or (ii) is eligible to use the “commercial user” exemption from clearing and margin requirements.

For purposes of the discussion below, we use the term “Hedging Swap” to mean a swap entered into “for hedging or mitigating commercial risk.” This term is not defined in the Derivatives Legislation which gives the CFTC authority to define it.

For purposes of this memorandum, we use the term “Investment Swap” to mean any swap that does not qualify as a Hedging Swap; e.g., a swap entered into to make a profit based on future price movements.<sup>14</sup>

## II. Major Swap Participant Status

The Derivatives Legislation potentially subjects buy-side participants to regulation as strict as that applicable to sell-side firms. In particular, an end user which is deemed a “major swap participant” will be subject to largely the same rules that apply to swap dealers.

There are three major costs or risks (and various lesser ones) that flow from being deemed a “major swap participant.” First, such an entity would be subject to capital regulation intended to be stricter than the capital regulation that applies to banks. Such capital regulation would likely be expensive and burdensome for most end users in the operation of their ordinary businesses. As a result, an end user so regulated would likely want to isolate its affected swaps activities in a separate subsidiary so that the Derivatives Legislation capital rules applicable to major swap participants did not burden all of the end user’s activities.<sup>15</sup> Second, a major swap participant is generally required to clear and margin its swaps including Hedging Swaps. Thus, an end user regulated as a major swap participant would lose the benefit of statutory exemptions from mandatory clearing and margin. Third, a major swap participant is subject to a variety of requirements with regard to its counterparties, even if its counterparty is a swap dealer, raising the possibility of both private and civil liability for failing to fulfill these obligations.

*Legal Entity Determination.* The determination of whether an entity is a “major swap participant” is, under the words of the Derivatives Legislation, to be made **on a legal entity basis** and not by considering the activities of an entire corporate group. In short, the term “major swap participant” means a “person” who meets one of the three tests described below.

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<sup>14</sup> The Commodity Exchange Act generally uses the term “speculative” to refer to transactions entered into for such purposes, but this memorandum uses the term “investment” inasmuch as “speculative” has a pejorative meaning that distracts from the legal analysis.

<sup>15</sup> As a practical matter, this separate subsidiary is likely to require either a parent guarantee to make it creditworthy or else require the airline to isolate a very substantial amount of “cash” in the subsidiary.

*The Three Tests.* The Derivatives Legislation provides three alternative tests to determine whether an entity is a “major swap participant.” End users must understand how these tests work to structure their business (i) to avoid falling within the “major swap participant” definition or (ii) to minimize the costs of being regulated. Note that each of the three tests requires detailed implementation and rulemaking by the Commissions, so end users will have to revisit their planning as the regulators specify what the three tests mean.

- The **first test** covers an entity that maintains a “**substantial position**” in swaps in any “**major swaps category**.”<sup>16</sup>
- The **second test** covers an entity whose “**swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets**.”<sup>17</sup>
- The **third test** covers a “**financial entity**” (a term that specifically includes employee benefit plans and that would also include an insurance company<sup>18</sup>) that is “**highly leveraged relative to the amount of capital that it holds**,” that is not an entity subject to U.S. bank capital requirements, and that maintains a “substantial position” in swaps in any “major swaps category.”<sup>19</sup>

*Two Exclusions From the First Test.* **For purposes of the first test only**, swaps held “for hedging or mitigating commercial risk”; *i.e.*, Hedging Swaps, are not included in the determination of a substantial position.<sup>20</sup> The first test also excludes positions held by any employee benefit plan as defined in Section 3(3) and 3(32) of ERISA “for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.”<sup>21</sup>

The scope of the Hedging Swap exemption is unclear. For example, can a Muni hedge “commercial risk” given that Munis are not generally regarded as being “in commerce.” For

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<sup>16</sup> Derivatives Legislation Sec. 721 (defining “Major Swap Participant”).

<sup>17</sup> *Id.*

<sup>18</sup> The term “financial entity” includes an entity predominantly engaged in activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act, which provision defines “insurance” as being “financial in nature.” Derivatives Legislation Sec. 723 (Clearing).

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

<sup>20</sup> The term “hedging or mitigating commercial risk” is not defined in the Derivatives Legislation. There is a somewhat similar term—bona fide hedge—which is used in the provisions regarding position limits, which are discussed in Section V of this memorandum.

<sup>21</sup> Derivatives Legislation Sec. 721 (defining Major Swap Participant). It should be noted that the hedging exclusion for plans may not apply, absent clarification, to certain employee benefit plans that use swaps for more than just, for example, mitigating interest rate risk or currency risk of cash market investments made by the plan. In this regard, some employee benefit plans use swaps for what could be characterized as investment purposes; *e.g.*, to gain exposure to an asset class.

example, if a Muni enters into an energy swap to hedge the cost of its buying oil to heat police and fire stations, is that hedging a “commercial” risk? Similarly, if a Muni borrows money at a floating rate to pay outstanding debt used for general governmental purposes and enters into a fixed-rate swap to hedge that debt, is that the hedging of a “commercial” risk?

*Definition of Substantial Position and Certain Considerations.* For the first and third tests, the Derivatives Legislation provides that “substantial position” should be defined by the relevant swaps regulator (*i.e.*, the CFTC or the SEC) at the “threshold that the swaps regulator determines to be prudent for the effective monitoring, management or oversight of entities that are systemically important or can significantly impact the financial system of the United States.”<sup>22</sup> This is an unusual determination for the CFTC and the SEC to make as the two agencies do not monitor the financial system of the United States at a global level.

The Derivatives Legislation further provides that, in setting the “definition” of substantial position, the regulators (i) **shall** consider the person’s “relative position in uncleared as opposed to cleared swaps” and (ii) **may** take into consideration the value and quality of collateral held against counterparty exposure.<sup>23</sup> The purpose of these two provisions is uncertain. As to the first requirement, it is unclear why the “relative position” matters; if one entity has \$400 of cleared exposure and \$200 of uncleared exposure, is that entity less likely be a major swap participant than an entity which has \$200 of each type of exposure? As to the second provision, it is unclear whether the regulators may only take into account collateral that is “held” by another party or if it is intended that the regulators should also take into account collateral that has been “posted” to another party (which would seem a more logical result).

*“Major Swap Category.”* The definition of a “substantial position” is dependent on the definition of a “major swap category”—a term left to the regulators to interpret. For example, a “major swap category” might be defined as (i) physical, non-agricultural commodities; (ii) energy; (iii) oil; or (iv) a particular type or grade of oil, since there is no guidance in the Derivatives Legislation. Further, it is not clear why the division of swaps into major categories is relevant to the purposes of the legislation. If the purpose of the Derivatives Legislation is to limit credit exposures relating to swaps, it is unclear why \$200 of swaps relating to interest rates and \$200 relating to gold should be treated differently from \$400 of swaps relating wholly to gold?

*Single Entity vs. Corporate Group: Matching the Swap to the Risk.* While the first test for being a “major swap participant” includes the hedging exception noted above, **it appears that the risk**

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<sup>22</sup> As to the second test, there is no similar guidance, but the Commissions will need to develop criteria for determining what constitutes a systemically risky counterparty exposure.

<sup>23</sup> Derivatives Legislation Sec. 721.

**being hedged must generally be in the same legal entity that is entering into the swap.** The one exception is that the Hedging Swaps may be held in (i) “an entity whose primary business is providing financing,” and (ii) uses derivatives to hedge commercial risks related to interest rates and foreign currencies, (iii) where 90% of the [rate and currency] exposures arise from financing the purchase or lease of products, (iv) 90% or more of which are “**manufactured**” [emphasis supplied] by the parent company directly or through a subsidiary.<sup>24</sup>

The above conditions are restrictive, even as to Corporates actually engaged in manufacturing. Thus, an automobile company would presumably have to calculate whether it met the required 90% tests. On the other hand, neither the airline nor the insurance company is commonly viewed as engaged in “manufacturing.” These types of business entities would be required to conduct all of their Hedging Swaps (including any “forwards” that were deemed to be Hedging Swaps) in the same legal entity in which the related commercial risk arose or else risk having the legal entity that entered into the swaps being deemed a major swap participant.

### III. Commercial User Status

A Hedging Swap is not subject to the Derivatives Legislation clearing requirements applicable to Investment Swaps; *provided* that several conditions are met. (This is the “commercial user” exemption from clearing.) The **first condition** is that the **legal entity** using the exemption can not be a “financial entity” (although there is an exception to this requirement). The **second condition** is that the relevant swap must be a Hedging Swap. The **third condition** is that the legal entity must notify the regulators how it generally meets its financial obligations with respect to non-cleared swaps.

*Meeting the Three Conditions.* As to the first condition, the term “financial entity” includes, among other things, (i) a major swap participant (which may cause an end user to isolate Investment Swaps in a separate entity from Hedging Swaps) or (ii) a person engaged in activities that are “financial in nature” as defined in the Bank Holding Company Act. Notably, an entity whose only business was entering into swaps would likely be deemed to be predominantly engaged in activities that are financial in nature. Thus, as a general matter, a separate swaps subsidiary could not be used for trading swaps that are not intended to be cleared and margined.<sup>25</sup>

The second requirement, that the swap be a Hedging Swap, is discussed above.

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

<sup>25</sup> There is a limited exception to the use of a separate entity, but this exception is only available with respect to “manufacturing,” as above, and thus could not be used by many Corporates.

The third requirement, a statement as to how the entity will meet its obligations with respect to swaps, is unclear. On the one hand, this requirement may merely be a formality; *i.e.*, an airline would say that it meets its swap obligations, the same way that it meets its electricity bill or pays its employees, by flying passengers. On the other hand, it may be that a more substantial requirement is intended; *e.g.*, a certification by corporate officers that the airline will not become insolvent and thus that it will be able to pay its obligations arising with respect to swaps. In the latter cases, such a certification could be problematic: if the airline financial officers were required to certify as to ongoing ability to pay, and the airline were to become insolvent, the officers who signed the certificate might face liability for having given a false representation.

*Unintended Contradiction?* One of the principal purposes of exempting end users from mandatory clearing with respect to their Hedging Swaps was to allow end users to avoid margin requirements set by central clearing counterparties. However, in many cases, end users will trade with swaps dealers and the Derivatives Legislation requires the regulators for swap dealers to establish **both initial and variation margin requirements for all swaps that are not cleared**, with no exemption provided for Hedging Swaps with end users.

As of today, it is unclear how this contradiction between the exemption for end user Hedging Swaps and the margin rules applicable to swap dealers will be resolved. One possibility is to revise the margin provisions of the Derivatives Legislation in an amendment to be passed before the effective date for the new legislation. Another possibility is for the regulators to use their discretion to set very low initial margin requirements for swaps that are Hedging Swaps with end users. In this regard, the Derivatives Legislation gives the regulators discretion to set margin requirements for uncleared swaps at a level, "appropriate for the risk associated with the non-cleared swaps."<sup>26</sup> However, the Derivatives Legislation also provides a general presumption that the risk for uncleared swaps is greater than for cleared swaps. It would appear difficult for regulators required to be responsible for the safety and soundness of dealers to provide the effective equivalent of a blanket exception for trades with end users. Until this issue is resolved, end users will face uncertainty as to whether, and to what extent, the Derivatives Legislation will provide an effective exemption from the margin requirements.

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<sup>26</sup> Derivatives Legislation Sec. 731 (Registration and Regulation of Swap Dealers and Major Swap Participants)

#### IV. Swap Reporting

All “swaps,” including Hedging Swaps, are subject to reporting requirements. Swaps that are not accepted for clearing at a derivatives clearing organization must be reported to a registered swap data repository or, if no swap data repository will accept the report, to the regulators.<sup>27</sup>

To a large extent, swap reporting requirements will not apply directly to end users. For swaps where one of the parties is a swap dealer or major swap participant, the swap dealer or major swap participant (and not the end user) is required to report. However, where neither party is a swap dealer or major swap participant (or where both parties are major swap participants), then parties must decide between themselves which party will report.<sup>28</sup> Therefore, end users must develop and implement compliance procedures to satisfy potential reporting requirements and to provide for the timely submission of reports when they are required.

End users will need to consider several questions when developing these reporting procedures. First and foremost, end users will need to assess the scope of the reporting requirement and identify contracts to which it applies; *i.e.*, end users must determine which contracts are “swaps.”

It seems unlikely that a swap data repository or the regulators have an interest in receiving a flood of reports for all manner of commercial contracts that include payment contingencies, so it is likely that the regulators will use their authority to further define the term “swap” to limit definitional overreach. Nevertheless, even in such a scenario, commercial end users must develop the capacity to identify contracts that may be deemed to be swaps and/or manage the risk of unintentional reporting failures.

Second, end users may be required to deal with difficult issues relating to what information is required to be reported and when. While both the timing and content of swap reports is largely in the discretion of the regulators, the Derivatives Legislation does **require** the CFTC to promulgate rules to provide for the “real time public reporting” of swap data, including for swaps that are exempt from clearing.<sup>29</sup> For this purpose, the Derivatives Legislation defines “real time public reporting” as public dissemination of swap data, including price and volume, “as soon as technologically practicable after the time at which the swap transaction has been executed.”<sup>30</sup>

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<sup>27</sup> Security-based swaps that cannot be reported to a swap data repository will be reported to the SEC.

<sup>28</sup> The legislation does not make clear whether the parties are jointly liable for a failure to report under this circumstance, or whether the parties can rely on an agreement that one of the parties will report to limit potential liability for a compliance failure to one of the parties.

<sup>29</sup> Derivatives Legislation Sec. 727 (Public Reporting of Swap Transaction Data).

<sup>30</sup> *Id.*

Thus, it is likely that parties to uncleared swaps will be required to report more or less immediately upon “execution.”

Lastly, end users must monitor for announcements as to start dates when swaps are to be reported. Transition rules in the Derivatives Legislation provide for the reporting of swaps (i) entered into before enactment of the Derivatives Legislation within 180 days of the general effective date of the legislation (*i.e.*, 540 days after enactment) and (ii) entered into after enactment but prior to the effective date within 90 days of the general effective date or by such other time as the CFTC prescribes by rule.<sup>31</sup> However, **another** provision of the Derivatives Legislation requires the CFTC to adopt a reporting rule for pre-enactment swaps within 90 days of enactment, and requires reporting of such swaps within 30 days of enacting the rule unless the CFTC determines another period to be appropriate.<sup>32</sup>

## V. Position Limits

The CFTC is authorized to set position limits, other than “bona fide hedge positions,” that may be held by “any person” with respect to swaps that are “economically equivalent” to futures traded on a U.S. futures exchange.<sup>33</sup>

The term “bona fide hedge” is defined in the Derivatives Legislation.<sup>34</sup> By contrast, the term “positions used to hedge or mitigate commercial risk” (which is the phrase used in the definition of major swap participant) is not a defined term. This could mean either that (i) the two terms are intended to be identical and the same language should have been used in both places or (ii) the term “bona fide hedge” is narrower—and that the CFTC could establish limits as to certain Hedging Swaps that are not considered to be “bona fide hedges.”

The Derivatives Legislation is unusual in that it allows the CFTC to set position limits not only on a “person,” and not only on a group of persons acting in concert, but on any “group or class of traders.”<sup>35</sup> This CFTC power—to apply position limits to a “group or class” of entities—is something that has received very little attention or explanation. However, it implies that the CFTC could apply a position limit to, for example, all airlines in the aggregate, or all transportation companies, or all commercial companies, or all speculators.

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<sup>31</sup> Derivatives Legislation Sec. 723 (Clearing).

<sup>32</sup> Derivatives Legislation Sec. 729 (Reporting and Recordkeeping).

<sup>33</sup> Derivatives Legislation Sec. 737 (Position Limits).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

## VI. Retroactivity

Another issue is the continued viability of swaps entered into before the date of the enactment of the Derivatives Legislation and whether such swaps can be terminated or modified by the parties? Section 739 of the Derivatives Legislation provides that “unless **specifically reserved**” [emphasis supplied] in the swap, the Derivatives Legislation and any rule adopted under the Derivatives Legislation can not constitute (i) a reason to terminate to the swap, (ii) an “illegality” under the swap; (iii) a reason to pass along any increased costs resulting from the swap; (iv) a “regulatory change” with respect to the swap; (v) or a reason to modify the swap.<sup>36</sup> (Note, however, that this Section only applies to those swaps that would be regulated by the CFTC; it does not apply to SEC-regulated swaps on securities. It is unclear if there is a reason for the difference in treatments.)

From a lawyer's perspective, Section 739 raises difficult questions. What does it mean for a right to be “specifically reserved”? Is a right that is included in the form of derivative contract (e.g., the standard ISDA agreement) specifically reserved? Are there rights that are included in a contract, but are not deemed to be specifically reserved? Is the Derivatives Legislation over-riding contractual terms between parties? That may raise questions both from a Constitutional standpoint (is this a “takings”?) and from a general limits on the power of government standpoint (should the government be over-riding private agreements?).

What are the implications of Section 739 for a contract that relates to an Investment Swap but does not provide a “specific reservation” that such contract can be terminated because of an illegality (or indeed any provision that it can be terminated because of an illegality) where such contract does not allow for the collection of margin, but the Derivatives Legislation requires one of the parties to post margin. The contract is now possibly subject to an illegality, but the party that might be required to post margin cannot post it (perhaps does not have liquid assets to post). Can such a party rely on Section 739 for the proposition that the Derivatives Legislation does not allow for amendment of the terms of the contract? That is, (i) the Derivatives Legislation makes the contract “illegal,” and (ii) the Derivatives Legislation does not allow a party to the contract to terminate the contract on the basis of the illegality. What happens in the face of these apparently contradictory provisions?

Finally, consider a contract that allows one party to pass along the costs of a change in law to the other party. The Derivatives Legislation is over 400 pages and clearly appears to constitute a change in law. But the Derivatives Legislation seems to say that it is not a change in law. Can one party nonetheless require the payment of increased costs? If the other party refuses to pay

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<sup>36</sup> Derivatives Legislation Sec. 739 (Legal Certainty for Swaps).

increased costs, can the first party terminate? Is it safer to pay in the increased costs and litigate for their return? These questions also require resolution by the regulations.

## VII. Planning and Corporate Structure

As we have said, notwithstanding the length of the Derivatives Legislation and the Act, there is a great lack of specificity in the Derivatives Legislation. For example, there is no way to know how broadly the regulators will define the term “major swap participant.” As a practical matter, regulators will likely be forced to limit the scope of the defined term “swap,” since, in its literal meaning in the Derivatives Legislation, it could include all insurance contracts, many commercial loans and numerous other contracts. In light of how much remains to be determined, the amount of real planning that can be done by end users is limited. Nonetheless, there are a few general items that should be considered.

### A. Identify “Swaps.”

End users should seek to identify contracts that might be considered swaps, being mindful that the statutory definition of the term is far broader than the plain meaning. As to transactions that might be considered swaps, end users should consider whether they are clearly swaps or they are in an area of legal uncertainty, and how the uncertainty may be resolved.

As to potential swaps, parties need to consider (i) which legal entity is the contracting party on the end user side; (ii) is the swap a “Hedging Swap” and, if so, is it being effected in the legal entity that actually requires the hedge; (iii) what type of entity is the counterparty; *e.g.*, U.S. or foreign, and how will the counterparty be affected by the Act; and (iv) are there terms of the swap that could be altered, or even made impermissible, by the Derivatives Legislation.

### B. Corporate Structure and the Location of Hedging Swaps.

As the Derivatives Legislation is drafted, end users may effectively be required to book Hedging Swaps into the same legal entity that requires the hedge. Accordingly, end users should consider where swaps are current booked and where they may be required to be booked going forward.

### C. Major Swap Participant Definition.

Forced registration as a major swap participant, and the related capital and other requirements, will likely be burdensome. Accordingly, end users should seek to arrange their activities so they do not fall within the definition. In this regard, one may wish to consider the following potential measures:

- Shift positions from swaps to futures, forwards, cash market positions and other non-swap contracts to the extent possible.
- Consider moving positions outside of the United States or away from U.S. counterparties, so as to minimize the potential affect of an entity's failure on the U.S. system (which is part of the second test of the major swap participant definition).
- Consider shortening the maturity of instruments so they mature prior to rule adoptions.
- Consider putting additional assets into a swaps entity so that it is not deemed to be highly leveraged. Similarly, separate swaps from borrowing activity so that the swaps entity does not become highly leveraged.
- Consider providing for posting margin on swaps that do not otherwise require margin if the provision of margin will make it less likely that an entity is deemed to hold substantial positions.

D. Monitor Developments.

As stated in this memorandum, major provisions of the Derivatives Legislation are either largely indeterminate or too broadly drafted to be implemented literally. Thus, there is necessarily much more to come.

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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# Clients & Friends Memo

## Changes to the Regulation of Broker-Dealers and Investment Advisers Under Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

August 12, 2010

Part I of this memorandum focuses on Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) as it relates to the regulation by the Securities and Exchange Commission (“SEC”) of broker-dealers and, to a lesser extent, investment advisers.<sup>1</sup> Part II of this memorandum covers a number of miscellaneous provisions included within Title IX that may affect broker-dealers. Part III describes studies to be conducted by the SEC, the reorganization of the SEC, and a provision that affects current beneficial ownership and short swing profit reporting requirements. Other memoranda prepared by Cadwalader cover the remaining provisions of Title IX, which include (i) significant requirements relevant to credit rating agencies and structured finance products,<sup>2</sup> and (ii) rules related to executive compensation and corporate governance that apply to public companies generally, not merely to those engaged in financial activities.<sup>3</sup>

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\* The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) was signed into law by President Obama on July 21, 2010. The Act will dramatically reshape the U.S. financial regulatory system, while also significantly impacting non-financial institutions, which will be affected, at least indirectly, through their use of regulated financial products.

Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act’s application to specific industries, entities and transactions. To see these other memoranda, please see [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

- <sup>1</sup> For a discussion of the provisions of the Act as it relates to the regulation of hedge funds, including investment adviser registration requirements, see our accompanying memorandum entitled “[Hedge Fund Regulation Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#)”. For a discussion of the Act as it relates particularly to security-based swaps, see our accompanying memorandum entitled “[The New Scheme for the Regulation of Swaps, with Appendices on Retroactivity, Special Entities and Tax, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#)”.
- <sup>2</sup> See our accompanying memorandum entitled “[Reforms to the Asset-Backed Securitization Process and the Regulation of Credit Rating Agencies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#)”.
- <sup>3</sup> See our accompanying memoranda entitled “[Executive Compensation and Corporate Governance Provisions Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#)” and “[Amendments to SOX, Including Section 404\(b\) Exemption for Nonaccelerated Filers, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#)”.

## I. Regulation of Broker-Dealers and Investment Advisers

### A. Overview

In light of the perceived convergence of the activities of broker-dealers and investment advisers, one of the goals of the provisions of Title IX is to implement coherent regulation of broker-dealers and investment advisers and otherwise harmonize the separate regulatory schemes.

Most notably, as discussed in Subpart B below, Title IX authorizes the SEC to impose a fiduciary standard of care on broker-dealers. Indeed, Title IX grants this authority in three separate provisions. These provisions are not uniform, however, and while the most broker-dealer specific of the provisions appears designed to tailor the effect that the fiduciary duty may have on broker-dealers, the other two provisions are not similarly limited and, therefore, raise a question as to whether the SEC can, in effect, override the limitations in one provision by acting under the other two provisions.

In its attempt to harmonize the regulation of broker-dealers and advisers, Title IX also includes provisions (discussed in Subparts C-E below):

- requiring the SEC to mandate increased disclosure of the terms of the relationship between broker-dealers and investment advisers, on the one hand, and their customers and clients, on the other;
- authorizing the SEC to require broker-dealers to provide their retail customers with disclosure documents on costs, risks, and compensation;
- authorizing the SEC to issue rules applicable to broker-dealers and investment advisers with respect to sales practices, conflicts of interest, and compensation schemes;
- restricting the ability of broker-dealers and investment advisers to require that disputes with their customers and clients be resolved through arbitration; and
- mandating application by the SEC of common enforcement standards against broker-dealers and investment advisers.

Title IX also includes a number of additional provisions, discussed in Part II of this memorandum, that will change the regulatory scheme applicable to broker-dealers. These provisions include:

- various matters relating to insolvency proceedings of broker-dealers;
- authorization for the SEC to issue new regulations related to securities lending and short sales;
- limitations on the ability of broker-dealers to cast proxy votes as to any “significant matter” on behalf of their customers; and
- the expansion of the SEC’s enforcement powers.

Additionally, Title VII changes the definition of “security” to include security-based swaps, subjecting broker-dealers to additional regulation with regard to their security-based swap transactions (see Subpart II.E).<sup>4</sup>

Finally, Part III of this memorandum describes (i) changes to the reporting requirements with regard to beneficial ownership of securities and short swing profits, (ii) a number of studies of issues related to broker-dealer regulation that the SEC must conduct, and (iii) provisions affecting the organization of the SEC.

## **B. Imposition of a Fiduciary Duty on Broker-Dealers**

### 1. Background

Traditionally, investment advisers have been subject to a fiduciary duty to their clients.<sup>5</sup> This means that advisers must deal with their clients in utmost good faith and must disclose to their clients all material facts concerning the advisory relationship, including any conflicts of interest.<sup>6</sup> By contrast, broker-dealers, at least when providing “recommendations” to non-discretionary accounts, are held to a “suitability” standard. That is, they do not have to act in their customer’s best interest but, instead, must only show that the recommendation is “suitable” for the customer.

Moreover, the ways in which these requirements are enforced and disputes with customers and clients resolved have evolved along different paths. Broker-dealers are closely overseen and disciplined by the SEC and the Financial Industry Regulatory Authority (“**FINRA**”) or another self-regulatory organization (“**SRO**”). In addition, because SRO rules provide

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<sup>4</sup> See also our accompanying memorandum entitled “[The New Scheme for the Regulation of Swaps, with Appendices on Retroactivity, Special Entities and Tax, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act](#)”.

<sup>5</sup> See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

<sup>6</sup> *Id.* at 194.

broker-dealer customers with the right to resolve disputes against broker-dealers in industry sponsored arbitration forums, customers can generally resolve suitability claims against a broker-dealer in an SRO-sponsored arbitration forum.

By contrast, investment advisers are not regulated by an SRO and their clients do not have access to an SRO or industry-sponsored arbitration forum. Instead, investment adviser clients generally are forced to litigate disputes with their advisers.<sup>7</sup>

Meanwhile, some have argued that the roles of broker-dealers and investment advisers have converged as trade execution has become commoditized and broker-dealers have increasingly distinguished themselves (and marketed themselves) as providers of investment advice. An influential report commissioned by the SEC and conducted by the RAND Institute for Civil Justice (the "**RAND Report**") reveals that many investors may not understand the differences between broker-dealers and investment advisers, or the different standard of care each must provide.<sup>8</sup> That said, the RAND Report does not provide much support for regulatory change as to the application of "fiduciary" standards. See p. 99 of the RAND Report, which indicates high levels of investor satisfaction with individuals and firms (both broker-dealers and investment advisers) providing financial services. In any case, a vigorous debate has erupted over whether the two distinct legal standards and enforcement mechanisms remain appropriate.<sup>9</sup>

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<sup>7</sup> In a private lawsuit, advisers may be sued on the theory of breach of a fiduciary duty, while a litigant alleging that a broker-dealer's recommendation was not suitable would generally have to prove fraud within the meaning of Section 10(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**") or Rule 10b-5 thereunder. See *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 31 (2d Cir. 1977) ("Analytically, an unsuitability claim is a subset of the ordinary § 10(b) fraud claim in which a plaintiff must allege, inter alia, (1) material misstatements or omissions, (2) indicating an intent to deceive or defraud, (3) in connection with the purchase or sale of a security.").

<sup>8</sup> RAND Institute for Civil Justice, Perspectives on Investment Advisers and Broker-Dealers 18-19, 31-32, 89-90, 108-09, 117-18 (2008), available at [http://www.sec.gov/news/press/2008/2008-1\\_randiabdreport.pdf](http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf).

<sup>9</sup> See, e.g., Dept. of the Treasury, "Blueprint for a Modernized Financial Regulatory Structure," 125-26 (Mar. 2008), available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>; Dept. of the Treasury, "A New Foundation: Rebuilding Financial Supervision and Regulation," 71-72 (2009), available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf); Letter from Mary L. Schapiro and Elisse B. Walter, NASD (now FINRA), to Annette Nazareth and Meyer Eisenberg, SEC (Apr. 4, 2005), available at <http://www.sec.gov/rules/proposed/s72599/nasd040405.pdf>; "SEC Oversight: Current State and Agenda," Hearing Before the Subcomm. on Capital Markets, Insurance, and Government-Sponsored Enterprises of the H. Comm. on Financial Servs., 111th Cong. 13 (July 14, 2009) (statement of Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n) (revising

## 2. SEC to Study the Issue

Because broker-dealers are currently regulated by an SRO and investment advisers are not, broker-dealers are subject to a greater level of oversight and examination than investment advisers. Without expressing a view as to the appropriateness of this different treatment, the Act provides for the SEC to study the level of examination of investment advisers and the desirability of designating an SRO to oversee them.<sup>10</sup>

As discussed below, the Act also gives the SEC authority to make rules imposing a fiduciary duty on broker-dealers. To guide the exercise of this authority, the Act directs the SEC to conduct a study to evaluate (i) the effectiveness of existing standards of care for broker-dealers and investment advisers; and (ii) the existence of regulatory gaps in the protection of retail customers relating to the standards of care for broker-dealers and investment advisers.<sup>11</sup>

In conducting the study, Section 913 orders the SEC to consider several factors, including:

- whether retail customers understand the different standards of care owed by broker-dealers and investment advisers;
- the resources devoted to enforcing existing standards of care;
- existing differences in regulation between broker-dealers and investment advisers as to providing investment advice to retail customers;
- the impact of subjecting broker-dealers to the same standard of care applied to investment advisers;
- the impact of eliminating the exclusion of broker-dealers from the definition of “investment adviser” under Section 202(a)(11)(C) of the Advisers Act;<sup>12</sup>

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previous position expressed in 2005 letter), *available at* [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/sec\\_testimony.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/sec_testimony.pdf).

<sup>10</sup> See Section 914 of the Act.

<sup>11</sup> See Sections 913(b)-(e) of the Act.

<sup>12</sup> Under Section 202(a)(11)(C) of the Advisers Act, the term “investment adviser” does not include “any broker or dealer whose [provision of investment advice or analysis] is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor.”

- the services provided by broker-dealers and investment advisers, respectively; and
- the potential costs to retail customers, broker-dealers and investment advisers resulting from changes in regulations.

By January 21, 2011 (six months from the enactment of the Act), the SEC must deliver a report of the results of its study to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.<sup>13</sup>

### 3. Rulemaking Authority Granted to the SEC

The Act includes three separate provisions that give the SEC rulemaking authority to impose a fiduciary duty on broker-dealers. One of these provisions amends the Exchange Act, one amends the Investment Advisers Act of 1940 (the “**Advisers Act**”), and the third is contained in the Act itself. As previously noted and further described below, while the provision added to the Exchange Act appears designed to tailor the effect that the fiduciary duty obligation may have on broker-dealers, the other provisions are not similarly limited and, therefore, raise a question as to whether the SEC can, in effect, avoid the Exchange Act limitations in one provision by acting under the other two provisions.

One of the three provisions is contained in Section 913(b)-(f) of the Act and authorizes the SEC, after conducting the study described above in Subpart B.2 of this memorandum, to issue rules to “address” the standard of care applicable to broker-dealers and investment advisers when giving personalized investment advice to retail customers<sup>14</sup> (or to other customers specified by the SEC).<sup>15</sup>

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<sup>13</sup> See Section 913(d) of the Act.

<sup>14</sup> Section 913(a) of the Act defines a “retail customer” as

“a natural person, or the legal representative of such natural person, who—

“(A) receives personalized investment advice about securities from a broker, dealer, or investment adviser; and

“(B) uses such advice primarily for personal, family, or household purposes.”

The term “retail customer” is given the same definition in new Section 211(g)(2) of the Advisers Act, which is also added by Section 213 of the Act. Note that this definition does not distinguish between “widows and orphans” and highly sophisticated investors.

<sup>15</sup> See Section 913(f) of the Act. This authority is not specifically included in either the Advisers Act or the Exchange Act, leaving it unclear whether this authority is independent of new Advisers Act Section 211(g) or new Exchange Act Section 15(k), both further described below.

Second, new Section 211(g) of the Advisers Act authorizes the SEC to promulgate rules that would require **broker-dealers** (even when not acting as “investment advisers”) and investment advisers providing personalized investment advice to retail customers (and such other customers as the SEC may require)<sup>16</sup> to act in the best interest of the client or customer and to disclose any material conflicts of interest and obtain the consent thereto of their customers or clients.

Finally, new Section 15(k) of the Exchange Act authorizes the SEC to issue a rule providing that the standard of care applicable to a broker-dealer giving advice to a retail customer is the same as that applicable to an investment adviser under Section 211(g) of the Advisers Act.<sup>17</sup> Accordingly, if the SEC issues rules promulgating a standard of care under Section 211(g) of the Advisers Act, then it could also issue a rule under Section 15(k) of the Exchange Act imposing that standard on broker-dealers. Since the SEC could impose that same standard on broker-dealers directly under section 211(g), however, it is not clear what, if anything, is gained by the dual structure of Sections 211(g) and 15(k), or whether this structure is purposeful.

#### 4. Limitations on Rulemaking Authority

The different provisions authorizing the SEC to impose a fiduciary standard on broker-dealers also specify varying limitations on that authority. Given these differences, it is unclear whether the SEC can avoid the limitations of the most specific provision by acting under the others or whether the three provisions are meant to be read collectively such that the various limitations would apply regardless of the provision utilized by the SEC.

The SEC's broadest authority arises under Sections 913(b)-(f) of the Act, which, as noted above, is not expressly incorporated into either the Advisers Act or the Exchange Act. Section 913(f) authorizes the SEC to issue rules to “address” the standard of care applicable to broker-dealers and investment advisers when giving personalized investment advice to retail customers (or to other customers specified by the SEC). Given the lack of guidance in this provision (the SEC must “consider” the results of

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<sup>16</sup> See Section 913(g)(2) of the Act.

<sup>17</sup> See Section 913(g)(1) of the Act.

its study of the issue) and the ability of the SEC to cover any “specified” customers, the SEC’s authority under this provision appears to be largely unconstrained.

New Section 211(g) of the Advisers Act authorizes the SEC to issue rules imposing a fiduciary standard on broker-dealers, but it limits that authority in two respects. First, to the extent the SEC promulgates a rule under Section 211(g), the rule must impose a standard of care on broker-dealers that is at least as strict as the standard applicable to investment advisers under Sections 206(1) and (2) of the Advisers Act.<sup>18</sup> Second, any such rule must require that broker-dealers operate in the best interest of their customers and disclose any material conflicts and obtain consent thereto from the customer.

Additionally, new Section 211(g) provides that “[t]he receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation” of any standard of care applied by the SEC under Section 211(g). (Firms should, however, be aware that the level of compensation, as opposed to its mere receipt, could raise an issue.)

New Section 15(k) of the Exchange Act, on the other hand, does not appear to allow the SEC to adopt a rule other than one that incorporates the standard of care provided by any rule issued under Section 211(g) of the Advisers Act. Put simply, it would appear that the SEC cannot issue a rule under Section 15(k) unless it first issues a rule with respect to investment advisers’ standard of care under Section 211(g). Moreover, any rule adopted under Section 15(k) cannot subject the broker-dealer to a continuing duty of care after giving advice or prohibit the sale by a broker-dealer of only proprietary products or of a limited range of products.

It is uncertain whether the SEC could avoid the limits of Section 15(k) by adopting rules only under Section 211(g) of the Advisers Act or Section 213(f) of the Act. While a literal reading of the Act would seem to allow this, courts might potentially view this approach as a violation of Congressional intent.

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<sup>18</sup> While Sections 206(1) and (2), by their terms, relate to fraudulent activity, it was under these sections that the Supreme Court found a fiduciary duty for investment advisers. See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

## 5. Implications

Broker-dealers have long been subject to a fiduciary duty when acting as investment advisers. They have not, however, been subject to this duty when, as to non-discretionary accounts, they fall within an exclusion from the term “investment adviser,” and thus from the applicability of the Advisers Act.<sup>19</sup> If the SEC exercises its rule-making authority, however, a broker-dealer will have fiduciary duties as to retail customers **whether or not** it fits within the definition of “investment adviser” under the Advisers Act.

As described above, the Act seems to allow the SEC considerable room to tailor the standard of care applicable to broker-dealers. For instance, while the standard of care that may be imposed by the SEC under the Advisers Act must be at least as strict as Sections 206(1) and (2) of the Advisers Act, it need not be as strict as Section 206(3), which generally requires pre-trade disclosure to and consent by a client to each principal transaction (in which the firm buys securities from or sells securities to a client for its own account).

### C. Disclosures, Sales Practices, Conflicts of Interest, and Compensation Schemes

New Section 211(h) of the Advisers Act and new Section 15(l) of the Exchange Act require the SEC to “facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with [broker-dealers] and investment advisers, including any material conflicts of interest.”<sup>20</sup> These provisions also require the SEC to examine sales practices, conflicts of interest, and compensation schemes for broker-dealers and investment advisers, and authorize the SEC to issue rules restricting or prohibiting these activities.

Additionally, new Section 15(n) of the Exchange Act authorizes the SEC to issue rules designating disclosure documents or information to be provided by broker-dealers to retail investors before the sale of any investment product or service.<sup>21</sup>

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<sup>19</sup> Section 202(a)(11)(C) of the Advisers Act. The exclusion applies to any broker-dealer whose provision of investment advice or analysis is “solely incidental” to its business and that receives no “special compensation” for its advice. For further discussion of this issue, see Arthur B. Laby, “Reforming the Regulation of Broker-Dealers and Investment Advisers,” 65 *The Business Lawyer* 395 (February 2010).

<sup>20</sup> See Section 913(g) of the Act.

<sup>21</sup> See Section 919 of the Act.

The documents must contain information about investment objectives, strategies, costs, and risks, as well as any compensation received in connection with the sale. The term “retail investor” is undefined in the Exchange Act, although the term “retail customer” is newly defined in Section 211(g)(2) of the Advisers Act.<sup>22</sup>

**D. Mandatory Arbitration**

New Section 15(o) of the Exchange Act<sup>23</sup> and new Section 205(f) of the Advisers Act<sup>24</sup> authorize the SEC to issue rules limiting or prohibiting the use of contractual clauses requiring customers and clients to submit any dispute arising under securities laws to mandatory arbitration. These sections apply to broker-dealers and investment advisers, respectively. The provisions are not restricted to retail customers, but rather apply to all customers and clients.

The provision applicable to broker-dealers raises the possibility of an asymmetry, since customers of broker-dealers can generally compel mandatory arbitration of disputes under SRO rules. If customers are not contractually compelled to submit disputes to arbitration, but retain the right to compel broker-dealers into arbitration, customers would be able to choose whichever forum (arbitration or the courts) they think is more favorable, while broker-dealers would be forced to defend themselves in the customer's chosen forum.

**E. Harmonization of Enforcement Authority**

New Section 15(m) of the Exchange Act<sup>25</sup> and new Section 211(i) of the Advisers Act<sup>26</sup> allow the SEC to exercise the enforcement authority provided by either the Exchange Act or the Advisers Act with regard to (i) violations of the Exchange Act related to the standard of care of broker-dealers giving personalized investment advice to retail customers, and (ii) violations of the Advisers Act related to the standard of care of investment advisers. These sections also require the SEC to seek to prosecute and sanction violations of the standards of care applicable to broker-dealers and investment advisers “to the same extent” under the Exchange Act and the Advisers Act.

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<sup>22</sup> See the discussion of the defined term “retail customer” at note 14 above.

<sup>23</sup> See Section 921(a) of the Act.

<sup>24</sup> See Section 921(b) of the Act.

<sup>25</sup> See Section 913(h)(1) of the Act.

<sup>26</sup> See Section 913(h)(2) of the Act.

The SEC's enforcement authority under the Exchange Act with regard to broker-dealers is already broadly similar to its authority under the Advisers Act with regard to investment advisers.<sup>27</sup> Additionally, most of the changes to the SEC's enforcement authority in the Act apply equally to the Exchange Act and the Advisers Act. These changes are described in Subpart II.E of this memorandum.

The requirement that the SEC exercise its enforcement powers "to the same extent" against broker-dealers and investment advisers with regard to their respective standards of care may be a response to the perception that broker-dealers are currently more closely regulated than investment advisers. Since broker-dealers are also subject to SRO regulation, examination, and enforcement actions, the same perception may have been the impetus for the requirement that the SEC study the creation of an SRO to oversee investment advisers, as described in Subpart I.B.2 above.

## II. Miscellaneous Provisions Affecting Broker-Dealers

### A. SIPA and Bankruptcy Changes

Section 983 of the Act permits a customer holding futures contracts, or options on futures, in a portfolio margin account to claim status as a securities "customer" under the Securities Investor Protection Act of 1970 ("**SIPA**") in the event of the insolvency of the broker-dealer holding the portfolio margin account.

The Act also amends SIPA to increase the cash advance paid by the Securities Investor Protection Corporation ("**SIPC**") to investors in a broker-dealer subject to a SIPA proceeding.<sup>28</sup> The Act provides the holder of a claim for cash an advance of up to \$250,000 (previously the limit was \$100,000), where the cash was held at the broker-dealer for the purpose of buying securities. This amount corresponds to the amount of cash in eligible deposit accounts insured by the Federal Deposit Insurance Corporation. SIPC, in its discretion, may increase the amount of financial protection covering claims for cash to keep pace with inflation. Note, however, that the total amount of a SIPC advance remains capped at \$500,000.

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<sup>27</sup> Compare Section 21 of the Exchange Act with Section 209 of the Advisers Act. Compare also Section 15(b)(4) of the Exchange Act and Section 203(e) of the Advisers Act.

<sup>28</sup> See Section 929H of the Act.

Additionally, the cap on the minimum assessment imposed on SIPC members is changed from \$150 per year to 0.02 percent of gross revenues from the securities business of each member.<sup>29</sup> This change does **not** alter the current assessment rate, which is 0.25 percent of gross revenues (currently SIPC imposes no minimum assessment).<sup>30</sup>

In the past, SIPC has imposed the minimum assessment when its financial resources have been ample, and it has imposed higher assessments when needed. In the event that SIPC chooses to impose a minimum assessment in the future, then it will be able to set the minimum assessment as high as 0.02 percent of gross revenues from each SIPC member's securities business.

Title VII of the Act amends the Exchange Act to provide that a security-based swap will be treated as a "security" for the purposes of liquidation under the Bankruptcy Code of stockbrokers that are not SIPC members.<sup>31</sup> This implies that a security-based swap dealer would be a "stockbroker" under the Bankruptcy Code, and that a security-based swap counterparty would be a "customer" entitled to the special protections provided for customers under the Bankruptcy Code. These protections would not be available for claims based on uncleared security-based swaps. Generally, see the discussion of this issue on pages 15-16 of our accompanying memorandum entitled "[\*The New Scheme for the Regulation of Swaps, with Appendices on Retroactivity, Special Entities and Tax, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*](#)".

## **B. Securities Lending and Short Sales**

Section 984 of the Act amends Section 10 of the Exchange Act to give the SEC broad authority to adopt regulations governing securities lending transactions, which authority may have been granted so that the SEC would have the power to limit securities lending at times when it wishes to discourage short selling. In addition, the SEC is required to adopt rules increasing the transparency of available information on securities lending, which information would presumably include volume and pricing data.

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<sup>29</sup> See Section 929V of the Act.

<sup>30</sup> See SIPC, "Notice to Members of Changes to Assessment Provisions Under the Securities Investor Protection Act," (July 23, 2010), available at <http://www.sipc.org/pdf/Membership Ltr 7-23-10.pdf>.

<sup>31</sup> Most broker-dealer liquidations proceed under SIPA, but certain limited-purpose broker-dealers that are not SIPC members may be liquidated under chapter 7 of the Bankruptcy Code.

Also relating to short sales, Section 929X of the Act amends Section 15 of the Exchange Act to provide that all persons are prohibited from effecting a “manipulative” short sale.<sup>32</sup>

Additionally, institutional investment managers subject to Section 13(f) of the Exchange Act, generally investors who either own or control over \$100 million in equity securities subject to Section 13(d) of the Exchange Act, will have to submit a report of the “aggregate amount of the number of short sales” of securities each month.<sup>33</sup> This requirement is somewhat similar to SEC Temporary Rule 10a-3T, which the SEC adopted on October 15, 2008 and allowed to expire on July 31, 2009. Temporary Rule 10a-3T required investment managers to report short positions to the SEC on Form SH on a weekly basis.<sup>34</sup> The Act provides, however, that the reports will be available to the public, unlike the information previously reported on Form SH.

It is not clear whether the required reports would be of all short sales during the month, which seems to be suggested by the language of the Act, or all open positions on the last day of the reporting period, which would be consistent with the current requirements of Section 13(f) as to long positions.

Finally, the Act adds new Section 15(e) to the Exchange Act (redesignating current Section 15(e) and the following subsections). New Section 15(e) provides that broker-dealers are required to notify their customers that each customer has the right to prohibit the broker-dealer from using the customer’s fully paid securities in connection with short sales. In light of the fact that it was impermissible under existing law for a broker-dealer to use fully paid securities in connection with short sales, absent a securities lending agreement, the purpose of the requirement is not clear; it seems possible that the new disclosure may confuse customers, who might infer that broker-dealers **can** use their fully paid securities absent an agreement to the contrary.

New Section 15(e) of the Exchange Act also provides that a broker-dealer must provide notice to its customers that the broker-dealer may receive compensation

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<sup>32</sup> It is unclear what activity this covers that would not already be covered by SEC Rule 10b-5 under the Exchange Act.

<sup>33</sup> See Section 929X of the Act.

<sup>34</sup> An investment manager subject to Temporary Rule 10a-3T was required to disclose “the start of day short position, the gross number of securities sold short during the day, and the end of day short position” for every day on which the investment manager engaged in short sale trading activity.

through lending the customers' securities.<sup>35</sup> Under pre-existing law, it would already be impermissible to rehypothecate customers' securities without providing notice of the practice. What is new is the requirement to notify customers specifically that the broker-dealer may profit by lending customers' securities.

**C. Voting by Brokers**

The Act amends Section 6(b) of the Exchange Act to require national securities exchanges to prohibit their member broker-dealers from casting votes on a "significant matter" on behalf of their customers absent instructions from the beneficial owner of a security.<sup>36</sup> In particular, unless the beneficial owner has agreed otherwise, broker-dealers will not be able to grant proxies for votes related to executive compensation or the election of directors. Additionally, the SEC is authorized to designate any other significant matters for which such proxy voting will also be proscribed.

**D. Enforcement Changes**

As discussed further below, the Act includes numerous provisions meant to strengthen the SEC's enforcement of securities regulations, including the expansion of aiding and abetting liability and enhanced whistleblower awards and protections. This memorandum highlights several of the changes, but does not address all of the provisions of the Act related to enforcement of securities law.

New Section 209(f) of the Advisers Act gives the SEC the ability to seek monetary damages in a civil action against a person who aids or abets a violation of the Advisers Act.<sup>37</sup> Previously, the Advisers Act (but not the Exchange Act) limited the SEC to injunctive relief in civil actions against aiders and abettors.

Significantly, new Section 209(f) also makes it clear that an aiding and abetting charge can be based not only upon a showing that the aider and abettor "knowingly" provided assistance to the wrongful scheme, but also upon a showing

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<sup>35</sup> See Section 929X of the Act. See also FINRA's recent enforcement action against Citigroup Global Markets, Inc., finding a failure to disclose certain material information related to securities it borrowed from its customers, including the difficulty of borrowing the securities on the open market, the commissions received during the duration of the loan, the payment of "cash-in-lieu" of dividends and the resulting tax consequences, and the fact that customers could sell the securities at any time. FINRA, "FINRA Fines Citigroup \$650,000 for Direct Borrow Program Deficiencies," (April 6, 2010), available at <http://www.finra.org/Newsroom/NewsReleases/2010/P121245>.

<sup>36</sup> See Section 957 of the Act.

<sup>37</sup> See Section 929N of the Act.

that the aider and abettor “recklessly” provided such assistance. Similarly, the Act also amends the Exchange Act to incorporate the new “reckless” standard with respect to aiding and abetting charges under the Exchange Act.<sup>38</sup> While the aiding and abetting provision of the Exchange Act continues to require the SEC to prove “substantial” assistance,<sup>39</sup> new Section 209(f) of the Advisers Act does not contain that requirement. Arguably, aiding and abetting liability may arise under the Advisers Act even when the assistance provided to the violator is not “substantial.”<sup>40</sup>

The Act also provides for the Comptroller General to conduct a study to determine the impact of authorizing a private right of action against aiders and abettors of violations of securities laws.<sup>41</sup>

The Act increases the compensation to be paid to whistleblowers in judicial or administrative actions that result in monetary sanctions.<sup>42</sup> Under new Section 21F of the Exchange Act, whistleblowers may receive an award equal to a fraction of the monetary sanctions imposed in an action based on original information provided by the whistleblower. The amount of the award is to be determined in each case by the SEC, but must fall within 10-30% of the amount of the monetary sanctions. Previously, whistleblowers could receive no more than 10% of any recovery.<sup>43</sup> New Section 21F(h) of the Exchange Act protects whistleblowers from retaliation by their employers.

Prior to the adoption of the Act, the Exchange Act authorized the SEC to bar an individual from associating with any broker-dealer for up to twelve months if that individual had committed a violation related to broker-dealer activities. The Exchange Act and the Advisers Act contained similar provisions with respect to municipal securities dealers, transfer agents, and investment advisers. Before the enactment of the Act, though, an individual barred from associating with broker-

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<sup>38</sup> See Section 929O of the Act.

<sup>39</sup> See Section 20(e) of the Exchange Act.

<sup>40</sup> As described in Subpart I.E. of this memorandum, the Act amends the Exchange Act and the Advisers Act to allow the SEC to exercise its enforcement authority under either act to address violations of the standard of care for both investment advisers and broker-dealers. Therefore, in an action against a broker-dealer alleging breach of fiduciary duty (if such a duty is imposed), the SEC may be able to prove liability under the aiding and abetting standard of the Advisers Act, even if it cannot prove “substantial assistance” under the Exchange Act.

<sup>41</sup> See Section 929Z of the Act.

<sup>42</sup> See Sections 922-24 of the Act.

<sup>43</sup> See Section 21A(e) of the Exchange Act.

dealers could still associate with, for instance, an investment adviser.<sup>44</sup> The Act amends these provisions to authorize the SEC (or, in the case of transfer agents, the appropriate regulatory agency) to bar such individuals from associating with **any** of these entities, or with municipal advisors or credit rating agencies, for up to twelve months.<sup>45</sup>

**E. Treatment of Swaps as Securities**

Title VII of the Act expands the scope of the term “security” in Section 3(a)(10) of the Exchange Act to include “security-based swaps.” (For a full discussion of Title VII, see our memorandum titled “*The New Scheme for the Regulation of Swaps, with Appendices on Retroactivity, Special Entities and Tax, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*”). We note that many firms that do not act as principals in swap transactions may act as agents arranging them. Accordingly, as Title VII goes into effect, firms engaging in swaps as “brokers” will be subject to securities regulations as to such transactions (e.g., sending of confirmations, record-keeping, rules as to marketing and communications, supervisory obligations, and the like).

**III. Beneficial Ownership and Short Swing Profit Reporting, SEC Studies, and SEC Reorganization**

**A. Beneficial Ownership and Short Swing Profit Reporting**

The Act makes a number of changes to the reporting requirements for holders of securities subject to Section 13(d) or insiders subject to Section 16(a), most significantly authorizing the SEC to shorten the time period between a transaction and the required report.<sup>46</sup> Additionally, Section 13(d) is amended so that the reports must only be provided to the SEC, and not to the issuer of the securities or the exchange on which they are traded.

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<sup>44</sup> See *Teicher v. S.E.C.*, 177 F.3d 1016 (D.C.Cir. 1999).

<sup>45</sup> See Section 925 of the Act.

<sup>46</sup> See Section 929R of the Act.

**B. Studies**

The Act also requires the SEC to conduct a number of additional studies to assess:

- financial literacy among retail investors;
- ways of improving investor access to information about broker-dealers and investment advisers, including any disciplinary actions;
- the extent to which private rights of action under the Exchange Act should be extended to cover securities transactions and conduct occurring outside the United States;
- the operations, structure, funding, and need for comprehensive reform of the SEC (this study is to be performed by an independent consultant); and
- the “revolving door” between the SEC and financial institutions it regulates.

Although these are merely studies and not immediate changes in the law, the conclusions reported by the SEC may affect its rulemaking and may motivate additional legislation by Congress.

**C. Reorganization of the SEC**

Additionally, the Act reorganizes the SEC in a variety of ways. Sections 961-68 of the Act require an annual report on SEC internal controls, an annual audit of the SEC's financial reporting, and a triennial report to Congress by the Comptroller General assessing the SEC's personnel management. Notably, the Act amends the Exchange Act to provide for each of the SEC's Division of Trading and Markets and its Division of Investment Management to have its own staff of examiners. Currently, the SEC's examination staff is consolidated in the Office of Compliance Inspections and Examinations (“OCIE”). While this provision does not mandate OCIE's dissolution, its implementation can be expected to cause the SEC to reevaluate OCIE's continued role within the SEC and how best to coordinate examinations among at least two and possibly three separate examination teams, as well as the required coordination with the Commodity Futures Trading Commission (the “CFTC”), given the radical expansion in the number of entities registered with both the SEC and the CFTC that will result from the Act. It should also be noted that mandating separate examination staffs to broker-dealers and advisers could be at odds with the more general tendency of

the Act towards increased harmonization of the regulatory schemes applicable to broker-dealers and advisers.

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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# Clients & Friends Memo

## Reforms to the Asset-Backed Securitization Process and the Regulation of Credit Rating Agencies Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

July 20, 2010

On July 15, 2010, the Senate voted in favor of adopting the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). The Act is far reaching in scope and represents the culmination of months of debate and intense lobbying.

The Act was precipitated by the financial crisis that began in 2007 and therefore its primary goal is to prevent a recurrence. Since the asset-backed securitization market and credit rating agencies have both been the subject of criticism in connection with the financial crisis, it comes as no surprise that Congress has included provisions in the Act that address both of these areas of the financial markets. However, like many other parts of the Act, the provisions regarding asset-backed securities and rating agencies will require a heavy dose of regulations and studies before the full impact of the Act will be understood.

The focus of this Memorandum is Title IX – Subtitle D “Improvements to the Asset-Backed Securitization Process” and Title IX – Subtitle C “Improvements to the Regulation of Credit Rating Agencies”.

### I. Asset Backed Securitization Process

Subtitle D of Title IX is entitled “Improvements to the Asset-Backed Securitization Process” and is an attempt by Congress to reform the asset-backed securitization process by instituting requirements for (i) risk retention (“skin in the game”), (ii) increased disclosure and (iii) ongoing periodic reporting. These provisions are summarized below.

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

Certain of the provisions discussed below overlap with various proposals contained in the SEC's proposed revisions to Regulation AB and in the FDIC's Notice of Proposed Rulemaking<sup>1</sup> regarding safe harbors for bank-sponsored securitizations. It is unclear how the FDIC and the SEC will adapt their proposals in light of the Act. Attached to this memorandum is a chart that compares and contrasts some of the key overlapping points in these initiatives.

A. **Risk Retention**

The most significant portion of the Act for participants in the asset-backed securities market is the introduction of a risk retention requirement. The Act provides that by no later than 270 days after the Act is signed by President Obama and enacted into law, the applicable regulators are required to jointly prescribe risk retention regulations that will apply to securitizers of asset-backed securities ("ABS"). It is important to note that while the Act gives specific directives to the applicable regulators on certain aspects, there are many points that are left to the regulators to consider and determine. For this reason there is still uncertainty as to a number of material elements of the new risk retention requirements.

*Note: The requirement that the applicable regulators work jointly to prescribe regulations seems to increase the likelihood that the resulting regulations will have uniform application to all types of securitizers, regardless of the regulatory regimes to which they are subject. Consistent regulations would allay industry concerns that insured depository institutions might be disadvantaged by more stringent regulation of securitization activities than non-insured depository institutions.*

1. **Effective Date**

The final risk retention regulations will become effective:

- (a) in the case of securitizations of residential mortgage loans, one year after the final regulations are issued; and
- (b) in the case of all other ABS, two years after the final regulations are issued.

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<sup>1</sup> See [Clients & Friends Memo: SEC Proposes Significant Enhancements to Regulation of Asset-Backed Securities](#) and [Clients & Friends Memo: FDIC Seeks "Stronger, Sustainable Securitizations" by Imposing Additional Conditions to Eligibility for Securitization Safe Harbor](#).

*Note: Since the applicable regulators are given nine months to finalize regulations, and the risk retention rules will be effective either one or two years thereafter, it appears that the risk retention rules will not come into effect until approximately April 2012 for RMBS, and April 2013 for CMBS and all other forms of ABS.*

2. Applicable Regulators

Congress has charged the Federal banking agencies (the Office of the Comptroller of the Currency (“OCC”), the Federal Deposit Insurance Corporation (“FDIC”) and the Board of Governors of Federal Reserve System (“Federal Reserve”)), the Securities and Exchange Commission (“SEC”), and with respect to securitizations of residential mortgage loans, the Secretary of Housing and Urban Development (“HUD”) and the Federal Housing Finance Agency (“FHFA”), with the responsibility of jointly prescribing the risk retention regulations that will apply to securitizations.

3. Applicability of Risk Retention Rules: Which Deals and Which Parties?

The Act amends the Securities Exchange Act of 1934 (the “Exchange Act”) to formally define the terms “asset-backed securities,” “securitizer” and “originator” in a manner that is generally consistent with industry usage. These terms are key to applying the risk retention rule, which requires that risk be retained by a “securitizer” or “originator” of “asset-backed securities,” as further described in this memo.

“**Securitizer**” means (i) an issuer of an asset-backed security or (ii) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.

“**Asset-backed Securities**” —

(a) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including:

(i) a collateralized mortgage obligation;

- (ii) a collateralized debt obligation;
  - (iii) a collateralized bond obligation;
  - (iv) a collateralized debt obligation of asset-backed securities;
  - (v) a collateralized debt obligation of collateralized debt obligations; and
  - (vi) a security that the SEC, by rule, determines to be an asset-backed security for the purposes of the risk retention requirements of the Act; and
- (b) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

“Originator” means a person who —

- (a) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and
- (b) sells an asset directly or indirectly to a securitizer.

4. Items to be Addressed in the Regulations

- (a) **Risk Retention Percentage.** Subject to certain exceptions or adjustments described below, the regulations are required to provide that securitizers retain a minimum of 5% of the credit risk of any asset transferred into a securitization.

*Note: Unlike the proposed revisions to Regulation AB, the Act requires risk retention for all offerings of ABS, not just those offered under a shelf-registration statement.*

- (b) **Prohibition on Hedging.** A securitizer is to be prohibited from directly or indirectly hedging or otherwise transferring the credit risk that it is otherwise required to retain.

- (c) **Form and Duration of Retention.** The regulators are to prescribe regulations detailing the form and duration of risk retention required for each asset class.

*Note: The SEC's Regulation AB proposals would require that a "vertical slice" of each class of ABS offered pursuant to a shelf registration statement be retained for as long as any third party owns related securities. While it seems likely (given that the Act grants increased regulatory authority to the SEC) that the risk retention requirement will be increased beyond that indicated in the SEC's Regulation AB proposals, it is unclear whether the "vertical slice" approach will be retained. It seems unlikely that the duration of the required retention period will be decreased.*

- (d) **Allocation of Risk Retention Between Securitizer and Originator.** The Federal banking agencies and the SEC, as they may deem appropriate, may allocate the risk retention requirement between a securitizer and an originator, with the amount of any retention by an originator resulting in a reduction of the retention otherwise required of the securitizer. In determining any such allocation, the regulators must consider (i) whether the assets have terms, conditions and characteristics that reflect low credit risk, (ii) whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of asset and (iii) the potential impact of the risk retention obligations on access of consumers and businesses to credit on reasonable terms.

- (e) **Exemptions, Exceptions and Adjustments to Risk Retention.**

- (i) **Regulatory Discretion.** The regulators may provide for the total or partial exemption from the risk retention requirements for any securitization, as they determine is appropriate in the public interest and for protection of investors.

The regulators may also adopt exemptions, exceptions or adjustments to the rules requiring risk retention and prohibiting hedging of such retention if they help ensure high quality underwriting standards for securitized assets and encourage appropriate risk management practices

by securitizers and originators, improve access of consumers and businesses to credit on reasonable terms, or are otherwise in the public interest and for protection of investors.

- (ii) Adjustment to 5% Retention Based on Prescribed Underwriting Standards. The regulators are required to establish underwriting standards for each asset class of ABS (e.g., ABS backed by residential mortgage loans, commercial mortgage loans, commercial loans, auto loans and any other asset class that the regulators deem appropriate) that specify the terms, conditions and characteristics of a loan within the asset class that indicate a low credit risk with respect to such loan. The rules adopted by the regulators are required to provide that securitizers may retain less than 5% credit risk if the assets meet the applicable underwriting standards.
- (iii) Exemption for Qualified Residential Mortgages. The Act requires that the regulations specify that the risk retention requirements will not apply to an ABS transaction where all of the assets in the ABS are “qualified residential mortgages.” The regulators must jointly define the term “qualified residential mortgages”, taking into consideration underwriting and product features that historical loan performance data indicate will result in a lower risk of default, such as:
- documentation and verification of the financial resources relied upon to qualify the mortgagor;
  - standards with respect to:
    - the residual income of the mortgagor after all monthly obligations;
    - the ratio of the housing payments to the monthly income of the mortgagor; and

- the ratio of total monthly installment payments to the income of the mortgagor;
- mitigating the potential for payment shock on adjustable rate mortgages through product features and underwriting standards;
- mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such insurance or credit enhancement reduces the risk of default; and
- prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other features that have been demonstrated to exhibit a higher risk of borrower default.

In addition, the regulators may not define “qualified residential mortgage” to be any broader than the definition of “qualified mortgage” as defined under Section 129C(c)(2) of the Truth in Lending Act, as amended by the Consumer Financial Protection Act of 2010, and regulations adopted thereunder.

In order for an ABS to fall within the qualified residential mortgage exemption, an issuer will be required to certify to the SEC that the issuer has evaluated the effectiveness of the internal supervisory controls of the issuer with respect to the process for ensuring that all assets that collateralize the ABS are qualified residential mortgages.

*Note: The foregoing exception for ABS backed by qualified residential mortgage loans will not apply to resecuritizations.*

(iv) Alternatives for Commercial Mortgages. With respect to commercial mortgage loans, the regulations must specify the types, forms and amounts of risk retention, which may include:

- retention of a specified amount or percentage of the total credit risk of the assets;
- retention of the first-loss position by a third-party purchaser that specifically negotiates for the purchase of such first-loss position, holds adequate financial resources to back losses, provides due diligence on all individual assets in the pool before issuance of the ABS and meets the same standards for risk retention as the regulators require of the securitizer (presumably including the prohibition on hedging the credit risk retained);
- a determination by the Federal banking agencies and the SEC that the underwriting standards and controls for the asset are adequate; and
- provision of adequate representations and warranties and related enforcement mechanisms.

*Note: The Act only provides that the regulators may include accommodations for the foregoing, but the regulators are not required to do so. It is unclear to what extent the regulators may be willing to reject these concepts, though specified in the Act.*

(v) Governmental Guarantee Exemption. The risk retention requirements will not apply to:

- any loan or other financial asset made, insured, guaranteed, or purchased by any institution that is subject to the supervision of the Farm Credit

Administration, including the Federal Agricultural Mortgage Corporation; or

- any residential, multifamily or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, which is insured or guaranteed by the U.S. or an agency of the U.S.

*Note: For this purpose, securities insured or guaranteed by Fannie Mae, Freddie Mac or the Federal home loan banks are not to be treated as insured or guaranteed by the U.S. or an agency of the U.S.*

- (vi) Regulations for CDOs Singled Out. The Act specifically identifies collateral debt obligations (“CDOs”), securities collateralized by CDOs and similar instruments collateralized by other ABS (e.g., resecuritizations) as an asset class that the regulators must establish appropriate standards for risk retention.

*Note: It is possible that regulators could fashion rules that are more onerous on securitizers of these asset classes.*

- (f) **Asset Class Specific Regulations.** Because it would be difficult to implement a one-size-fits-all requirement, the Act requires regulators to prescribe separate risk retention regulations for securitizers of different asset classes.

## B. Study on Risk Retention

The Federal Reserve, in coordination and consultation with the other regulators, is required to conduct a study of the combined impact on each asset class of the new credit risk retention requirements, including the effect those requirements will have on increasing the market for Federally subsidized loans and the impact such requirements will have on securitizers under the new accounting rules of FAS 166 and FAS 167. A report on such study is required to be delivered to Congress no later than 90 days after the Act is enacted and the report is required to contain statutory and regulatory recommendations for eliminating any negative impacts on

the viability of the asset-backed securitization markets and the availability of credit for new lending.

C. Ongoing Reporting

The Act eliminates the ability of an ABS issuer to “de-list” ABS transactions and suspend periodic reporting. Previously, issuers of ABS in SEC-registered offerings were permitted (under Section 15(d) of the Exchange Act) to suspend periodic reporting under the Exchange Act for ABS offered in a transaction registered under the Securities Act of 1933 (the “**Securities Act**”). These offerings typically suspended reporting after the end of the year of issuance because the securities are held by less than 300 persons. Nevertheless, the Act does give the SEC the authority to issue rules and regulations that could provide ABS issuers the right to suspend or terminate such ongoing reporting requirements as the SEC deems necessary or appropriate in the public interest or for protection of investors.

*Note: The elimination of an ABS issuer's ability to suspend its Exchange Act filings is effective immediately. Because the ability to suspend reporting is tested on an annual basis, the exclusion of ABS from the suspension provisions in Section 15(d) of the Exchange Act could be interpreted as applying to ABS issued prior to the effective date of the Act, which would have an adverse effect on ABS issuers that previously qualified for suspension and whose transaction documents did not anticipate ongoing reporting. Industry participants believe that the amendments to Section 15(d) were only intended to apply to ABS issued after the effective date of the Act and have requested confirmation from the SEC. Consequences of ongoing reporting obligations include, among others, (i) preparing and filing annual Sarbanes-Oxley certifications by the senior officer in charge of securitization at the depositor or senior servicing officer at the servicer, and (ii) the failure to timely comply with any Exchange Act reporting requirement disqualifies an issuer from filing a new shelf-registration statement (although take-downs from existing shelf registration statements would not be impacted).*

D. **Additional Regulations**

The Act requires the SEC to issue regulations addressing the following additional matters:

1. Regulations to enhance the disclosure regarding the assets that back ABS. These regulations are required to address:
  - (a) standardized formats for providing data to facilitate the comparison of data across securities types of ABS; and
  - (b) loan-level or asset-level data if such data is necessary for investors to independently perform due diligence.

*Note: No time frame is specified for the issuance of these regulations, but much of these disclosure enhancements are addressed by the SEC's proposed revisions to Regulation AB.<sup>2</sup>*
2. Regulations regarding the use of representations and warranties. These regulations must:
  - (a) require each rating agency rating an ABS to include in any reports they issue regarding the ABS, a description of (i) the representation and warranties and enforcement mechanisms and (ii) how they compare to the representation and warranties in issuances of similar securities; and
  - (b) require a securitizer to disclose its fulfilled and unfulfilled repurchase requirements for alleged breaches of representations and warranties so that investors can identify originators with clear underwriting deficiencies.
3. Regulations relating to due diligence on publicly offered ABS. These regulations will address publicly offered ABS and require an ABS issuer to:
  - (a) perform a review of the assets underlying the ABS; and
  - (b) disclose the nature of such review.

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<sup>2</sup> See [Clients & Friends Memo: SEC Proposes Significant Enhancements to Regulation of Asset-Backed Securities](#).

*Note: It remains to be seen how the regulators will implement this directive.*

4. Third-Party Due Diligence Reports. The Act also requires that issuers and underwriters of ABS make publicly available the findings and conclusions of any third-party due diligence report that they obtained. See also “Rating Agency Regulation—Transparency—Third Party Reports” below.

**E. Prohibitions on Conflict of Interest Relating to Securitizations**

The Act prohibits an underwriter, placement agent, initial purchaser or sponsor of an ABS (or any of their subsidiaries or affiliates), during the one-year period after the first closing of a sale of such ABS, from engaging in any transaction that would involve or result in a material conflict of interest with respect to any investor in a transaction arising out of such activity.

The SEC is required to issue rules not later than 270 days after enactment of the Act regarding the implementation of this prohibition. The prohibition will take effect on the date the rules are issued by the SEC.

This prohibition does not apply to:

1. risk mitigating hedging activities in connection with positions held as a result of the placement or sponsorship of the ABS; or
2. purchases and sales of the ABS pursuant to commitments made by such parties to provide liquidity for the ABS or bona fide market-making activities.

**F. Removal of Registration Exemption for Mortgage Securities and Notes**

The Act deletes Section 4(5) of the Securities Act, which exempted certain mortgage securities and notes from the registration requirements of the Securities Act.

*Note: This was not often relied upon as an exemption from the Securities Act registration requirements.*

## II. Rating Agency Regulation

Subtitle C of Title IX is entitled “Improvements to the Regulation of Credit Rating Agencies” and institutes reforms in the regulation, oversight and accountability of nationally recognized statistical rating agencies (“NRSROs”). The Act expresses Congressional concerns with the conflicts of interests faced by credit rating agencies and with the inaccuracy of ratings on structured finance products, which “contributed significantly to the mismanagement of risks by financial institutions and investors,” resulting in the need for “increased accountability on the part of credit rating agencies.” As a result, most of the provisions of Subtitle C are directed at the rating agencies themselves, who will be under heightened SEC scrutiny and increased regulation, rather than the issuers or underwriters who request ratings or the investors who rely on ratings. These provisions are summarized below and highlight the nature and scope of attention that will be focused on credit rating agencies going forward. The Congressional findings conclude that the inaccuracy of ratings on structured products adversely impacted the health of the economy in the United States and around the world. The consistent theme of the provisions of Subtitle C is to identify and eliminate conflicts of interest and restore confidence in the ratings process.

### A. Internal Controls

1. Each NRSRO must implement an internal control structure. The SEC will establish rules requiring an annual report from the rating agency describing the responsibility of management in establishing and maintaining effective internal controls, assessing the effectiveness of its internal controls, and an attestation of the CEO.
2. The NRSRO must have a designated compliance officer who may not perform credit ratings and whose compensation is not linked to the agency’s financial performance. The compliance officer will submit annual reports to the SEC describing the agency’s compliance with securities laws and its own internal policies and procedures.
3. The NRSRO must have a board of directors consisting of one-half, but no fewer than two, independent directors, including users of ratings.

### B. Conflicts

1. The SEC will promulgate rules to prevent sales and marketing considerations from influencing ratings.

2. If a former employee of an NRSRO is hired by an issuer, underwriter or sponsor of a security rated by the NRSRO, the rating agency must review its ratings for any such entity or securities in which such employee participated during the one year period prior to the rating action to determine whether any conflicts existed.
3. Each NRSRO must report to the SEC the names of certain former employees of the agency who, within the previous five years, became an employee of any issuer, underwriter, or sponsor of a security rated by such agency, and who participated in the rating process during the twelve months prior to such employment. The SEC will make this information publicly available.

**C. SEC Oversight**

1. The SEC will establish an Office of Credit Ratings (“OCR”), whose stated purpose is to administer SEC rules to:
  - (a) protect users of credit ratings and in the public interest;
  - (b) promote accuracy of ratings issued by NRSROs; and
  - (c) ensure that ratings are not unduly influenced by conflicts of interest.
2. The OCR will conduct annual examinations of each NRSRO and make a summary of its findings publicly available.
3. The annual examination will include a review of whether the agency conducts its business consistent with its own policies, procedures and methodologies; its management of conflicts of interest; its supervisory controls; its processing of complaints; and its policies regarding post-employment activities of its former staff.

**D. Transparency**

1. The SEC will adopt rules requiring that each NRSRO disclose comparable information regarding its ratings, including performance information, so that users can compare the performance of credit ratings issued by different agencies.

2. Each rating must be accompanied by a detailed description of the rating, including the assumptions and methodologies underlying the rating, the data used in determining the rating, and how servicer or remittance reports are used to conduct surveillance.
  - (a) The form of the report will also include qualitative information, such as information regarding the uncertainty of the ratings, including information on the reliability, accuracy and quality of the underlying data, and a description of the scope and findings of third party reports used in establishing the rating.
  - (b) Quantitative information is also required, including information regarding performance, probability of default and expected losses, sensitivity to certain assumptions, and a description of five assumptions that would have the greatest impact on the rating if the assumptions were false or inaccurate.
3. Third party reports: Issuers or underwriters of ABS must make publicly available the findings and conclusions of any third party reports. Any report used by a NRSRO must be accompanied by a certification from the author of the report in order to ensure that the report is based on a thorough review of data and other relevant information necessary for the NRSRO to provide an accurate rating. The certification must be made publicly available by the NRSRO.

*Note: The SEC has given verbal clarification to the American Securitization Forum that the Act requires the SEC to issue rules within one year of enactment addressing how and under what circumstances third party reports should be made publicly available.*

4. In issuing their ratings, NRSROs should consider credible and potentially significant information received from sources other than an issuer or underwriter.

#### **E. Liability and Statutory Changes**

1. Private Right of Action and "State of Mind". The Congressional findings related to Subtitle C conclude that the activities of credit rating agencies should be subject to the same standards of liability as auditors and analysts. Thus statements made by a credit rating agency will be subject to the enforcement and penalty provisions applicable to accountants and

securities analysts. In an action for securities fraud by a private plaintiff against a credit rating agency, the required “state of mind” is that the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation of the facts it relied upon or to obtain reasonable verification of the facts from other competent sources independent of the issuer and the underwriter.

*Note: Transaction parties providing indemnification to the rating agencies should carefully consider expanded rating agency liability to investors to which indemnifying parties may be exposed.*

2. SEC Sanctions. The SEC may sanction or penalize the NRSRO or its employees for misconduct. The SEC may suspend or revoke the NRSRO's ability to rate a class of securities if it finds that the agency does not have adequate resources “to consistently produce credit ratings with integrity.”
3. Rescission of Rule 436 (g). For public offerings registered under the Securities Act, initial ratings by NRSROs will now be considered part of the registration statement. As with accountants who include their report on audited financial statements in the registration statement (or prospectus), the consent of the rating agency must be filed with the SEC prior to use of the rating information in connection with the offering of securities. No longer exempt from the liability provisions of Section 11 of the Securities Act, a NRSRO will have liability for information regarding its rating unless it can sustain the burden of proof that it had no reasonable grounds to believe that the information was untrue or misleading.

*Note: On July 15, 2010, Moody's Investors Service released a commentary describing the effect of the Act on its activities, and noted that “given the potential legal consequences, we cannot consent to the inclusion of ratings in prospectuses and registration statements without further study.” In a statement issued on July 16, 2010, Standard & Poor's said that it would “explore mechanisms outside of the registration statement to allow ratings to continue to be disseminated to the debt markets” and also noted that its ratings on new issues and pre-sale reports would be available on their website. ABS issuer's, on the other hand, noted that they are required under Items 1103 and 1120 of Regulation AB to disclose in a prospectus the ratings of their registered ABS. In response to the resulting standstill in registered ABS issuance and in order to facilitate a transition for ABS issuers, on July 22, 2010,*

*the SEC issued a no-action letter in which the SEC stated that it will not recommend enforcement actions if an ABS issuer fails to comply with Items 1103 and 1120 of Regulation AB and omits the disclosure of the ratings of registered ABS from a prospectus. The no-action letter is due to expire on January 24, 2011. ABS issuers can still disclose the ratings of offered ABS in a free writing prospectus in accordance with Rule 433 of the Securities Act without obtaining and filing rating agency consents.*

4. Repeal of Exemption from Regulation FD. Regulation FD is designed to prevent selective disclosures by SEC-reporting issuers or issuers of securities registered under the Exchange Act of non-public material information to selected persons. Regulation FD does not apply to issuer communications with among others, rating agencies. However, within 90 days after enactment of the Act, the SEC is required to amend Regulation FD to remove the exemption for rating agencies.

*Note: Other exemptions from the disclosure requirements will continue to apply and may be relied upon by issuers and rating agencies, including the exemption provided by 17 C.F.R. 243.100 (b)(2)(ii) for disclosure "to a person who expressly agrees to maintain the disclosed information in confidence."*

**F. Removal of Statutory References to Ratings**

1. Certain references to ratings as a criteria for various provisions of the securities and other federal laws will be removed. Instead, the applicable regulatory agency will have the discretion to establish appropriate credit-worthiness standards. This change will go into effect two years after the date of enactment of the Act.

*Note: Among other things, this change will affect shelf registration eligibility requirements, which previously limited registered ABS securities to those rated investment grade. Depending on the nature and subjectivity of the new criteria, shelf registration may become more complex or difficult.*

2. Within one year after the date of enactment of the Act, each Federal agency must review references to credit ratings in its regulations and modify such regulations to remove any reference to the requirement of, or reliance on, ratings. The references to ratings will be replaced by

standards of credit-worthiness deemed appropriate by each Federal agency.

*Note: Among other things, this will affect one of the common exemptions from registration under the Investment Company Act of 1940 used for many ABS issuances.*

#### G. Studies

The Act requires that certain studies and reports be undertaken, including:

1. Report on Strengthening Agency Independence. The SEC must study the conflicts of interest raised by NRSROs providing services other than ratings and the impact of prohibiting a NRSROs from providing services other than ratings to an issuer. The report on the results of the study is due no later than three years after the date of enactment of the Act.
2. Study on Alternative Business Models. The Comptroller General must conduct a study on alternative means of compensation to create incentives to NRSROs to provide more accurate ratings. The report on this study is due no later than 18 months after the date of enactment of the Act.
3. Study and Implementation of Assigned Credit Ratings. The SEC must carry out a study of the rating process for structured finance products and the conflicts of interest associated with the issuer-pay model. It will evaluate the feasibility of establishing a system under which rating agencies are assigned to rate structured finance products; study the range of metrics that could be used to determine the accuracy of ratings; and consider alternative means of compensating rating agencies. The report is due 24 months after the date of enactment of the Act. After the report is submitted, the SEC will, as it determines necessary or appropriate in the public interest or for the protection of investors, establish a system providing for an independent body to be responsible for assignment of NRSROs that will rate structured finance products in a manner that prevents transaction parties from selecting the NRSRO that will provide the ratings. The SEC is required to implement the system added by the Franken Amendment to H.R. 4173 as passed by the Senate, unless it determines that another system would better serve the public interest and protection of investors.

\* \* \* \* \*

We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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**COMPARISON OF DODD-FRANK ACT WITH SEC AND FDIC PROPOSED SECURITIZATION PROVISIONS**

<b>Provision</b>	<b>Dodd-Frank Act</b>	<b>FDIC NPR</b>	<b>SEC Reg AB Proposal</b>
<b>Credit Risk Retention:</b>			
<u>Credit Risk Retention Percentage:</u>	5%.	5%.	5%.  Retention requirement doesn't apply to non-shelf offerings (i.e., public deals registered on Form SF-1 and private offerings).
<u>Type of Risk Retained:</u>	To be specified in regulations.	An interest (i) in each tranche or (ii) in a representative sample of the securitized financial assets.	An interest in (i) each tranche sold to investors or (ii) in the case of a revolving asset master trust, an originator's interest, provided the originator's interest and the securities sold to investors are backed by the same pool of receivables and payments on the originator's interest are not less than 5% of the payments on the securities held by investors collectively.
<u>Duration of Risk Retention:</u>	To be specified in regulations.	The term of the securitization.	As long as non-affiliates of the depositor hold any of the securities.
<u>Risk Retention by Whom:</u>	(i) A securitizer and (ii) an originator that sells an asset directly or indirectly to a securitizer.	Sponsor. Note that the FDIC safe harbor is only relevant to securitizations involving transfers of assets by FDIC-insured banks (not non-bank subsidiaries).	Sponsor or an affiliate.
<u>Definition of "securitizer" or "sponsor":</u>	(A) An issuer of an ABS; or (B) a person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.	"A person or entity that organizes and initiates a securitization by transferring financial assets, either directly or indirectly, including through an affiliate, to an issuing entity. . ."	"The person who organizes and initiates an asset backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."
<u>Prohibition on Hedging:</u>	Securitizers are prohibited from directly or indirectly hedging or otherwise transferring the credit risk.	The retained interest may not be transferred or hedged for credit risk during the term of the securitization.	Hedge positions <u>directly related</u> to the securities retained or exposures taken by the sponsor or affiliate are counted against the 5%.
<u>Risk Sharing:</u>	Yes. Risk can be allocated between a securitizer and an originator as jointly deemed appropriate by the federal banking agencies and the SEC, considering whether (i) the assets have terms, conditions and characteristics that reflect low credit risk, (ii) the form or volume of transactions in securitization markets creates incentives for imprudent origination of that type of asset and (iii) the potential impact of the risk retention obligations on access of consumers and businesses to credit on reasonable terms.	No.	No.

## COMPARISON OF DODD-FRANK ACT WITH SEC AND FDIC PROPOSED SECURITIZATION PROVISIONS

Provision	Dodd-Frank Act	FDIC NPR	SEC Reg AB Proposal
<u>Effective Date:</u>	1 year after publication of regulations for residential mortgage loans; 2 years after publication of regulations for all other forms of ABS. Regulations are due within 270 days after legislation is enacted.	October 2010. Comments on NPR due by July 1, 2010.	Not specified. Comments on proposal due by August 2, 2010.
<b>Exceptions to Credit Risk Retention:</b>			
<u>Regulatory Discretion:</u>	Total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors. Exemptions, exceptions or adjustments to the rules on risk or risk retention, including the prohibition on hedging.	No.	No.
<u>Qualified Residential Mortgages:</u>	No risk retention requirement for any asset included in an ABS if all the assets backing the ABS are "qualified residential mortgages." Federal banking agencies, the SEC, Secretary of HUD and the Director of the Federal Housing Finance Agency must jointly define "qualified residential mortgages", taking into consideration underwriting and product features that historical data indicate result in a lower risk of default. This exception would not be available for resecuritizations.	No.	No.
<u>Underwriting Guidelines:</u>	Securitizers can retain less than 5% credit risk if the originator meets underwriting standards to be established for each asset class (e.g., residential mortgages, commercial mortgages, commercial loans, auto loans, and other classes the federal banking agencies and the SEC deem appropriate), which specify terms, conditions and characteristics of a loan within each asset class that indicate a low credit risk.	No.	No.
<u>First Loss Purchaser:</u>	Regulations must specify, with respect to commercial mortgages, the permissible types, forms and amounts of risk retention, which <u>may</u> include (i) retention of a specified amount or percentage of total credit risk of the assets, (ii) retention of a first loss position by a 3rd party purchaser that specifically negotiates for the purchase of the first loss position, holds adequate financial resources to back losses, provides due diligence on all the pool assets prior to issuance of the ABS and meets the same standards for risk retention as the regulators require of the securitizer, (iii) determination by the federal banking agencies and the SEC that the underwriting standards and controls for the asset are adequate, and (iv) provision of adequate representations and warranties and related enforcement mechanisms.	No.	No.

## COMPARISON OF DODD-FRANK ACT WITH SEC AND FDIC PROPOSED SECURITIZATION PROVISIONS

Provision	Dodd-Frank Act	FDIC NPR	SEC Reg AB Proposal
<u>Governmental Guarantee Exclusion:</u>	Credit risk retention provisions do not apply to: (i) any loan made, insured, guaranteed or purchased by any person subject to supervision by the Farm Credit Administration, including the Federal Agricultural Mortgage Corporation; and (ii) any residential, multifamily or healthcare facility mortgage loan asset, or securitization based directly or indirectly on such asset, which is insured or guaranteed by the U.S. or any agency of the U.S. Fannie Mae and Freddie Mac are NOT agencies of the U.S. for this purpose.	No.	NA
<b>Improved Disclosure:</b>			
<u>Continued Periodic Reporting with the SEC:</u>	Yes. Requires continued filing of Exchange Act reports for registered ABS after the first fiscal year even if there are less than 300 holders of record.  The SEC may suspend or terminate the duty to file for any class of ABS as necessary or appropriate in the public interest or for protection of investors.	No. However, the Proposed Rule requires periodic reporting to investors by the sponsor, issuer and/or servicer, as frequently as monthly, regarding asset performance, including data related to the substitution and removal of financial assets, servicer advances, and loss allocations.	Yes, for shelf-registered ABS, and for Rule 144A ABS offerings, and for other structured finance product offerings under Rule 144A.
<u>Identity of Loan Brokers and Originators; Nature and Extent of Compensation; Amount of Risk Retained:</u>	Disclose (i) identifiers relating to loan broker or originator, (ii) nature and extent of compensation of broker or originator and (iii) amount of risk retained by originator and securitizer.  Applies to Securities Act filings.	Disclose the nature and amount of compensation paid to the originator, sponsor, rating agency or third-party advisor, and any mortgage or other broker, compensation expenses of servicers and the risk of loss retained by any such party.	Yes, as to nature and extent of interest in transaction retained by the sponsor or originator.  Applies to ABS public offerings and offerings of ABS and other structured finance products under Rule 144A and Regulation D.
<u>Assets Backing Each Class or Tranche:</u>	Regulations must require issuers to disclose information regarding the assets backing each tranche or class of security.  Applies to Securities Act filings.	Disclose asset, pool and security-level detail required prior to issuance and monthly while outstanding.	Yes.  Applies to ABS public offerings and offerings of ABS and other structured finance products under Rule 144A and Regulation D.
<u>Loan-Level Detail:</u>	Regulations must require issuers to disclose asset level or loan level data if such data is necessary for investors to independently perform due diligence.  Applies to Securities Act filings.	For residential mortgage loans, prior to issuance disclose loan-level information including, but not limited to, loan type, loan structure, maturity, interest rate and/or annual percentage rate, and location of property.	Yes as to all asset classes (or grouped account data for credit cards).  Applies to ABS public offerings and offerings of ABS and other structured finance products under Rule 144A and Regulation D. Applies to offering documents and to ongoing reporting for public and Rule 144A offerings.
<u>Standardization of Data Format Provided by Issuers:</u>	Regulations must set standards for format of data provided by ABS issuers to facilitate comparison of data across securities of similar types and asset classes.	No.	Yes, for ABS public offerings and, it appears, for offerings of ABS and other structured finance products under Rule 144A and Regulation D.
<u>Disclosure of Due Diligence Analysis:</u>	Regulations regarding registration statements must require ABS issuers to perform a review of assets backing ABS and disclose the nature of such review.	For residential mortgage loans, sponsors must disclose a third party due diligence report on compliance with underwriting standards and representations and warranties.	No.

**COMPARISON OF DODD-FRANK ACT WITH SEC AND FDIC PROPOSED SECURITIZATION PROVISIONS**

Provision	Dodd-Frank Act	FDIC NPR	SEC Reg AB Proposal
<b>Representations and Warranties:</b>			
<u>Description of Representations, Warranties and Enforcement Mechanisms and Comparison to Similar Transactions:</u>	Regulations to require rating agencies to include in any report accompanying a credit rating a description of (i) the representations, warranties and enforcement mechanisms available to investors and (ii) how they differ from issuances of similar securities.	Disclose the representations and warranties made, the remedies for breach and the time period to cure.  For residential mortgage loans, a reserve fund would be required in an amount equal to 5% of cash proceeds from the securitization payable to the sponsor, which reserve would be held for 12 months to cover any repurchases required for breaches of representations and warranties.	Disclose the representations and warranties made and the remedies for breach. Must disclose whether or not a fraud representation is made.
<u>Disclosure of Repurchase Requests by Originator:</u>	Regulations to require securitizers to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so investors may identify asset originators with clear underwriting deficiencies.	No.	Disclosure required for sponsors and 20% originators as to repurchase demands and performance during prior 3 years, including the percentage that was not then repurchased or replaced by the sponsor or originator and whether an opinion of an unaffiliated third party had been furnished to the trustee that confirms that the assets did not violate a representation or warranty. Disclosure also required of financial condition of warranting party to the extent the financial condition could have a material impact on repurchase ability.  Shelf-registered ABS must require a warranting party to furnish an opinion or certificate, furnished to the trustee at least each quarter, from a non-affiliated third party relating to any asset for which the trustee has asserted a breach of a representation or warranty and for which the asset was not repurchased or replaced by the obligated party on the basis of an assertion that the asset did not violate a representation or warranty contained in the pooling and servicing agreement or other transaction agreement.
			Periodic reports must include disclosure of any repurchase demands made of the obligated party in the reporting period, including the percentage that was not then repurchased or replaced by the originator and whether an opinion of an unaffiliated third party had been furnished to the trustee that confirms that the assets did not violate a representation or warranty.

# Clients & Friends Memo

## Executive Compensation and Corporate Governance Provisions Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

July 20, 2010

### I. Introduction

The focus of this Memorandum is Title IX – Subtitle E “Accountability and Executive Compensation” and Title IX – Subtitle G “Strengthening Corporate Governance” of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). We note that the Act requires the Securities and Exchange Commission (“SEC”), or other specified federal regulator, to develop rules in order to fully implement many of these compensation and corporate governance provisions. Accordingly, the ultimate impact of such provisions will in large part depend on how such rules are implemented.

In short, the Act:

- Requires a non-binding shareholder vote to approve a publicly traded company’s executive compensation packages for its named executive officers.
- Requires another non-binding shareholder vote to determine whether the non-binding shareholder vote approving executive compensation packages will occur every 1, 2 or 3 years.
- Requires a non-binding shareholder vote to approve golden parachute arrangements in connection with certain corporate transactions.
- Requires compensation committee and compensation adviser independence and disclosure of compensation consultants retained, including any conflict of interest that arises.

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act’s application to specific industries, entities and transactions. To see these other memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

- Requires disclosure of the relationship between executive compensation paid to executive officers and the issuer's financial performance (in addition to any compensation disclosure required under Item 402 of Regulation S-K).
- Requires disclosure of the median annual employee compensation (excluding CEO compensation), the annual CEO compensation and the ratio of the median annual employee compensation (excluding CEO compensation) to the annual CEO compensation.
- Requires publicly traded companies to implement a "clawback" policy that would allow companies to reclaim compensation paid to current or former executive officers during the 3-year period prior to any accounting restatement due to the company's material noncompliance with financial reporting requirements.
- Requires disclosure of whether any employee or board member of a publicly traded company can purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities granted as part of their compensation, or held, directly or indirectly, by the employee or board member.
- Requires "appropriate federal regulators" to prescribe regulations requiring each "covered financial institution" to disclose incentive-based compensation arrangements and to prohibit the arrangements that provide an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or that could lead to material financial loss.
- Prohibits non-beneficial owners from voting a security with respect to a board member election, executive compensation or any other significant matter that the SEC determines, unless instructed by the beneficial owner.
- Permits the SEC to prescribe rules requiring that a company's proxy solicitation, consent or authorization include a nominee submitted by a shareholder to serve on the board of directors.
- Requires disclosure to investors in publicly traded companies the reasons that the company has chosen the same person to serve as chairman of the board and CEO (or equivalent positions), or different individuals to serve in those positions.

The balance of this memorandum is divided into two parts: Part II discusses the executive compensation provisions of the Act, and Part III discusses the corporate governance provisions of the Act.

## II. Executive Compensation

### A. Shareholder Vote on Executive Compensation and Golden Parachute Disclosures

The Act requires publicly traded companies to provide for non-binding shareholder votes on executive compensation (“**say on pay**”) and golden parachute packages (“**say on golden parachutes**”) of named executive officers. Non-binding “say on pay” votes are already mandatory for companies that received government assistance through the Troubled Asset Relief Program (“**TARP**”).<sup>1</sup>

The executive compensation provisions of the Act will subject executive pay to greater shareholder scrutiny. Accordingly, public companies should undertake a proactive and comprehensive review of their executive compensation and golden parachute packages and policies, analyzing whether it is likely shareholders will approve such packages and how best to avoid a negative reaction from institutional investors and proxy advisors.

Even without the mandate of the Act, in recent years, executive compensation packages at public companies have been subject to increased scrutiny by shareholders. For example, certain companies have voluntarily given shareholders a “say on pay” in their proxy statements in recent years.<sup>2</sup> This year, for the first time, shareholders for Motorola, Inc., Occidental Petroleum Corporation and KeyCorp rejected executive compensation proposals in non-binding “say on pay” votes.<sup>3</sup>

“Say on Pay”. The Act requires publicly traded companies to provide for a non-binding shareholder vote to approve executive compensation packages at least

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<sup>1</sup> Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(e) (2008) (as amended by the American Recovery and Reinvestment Act of 2009); 31 C.F.R. § 30.13 (2009). See also 17 C.F.R. Part 240 (2010) for SEC amendments to the proxy rules under the Securities Exchange Act of 1934 requiring TARP recipients to include a “say on pay” vote in their proxies.

<sup>2</sup> See American Federation of State, County and Municipal Employees, AFL-CIO, “More Than 50 Companies Voluntarily Adopt “Say on Pay” as Institutional Investors Continue to Press for an Advisory Vote”, Mar. 2, 2010, available at <http://www.afscme.org/press/27802.cfm>.

<sup>3</sup> See Motorola, Inc., Current Report (Form 8-K), at 1 (May 5, 2010); Motorola, Inc., Proxy Statement (Form DEF 14A), at 19 (Mar. 12, 2010); Occidental Petroleum Corp., Current Report (Form 8-K), at 1 (May 11, 2010); Occidental Petroleum Corp., Proxy Statement (Form DEF 14A), at 40 (Mar. 23, 2010); KeyCorp, Current Report (Form 8-K), at 3 (May 24, 2010); KeyCorp, Proxy Statement (Form DEF 14A), at 49 (Apr. 2, 2010). KeyCorp was required to include a “say on pay” vote in its proxy because it is a TARP recipient.

once every 3 years (although more frequent voting may be required).<sup>4</sup> The voting must be provided for in any proxy or consent or authorization for an annual (or other) shareholder meeting for which SEC proxy solicitation rules require compensation disclosure.

The Act also requires a shareholder vote at least once every 6 years to determine whether non-binding votes to approve executive compensation packages will occur every 1, 2 or 3 years, the result of which is not binding on the company. The proxy or consent or authorization for the first annual (or other) shareholder meeting occurring at least 6 months after enactment of the Act must include a non-binding shareholder vote to approve executive compensation packages and a shareholder vote to determine the frequency of such non-binding voting.

“Say on Golden Parachutes”. The Act requires disclosure in any proxy or consent solicitation material for a shareholder meeting occurring at least 6 months after enactment at which shareholders are asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of an issuer’s assets, by the person making such solicitation of any agreements that such person has with any named executive officers of the issuer (or of the acquiring issuer, if such issuer is not the acquiring issuer) concerning (1) any type of compensation (whether present, deferred or contingent) that is based on or otherwise relates to the transaction, (2) the aggregate amount of such compensation, and (3) the conditions upon which the compensation may be paid. In addition, any proxy containing the disclosure will include a non-binding shareholder vote to approve the disclosed agreements and compensation, unless the agreements have been subject to a “say on pay” vote.

Disclosure. The Act requires every institutional investment manager subject to section 13(f) of the Securities Exchange Act of 1934 to disclose at least annually how it voted on “say on pay” or “say on golden parachute” resolutions, unless the SEC rule or regulation requires the vote to be otherwise publicly reported.

Exemptions. The Act permits the SEC to exempt an issuer or class of issuers from these requirements, and, in determining any exemption, requires the SEC to take into account whether these requirements disproportionately burden small issuers.

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<sup>4</sup> Last year, Microsoft Corporation voluntarily adopted a non-binding advisory shareholder vote on the company’s executive compensation plan every 3 years. See “Microsoft Board Authorizes “Say-on-Pay” Advisory Vote on Executive Compensation”, available at <http://www.microsoft.com/presspass/press/2009/sep09/09-18boardpr.mspx>. Certain other companies have adopted “say on pay” voting every 2 years.

## B. Compensation Committee Independence

Compensation Committee Independence. The Act directs the SEC to promulgate rules requiring that each compensation committee member be a board member and be “independent”.<sup>5</sup> The Act also requires the SEC to direct the stock exchanges and FINRA<sup>6</sup> to prohibit the listing of issuer equity securities for any issuer that does not comply with the compensation committee independence requirements.<sup>7</sup> The Act further mandates that the SEC rules to determine independence include the following factors: (1) the board member’s source of compensation, including any consulting, advisory or other compensatory fee paid by the issuer, and (2) whether the board member is affiliated with the issuer, an issuer subsidiary or an affiliate of an issuer subsidiary. Publicly traded companies will need to consider these rules alongside the “outside director” requirement of section 162(m) of the Internal Revenue Code of 1986, and the “non-employee director” requirement of SEC Rule 16b-3.<sup>8</sup>

Compensation Adviser Independence. The Act further provides that the compensation committee may select a compensation consultant, legal counsel or

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<sup>5</sup> SEC rules will permit an exchange or FINRA (as the exchange or FINRA deems appropriate, taking into consideration an issuer’s size and other relevant factors) to exempt particular relationships from these requirements with respect to the compensation committee members.

<sup>6</sup> The Act refers to the national securities associations, of which the only one relevant is the Financial Industry Regulatory Authority, better known as “FINRA”.

<sup>7</sup> This rule excludes controlled companies, limited partnerships, companies in bankruptcy proceedings, open-ended management investment companies registered under the Investment Company Act of 1940, and foreign private issuers that provide annual disclosures to shareholders of the reasons that they do not have independent compensation committees.

<sup>8</sup> Section 162(m) of the Internal Revenue Code generally provides for a \$1 million deduction limitation on certain executive compensation, with specified exceptions including certain performance-based compensation. The performance-based compensation exception generally requires that the performance goals under which such compensation is paid be established by a compensation committee composed solely of two or more “outside directors.” For purposes of section 162(m), a director is an “outside director” if the director (a) is not a current employee of the publicly held corporation, (b) is not a former employee of the corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year, (c) has not been an officer of the publicly held corporation and (d) does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director.

SEC Rule 16b-3 exempts certain transactions between issuers of securities and their officers and directors from the provisions of Section 16(b) of the Exchange Act. This exemption applies if, among other things, the transaction is approved by the board of directors of the issuer, or a committee of such board that is composed solely of two or more “non-employee directors”. SEC Rule 16b-3 defines a “non-employee director” to mean a director who (a) is not currently an officer of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or a parent or subsidiary of the issuer, (b) does not receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director (except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to Item 404 of Regulation S-K) and (c) does not possess an interest in any other transaction for which disclosure would be required pursuant to Item 404 of Regulation S-K.

other adviser to the committee (each, an “**Adviser**”) only after considering the independence factors the SEC identifies, which will be competitively neutral among categories of Advisers, including: (1) the other services provided to the issuer by the person that employs the Adviser; (2) the amount of fees received from the issuer by the person that employs the Adviser, as a percentage of the total revenue of the person that employs the Adviser; (3) the policies and procedures of the person who employs the Adviser that are designed to prevent conflicts of interest; (4) any business or personal relationship of the Adviser with a member of the compensation committee; and (5) any issuer stock owned by the Adviser.

Disclosure. The Act requires each issuer to disclose in any proxy or consent solicitation material for an annual shareholder meeting (or special meeting in lieu of the annual meeting) occurring at least 1 year after enactment in accordance with SEC regulations, whether (1) the compensation committee retained or obtained the advice of a compensation consultant, and (2) the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

SEC Rules. The Act mandates that, within 360 days following enactment, the SEC will direct the exchanges and FINRA to prohibit the listing of securities for issuers that are not in compliance with these compensation committee independence requirements. The SEC rules will provide appropriate procedures for an issuer to have a reasonable opportunity to cure any defects prior to delisting.

Exemptions. The compensation committee independence rules will not apply to an issuer (i) that is listed on an exchange or by FINRA, (ii) that holds an election for the board of directors, and (iii) in which an individual, group or another issuer holds more than 50% of the voting power. In addition, the SEC may permit exchanges and FINRA to exempt a particular relationship from the compensation committee independence requirements as the exchanges and FINRA determine is appropriate, taking into account the issuer’s size and any other relevant factors.

Compensation Committee Authority. The Act permits a compensation committee to, in its sole discretion, retain or obtain the advice of an Adviser and, be directly responsible for the appointment, compensation, and oversight of such Adviser’s work.

Adviser Compensation. The Act requires each issuer to provide appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to Advisers.

SEC Study and Report. The Act requires the SEC to conduct a study and review of the use of compensation consultants and the effects of such use and submit a report to Congress on the results of the study and review within 2 years of enactment.

**C. Executive Compensation Disclosures – “Pay for Performance” and “Pay Disparity”**

The Act directs the SEC to require each publicly traded issuer to disclose in any proxy or consent solicitation material for an annual shareholder meeting a clear description of any compensation required to be disclosed under Item 402 of Regulation S-K, including information that shows the relationship between executive compensation actually paid and the issuer’s financial performance, taking into account any change in stock value and issuer dividends and any distributions.<sup>9</sup>

The Act also directs the SEC to amend Item 402 of Regulation S-K to require each publicly traded issuer to disclose: (1) the median annual total compensation of all employees, except the CEO (or equivalent); (2) the annual total compensation of the CEO (or equivalent); and (3) the ratio of the median annual total compensation of all employees (except the CEO) to the annual total compensation of the CEO.<sup>10</sup>

**D. Recovery of Erroneously Awarded Compensation – “Clawbacks”**

The Act directs the SEC to promulgate rules requiring each publicly traded issuer to develop and implement a policy providing: (1) for disclosure of the issuer’s policy on incentive-based compensation that is based on financial information required to be reported under the securities laws; and (2) that, in the event that the issuer is required to prepare an accounting restatement due to the issuer’s material noncompliance with any financial reporting requirement under the securities laws, any current or former executive officer who received incentive-based compensation (including stock options), based on the erroneous data, during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement to repay the issuer the excess of what would have been paid to the executive officer under the accounting restatement. The SEC will direct the exchanges and FINRA to prohibit the listing of securities for any issuer that does not comply with the clawback requirements.

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<sup>9</sup> The disclosure may include a graphic representation of this information.

<sup>10</sup> An employee’s total compensation must be determined in accordance with the SEC’s executive compensation disclosure rules.

We note that the Act's clawback provision is broader than section 304 of the Sarbanes-Oxley Act, which generally requires CEOs and CFOs to reimburse a company for any bonus or incentive-based compensation received and profits from stock sales realized during the 12-month period after publication of a misstated financial filing if a company is required to prepare an accounting restatement due to misconduct. By contrast, the Act's clawback provision does not require any misconduct as a basis for an accounting restatement and applies to any current or former executive officer who received incentive-based compensation during the 3-year period preceding the restatement. Companies should begin considering how their clawback policies will be implemented, including whether any existing employment agreements or incentive arrangements will need to be amended to comply with such a policy.

As further described in the memorandum titled Orderly Liquidation of Financial Companies, Including Executive Compensation Clawback, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Title II of the Act also permits the Federal Deposit Insurance Corporation, as receiver of a "covered financial company," to clawback certain compensation from any current or former senior executive or director who is substantially responsible for the failed condition of the company.

**E. Disclosure Regarding Employee and Director Hedging**

The Act directs the SEC to issue rules requiring each publicly traded issuer to disclose, in any proxy or consent solicitation material for an annual shareholder meeting, whether any employee or board member, or any designee of the employee or member, is permitted to purchase financial instruments (including, prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities (1) granted to the employee or board member as part of his or her compensation; or (2) held, directly or indirectly, by the employee or board member.

**F. Enhanced Compensation Structure Reporting**

The Act provides that, within 9 months of enactment, the "appropriate federal regulators"<sup>11</sup> jointly will prescribe regulations or guidelines that: (1) require each

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<sup>11</sup> The Act defines the term "appropriate federal regulator" as the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC, and the Federal Housing Finance Agency.

“covered financial institution”<sup>12</sup> (generally banking institutions) to disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements offered by such institutions sufficient to determine whether the compensation structure (a) provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or (b) could lead to material financial loss to the covered financial institution; and (2) prohibit any type of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks (a) by providing excessive compensation, fees, or benefits, or (b) that could lead to a material financial loss to the covered financial institution. This provision will not apply to covered financial institutions with assets of less than \$1 billion.

**G. Voting by Brokers**

The Act prohibits non-beneficial owners of a security registered under section 12 of the Securities Exchange Act of 1934 from granting a proxy to vote the security in connection with a shareholder vote for a board member election, executive compensation or any other significant matter as determined by the SEC (excluding a vote with respect to the uncontested board member election of any SEC-registered investment company), unless the beneficial owner has instructed the non-beneficial owner to vote the proxy in accordance with the beneficial owner's voting instructions.

**III. Corporate Governance**

**A. Proxy Access**

The Act permits the SEC to develop rules and regulations requiring: (1) a proxy solicitation, consent or authorization by (or on behalf of) an issuer to include a nominee submitted by a shareholder to serve on the board of directors; and (2) an issuer to follow a certain procedure in relation to the solicitation. The SEC may also issue rules permitting shareholders to use proxy solicitation materials supplied by an issuer to nominate individuals to the board, under such terms and conditions that the SEC determines are in the interests of shareholders and for the protection of investors. The SEC may exempt an issuer or class of issuers from the proxy access requirement and, in making such determination, will take into account whether the

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<sup>12</sup> The Act defines the term “covered financial institution” as a depository institution or depository institution holding company, a broker-dealer registered under section 15 of the Securities Exchange Act of 1934, a credit union, an investment advisor, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and any other financial institution that the appropriate federal regulators jointly determine should be treated as a covered financial institution.

proxy access requirement disproportionately burdens small issuers, among other things.

**B. Disclosures Regarding Chairman and CEO Structures**

The Act directs the SEC to issue rules, within 180 days of enactment, requiring an issuer to disclose in the annual proxy sent to investors the reasons why the issuer has chosen (1) the same person to serve as chairman of the board and CEO (or equivalent positions); or (2) different individuals to serve as chairman of the board and CEO (or equivalent positions).

\* \* \* \* \*

If you have any questions regarding this memorandum, please contact the individuals listed below or any other member of the Cadwalader Tax Department.

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# Clients & Friends Memo

## Amendments to SOX, Including Section 404(b) Exemption for Nonaccelerated Filers, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act\*

July 20, 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act") has now been passed by both houses of Congress and is awaiting signature by President Obama. The Act, once implemented by the required regulations, will completely alter the U.S. financial regulatory system. Financial institutions will be materially affected by these regulations, and non-financial institutions will be affected at least indirectly through their use of regulated financial products. Additionally, the Act's amendments to the Sarbanes-Oxley Act of 2002 ("SOX") and broad changes to executive compensation and corporate governance rules will impact public companies in the United States.

This memorandum is focused on certain provisions of Title IX of the Act that relate to SOX Section 404, including an amendment to SOX Section 404 which exempts nonaccelerated filers from the SOX Section 404(b) requirement to obtain an auditors' report on management's assessment of the effectiveness of the company's internal control over financial reporting.

### I. Exemption for Nonaccelerated Filers

Title IX of the Act amends SOX Section 404 to exempt nonaccelerated filers (including smaller reporting companies) from the SOX Section 404(b) requirement to obtain an auditors' report on management's assessment of the effectiveness of the company's internal control over financial reporting. The text of the new subsection (c) reads in its entirety as follows:

"(c) EXEMPTION FOR SMALLER ISSUERS.—Subsection (b) shall not apply with respect to any audit report prepared for an issuer that is neither a 'large accelerated filer' nor an 'accelerated

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

filer' as those terms are defined in Rule 12b-2 of the Commission (17 C.F.R. 240.12b-2)."

In addition, the Act directs the Commission to conduct a study to determine how the Commission could reduce the burden of complying with SOX Section 404(b) for companies whose market capitalization is between \$75,000,000 and \$250,000,000 while maintaining investor protections for such companies. The Commission is also directed to consider whether any such methods of reducing the compliance burden or a complete exemption for such companies from compliance with SOX Section 404(b) would encourage companies to list their initial public offerings on exchanges in the United States. The Commission is directed to provide its report of such study to Congress not later than nine months after the date of the enactment of the Act.

## II. GAO Study Regarding Exemption for Smaller Issuers

The Act also directs the Comptroller General of the United States to carry out a study on the impact of the amendment to SOX Section 404, including an analysis of:

1. whether issuers that are exempt from SOX Section 404(b) have fewer or more restatements of published accounting statements than issuers that are required to comply with SOX Section 404(b);
2. the cost of capital for issuers that are exempt from SOX Section 404(b) compared to the cost of capital for issuers that are required to comply with SOX Section 404(b);
3. whether there is any difference in the confidence of investors in the integrity of financial statements of issuers that comply with SOX Section 404(b) and issuers that are exempt from compliance with SOX Section 404(b);
4. whether issuers that do not receive the attestation for internal controls required under SOX Section 404(b) should be required to disclose the lack of such attestation to investors; and
5. the costs and benefits to issuers that are exempt from SOX Section 404(b) that voluntarily have obtained the attestation of an independent auditor.

The Comptroller General is directed to provide its report of such study to Congress not later than three years after the date of the enactment of the Act.

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# Clients & Friends Alert

## SEC Releases Timetable for Rulemaking and Reporting for Asset-Backed Securities Under the Dodd-Frank Wall Street Reform and Consumer Protection Act

September 22, 2010

The Securities and Exchange Commission has recently published a timetable setting forth a schedule for the release of reports, rule proposals and adoption of final rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act").

The Act was signed into law on July 2010 and requires applicable regulators, including the Securities Exchange Commission to accomplish substantial rule making and to deliver reports to Congress on various topics. The Act consists of sixteen distinct Titles on a wide variety of topics. Once implemented by the required regulations, the Act will significantly alter the U.S. financial regulatory system.

The first set of rules is expected to be released as early as October 2010 and additional rules will continue to be released through July 2011. The table below outlines the schedule for reports and proposed and final rules that directly affect asset backed securities. The full schedule can be viewed at the [SEC's website](#).

Expected Date of Release	Section of the Act	Subject Matter
October 2010- December 2010	§621	Propose rules prohibiting material conflicts of interests between certain parties involved in asset-backed securities and investors in the transaction
	§941(c)(1)	Report by the Federal Reserve Board, after consulting with the SEC and others, regarding the impact on each class of asset-backed securities on risk retention requirements
	§941	Propose rules (jointly with others) regarding risk retention by securitizers of asset-backed securities, and implementing the exemption of qualified residential mortgages from this prohibition
	§943	Propose rules regarding the use of representations and warranties in the asset-backed securities market

Expected Date of Release	Section of the Act	Subject Matter
	§945	Propose rules regarding asset-backed securities' issuers' responsibilities to conduct and disclose a review of the assets
January 2011- March 2011	§932	Propose rules requiring third parties retained for the purpose of conducting due diligence related to asset-backed securities, to provide a certification containing specified information to the NRSRO that is producing a rating for the ABS
	§938	Propose rules regarding ratings symbols
	§943	Adopt rules regarding the use of representations and warranties in the asset-backed securities market
	§945	Adopt rules regarding asset-backed securities' issuers' responsibilities to conduct and disclose a review of the assets
April 2011 – July 2011	§932	Adopt rules requiring third parties retained for the purpose of conducting due diligence related to asset-backed securities, to provide a certification containing specified information to the NRSRO that is producing a rating for the ABS
	§938	Adopt rules regarding ratings symbols
	§621	Adopt rules prohibiting material conflicts of interests between certain parties involved in asset-backed securities and investors in the transaction
	§941	Adopt rules (jointly with others) regarding risk retention by securitizers of asset-backed securities, and implementing the exemption of qualified residential mortgages from this prohibition

Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these memoranda please see a [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

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## SEC Schedule for Implementing Dodd-Frank Act

### October 2010

#### *Enforcement*

- §922: Report to Congress on Whistleblower Program
- §924: Establish Whistleblower Office

#### *Corporate Governance & Disclosure*

- §951: Propose rules regarding shareholder votes on “say-on-pay,” “say-when-on-pay” and “golden parachute say-on-pay”
- §951: Propose rules regarding disclosure by institutional investment managers of votes on executive compensation

#### *Auditing*

- §989G: Request for public comment related to study regarding reducing the costs to smaller issuers (with market capitalization between \$75 and \$250 million) for complying with §404(b) of the Sarbanes-Oxley Act of 2002, while maintaining investor protections for such companies

### November-December 2010

#### *Enforcement*

- §922: Propose rules to implement a Whistleblower Incentives & Protection Program
- §924: Appoint head of new Whistleblower Office

#### *Corporate Governance & Disclosure*

- §952: Propose exchange listing standards regarding compensation committee independence and factors affecting compensation adviser independence; propose disclosure rules regarding compensation consultant conflicts

### January-March 2011

#### *Enforcement*

- §922: Adopt rules to implement a Whistleblower Incentives & Protection Program

### *Corporate Governance & Disclosure*

- §951: Adopt rules regarding shareholder votes on “say-on-pay,” “say-when-on-pay” and “golden parachute say-on-pay”
- §951: Adopt rules regarding disclosure by institutional investment managers of votes on executive compensation

### April-June 2011

### *Corporate Governance & Disclosure*

- §952: Adopt exchange listing standards regarding compensation committee independence and factors affecting compensation adviser independence; adopt disclosure rules regarding compensation consultant conflicts
- §§953 & 955: Propose rules regarding disclosure of executive pay-for-performance, CEO internal pay ratios, and hedging by employees and directors
- §954: Propose rules regarding clawback of executive compensation
- §957: Propose rules defining “other significant matters” for purposes of exchange standards regarding broker discretionary voting of uninstructed shares

### *Auditing*

- §989G: Report to Congress on study regarding reducing the costs to smaller issuers (with market capitalization between \$75 and \$ 250 million) for complying with §404(b) of the Sarbanes-Oxley Act of 2002, while maintaining investor protections for such companies

**FINANCIAL OVERHAUL LEGISLATION – HOW DOES IT AFFECT YOUR  
COMPANY?**

**AN ANALYSIS OF THE  
CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION PROVISIONS IN  
THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION  
ACT**

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## I. INTRODUCTION

- A. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) was signed into law on July 21, 2010. The Act consists of sixteen distinct titles on a wide variety of topics. Once implemented by the required regulations, the Act will significantly alter the U.S. financial regulatory system. All financial institutions will be directly and materially affected by the Act’s accompanying regulations, and non-financial institutions that use regulated financial products will be indirectly affected. Additionally, the Act’s amendments to the Sarbanes-Oxley Act and broad changes to executive compensation and corporate governance rules will impact all U.S. public companies.
- B. Only one out of sixteen titles and nine out of hundreds of sections of the Act pertain to corporate governance and executive compensation. Subtitle E of Title IX of the Act is entitled “Accountability and Executive Compensation” and Subtitle G of Title IX is entitled “Strengthening Corporate Governance.”
- C. Although the Act is generally intended to regulate financial institutions, those sections pertaining to corporate governance and executive compensation will likely have a profound effect on the corporate landscape of America. Most significantly, many of the rules to be promulgated by the SEC, as directed by the Act, place unprecedented power in the hands of shareholders and remove or, at the least, neutralize the power of the company’s management and board of directors. Additionally, executive compensation, as directed by the Act, will be subject to both non-binding shareholder votes as well as enhanced scrutiny through mandatory votes and public disclosures. Executive compensation, even for former executives, is also now subject to clawbacks in certain circumstances in the event that a company must restate its financial statements.
- D. This outline will begin by discussing the aspects of the Act that increase shareholders’ input in a public company: Proxy Access for Director Nominations; Say-on-Pay and Say When on Pay Shareholder Votes; Disclosure by Investment Advisors of their Voting Record on Compensation Matters; and Limitations on Broker Discretionary Voting. The outline will continue by addressing the Act’s executive compensation provisions: Mandatory Disclosures of (i) the Relationship Between Executive Compensation and Financial Performance, (ii) the CEO Internal Pay Ratio, and (iii) Company Policies related to Hedging of Company Shares; Clawbacks of Executive Compensation in the Event of a Restatement of Financials; and Compensation Committee Independence Requirements. The outline will conclude by discussing other aspects of the legislation that are of consequence to large companies: Increased Whistleblower Protections and Rewards; Expansion of Liability for Aiding and Abetting a Fraud; and Disqualification of Bad Actors from Regulation D Offerings.

## II. LEGISLATION INTENDED TO EMPOWER SHAREHOLDERS

### A. Proxy Access for Director Nominations

- i. On August 25, 2010, the SEC passed new Rule 14a-11 under the Securities Exchange Act of 1934, which permits shareholders or groups holding at least 3% of the voting power of U.S. public companies continuously for at least three years to include director nominees in company proxy materials. The SEC also amended Rule 14a-8 of the Exchange Act to prohibit management's exclusion of a proxy access shareholder proposal, unless such proxy access proposal conflicts with state law or Rule 14a-11.
- ii. *Recent Developments:*
  - a. On October 4, 2010, the SEC stayed the effect of Rule 14a-11 and Rule 14a-8 pending the resolution of its litigation with Business Roundtable and the Chamber of Commerce of the United States of America.
  - b. On September 29, 2010, Business Roundtable and the Chamber of Commerce filed a petition with the D.C. Court of Appeals seeking a review of the recently-passed proxy access rules. The petition argued that Rule 14a-11 is arbitrary and capricious, violates the Administrative Procedure Act, and that the SEC failed to properly assess the rule's effects on "efficiency, competition and capital formation" as required by law. In addition, the petition stated that the rule gave short shrift to existing state laws regarding access to the proxy and related principles, including the law in Delaware and the Model Business Corporation Act, and created significant ambiguities regarding the application of federal and state law to the nomination and election process."
  - c. The stay of Rule 14a-11 and Rule 14a-8 by the SEC effectively makes proxy access a non-issue for the 2011 proxy season, at least for companies with annual meetings scheduled for the usual March-April period. Prior to the stay, the rule was scheduled to apply to the 2011 annual meeting for companies that mailed their 2010 proxy materials on or after March 15, 2010.
- iii. *Application:*
  - a. The rule will apply to companies subject to the proxy rules, including companies that voluntarily register securities under Section 12(g), except those companies that are subject to the proxy rules solely because they have registered debt securities.
  - b. Companies cannot opt out of being subject to Rule 14a-11.

- c. The rule will not apply to foreign private issuers.
  - d. Rule 14a-11 will not apply where applicable state or foreign law or a company's governing documents (e.g., charter, by-laws, etc.) prohibit shareholders from nominating directors.
- iv. *Smaller Reporting Companies Delay:*
- a. There is a three year delay of effectiveness of Rule 14a-11 for smaller reporting companies, as defined under the Exchange Act. However, smaller reporting companies will be subject to Rule 14a-8 during the three year deferral period.
- v. *Nominating Shareholders Requirements:*
- a. Shareholders must continuously own at least 3% of the voting shares for at least three years, through the annual meeting, including shares lent out with rights to recall, but excluding borrowed shares. Shareholders must have voting control over any shares counted toward the 3% threshold. Shareholders must provide a statement that they intend to hold their shares until the shareholder meeting and must disclose their ownership intent for their shares after the meeting.
  - b. Rule 14a-11 cannot be used by shareholders with the current intent to either change control of the company or gain more than 25% of the seats on the board of directors. Nominating shareholders must certify to their lack of intent of control of the company on their Schedule 14N.
  - c. Nominating shareholders must complete Schedule 14N with information concerning their board nominee during the period from 150 days to 120 days prior to the first anniversary of the mailing date of the previous year's proxy materials. Information to be disclosed on Schedule 14N includes biographical information concerning the nominee, any relationships between the nominee and the nominating shareholders and a statement in support of the nominee.
  - d. In the event of multiple qualified nominating shareholders or groups of shareholders, priority will be given to the holder of the largest stake of voting shares, in the event that there is a greater number of board nominees than board positions available to shareholder-nominated nominees.

vi. *Eligibility of Nominees:*

- a. Shareholder nominees may comprise up to 25% of the entire board, even for classified or staggered boards.
- b. Nominees must meet objective independent director standards of the applicable listing exchange.
- c. There is no restriction on a relationship existing between the nominating shareholder and the shareholder nominee, but any such relationship must be disclosed by the nominating shareholder.
- d. Nominees must not have any direct or non-direct nomination agreement in place with the company.

vii. *Exclusion of Shareholder Nominees:*

- a. Companies may exclude a shareholder nominee if they believe the application for such nominee by the nominating shareholders set forth in Schedule 14N is deficient. Nominating shareholders will have fourteen days to correct any deficiencies. If companies still believe that there is a deficiency, they must provide notice to the SEC of their exclusion of the shareholder nominee at least 80 days prior to the filing of their definitive proxy statement. Companies may also request no-action relief from the SEC in regards to this matter.

viii. *Liability:*

- a. Companies will not be liable for false or misleading statements in the information provided by nominating shareholders.

ix. *Schedule 13G Eligibility:*

- a. Nominating shareholders will not lose their Schedule 13G eligibility on account of submitting a Rule 14a-11 director nomination.

x. *Related Amendments and Rule Adoptions:*

- a. The SEC also amended Rule 14a-8(i)(8) of the Exchange Act to prohibit companies from excluding shareholder proposals that relate to the proxy access rules, unless the proposal conflicts with state law or Rule 14a-11.
- b. As noted above, the effectiveness of the amendment to Rule 14a-8 was stayed by the SEC on October 4, 2010, pending the resolution of related litigation.

- xi. *Hint of Upcoming Rulemaking:*
  - a. The Proxy Access Rules may be only the first step in a series of changes to the proxy rules.
  - b. The SEC issued a concept release on July 14, 2010 seeking comment on various aspects of the U.S. proxy system, including:
    - i. the proxy voting process, soliciting comments on issues such as over- and under-voting of shares and proxy voting by institutional securities lenders;
    - ii. shareholder communication and participation, soliciting comments on issues such as issuers' ability to communicate with beneficial owners and retail voting participation; and
    - iii. the relationship between voting power and economic interest, soliciting comments on issues such as the role of proxy advisory firms, dual record dates and empty voting
  - c. The concept release will lead to significant SEC rulemaking in the coming years.
- xii. **Questions Remaining.** The Act and Rule 14a-11 leave open a number of questions relating to proxy access for shareholders, including:
  - a. Group status. Rule 14a-11 gives no further guidance as to whether a shareholder group formed for the purposes of nominating a director has also formed a "group" for the purposes of Section 13 or Section 16 of the Exchange Act. Nominating shareholders forming a group for such purpose will have to use the existing facts and circumstances analysis to determine their group status under Section 13 or Section 16.
  - b. Affiliate status. Rule 14a-11 does not provide a safe harbor from affiliate status for nominating shareholders. Nominating shareholders will be forced to use the facts and circumstances test to determine if they would be considered affiliates of the companies for which they have nominated director candidates.
- xiii. **Pros.** Proxy access for director nominations could result in a number of benefits for shareholders and companies alike.
  - a. Rule 14a-11 will likely lead to increased shareholder participation in determining the direction of the company. For the nominating shareholders, at the least, a nominated director sitting on the board will give them a voice to influence the direction of the company,

which would have been unlikely prior to the new proxy access rules.

- b. Proxy access will probably decrease the cost for shareholders to nominate board candidates by avoiding costly proxy contests. As such, activist institutional investors or wealthy individuals waging proxy fights will no longer be the only shareholders capable of nominating board candidates.
  - c. Nominating shareholders will be able to solicit outside of the company management's proxy statement under the cover of a separate Schedule 14N, so long as the nominating shareholders making the solicitation do not seek to act as proxies for shareholders. As such, nominating shareholders will generally have direct access to other shareholders without having to go through management.
- xiv. **Cons.** Increased proxy access for shareholders nominating candidates for the board could also yield negative results for both companies and shareholders by championing short-term results and increasing the influence of institutional investors.
- a. Rule 14a-11 provides shareholders with an annual opportunity to nominate directors. This could place undue emphasis on short term results for companies because they know that the composition of the board could be changed yearly by the shareholders.
  - b. Proxy access for director nominations presents an opportunity for institutional investors and activist hedge funds. Widely-held companies that are unlikely to have holders of 3% or more of the voting shares, other than institutional investors, face the increased possibility that institutional investors and activist hedge funds could exert disproportionate control through their shareholder nominations for board seats. This could result in the narrow interests of institutional holders being given priority over the long-term value driven interests of these widely-held companies.
  - c. By increasing the likelihood of multiple candidates for the same board seats, the proxy access rules both increase the cost of the proxy solicitation process for company management that is seeking the election of its own slate of directors and further distract management from its leadership of the company.
- xv. **Practice Points.** Below are some practice points for officers and directors of companies looking to address the proxy access rules:
- a. Company leadership should be proactive in communicating with large shareholders and understanding their positions concerning

the company. By being receptive to their concerns prior to the proxy season, a company could possibly avoid having these large shareholders nominate directors that are antagonistic to the company's current leadership.

- b. Company management should review and revise their company's director nomination procedures and other anti-takeover provisions in light of the new shareholder nomination processes in Rule 14a-11 and Rule 14a-8. Management should consider whether under its current procedures it has sufficient time to consider shareholder nominees for the board of directors.

**B. “Say-on-Pay” and “Say-When-on-Pay”**

- i. Section 951 of the Act adds a new Section 14A to the Exchange Act that provides that public companies will be required to give shareholders a non-binding vote (“say-on-pay”) on the compensation of their named executive officers, including base salary, bonus, equity and non-equity compensation awards, perquisites and severance benefits. The board is not required to follow the decision of the “say-on-pay” shareholder vote.
- ii. The “say-on-pay” vote, also known as “management say-on-pay” or MSOP, must be included in any proxy, consent or authorization for a shareholder meeting that also discloses executive compensation as required pursuant to Item 402 of Regulation S-K. The “say-on-pay” vote will cover all executive compensation including compensation disclosed in tables in the proxy statement as well as in the CD&A section.
- iii. *Application:*
  - a. “Say-on-pay” votes must be provided for all named executive officers subject to disclosure under Item 402 of Regulation S-K.
- iv. *“Say-when-on-pay”:*
  - a. The Act also directs companies to give shareholders a vote on the frequency of their non-binding “say-on-pay” vote. Shareholders can vote whether a non-binding “say-on-pay” vote should occur every one, two or three years. Such a vote must take place once every six years, at the minimum.
- v. *Effectiveness:*
  - a. The “say-on-pay” and “say-when-on-pay” votes must be conducted as part of the company's first shareholder meeting occurring after January 21, 2011. The proxy statement, consent or authorization for such meeting must include a non-binding shareholder vote on whether to approve executive compensation

packages for the named executive officers and a shareholder vote to determine the frequency of such non-binding vote.

vi. *Smaller Reporting Companies Exemption:*

- a. The Act authorizes the SEC to create an exemption from “say-on-pay” and “say-when-on-pay” votes for smaller reporting companies, if the SEC determines the implementation of such votes to be too burdensome.

vii. *SEC Timetable:*

- a. The SEC plans to issue proposed rules regarding “say-on-pay” and “say-when-on-pay” shareholder votes sometime between October and December 2010.

viii. **Questions Remaining.** Below are open questions related to the Act’s legislation of the “say-on-pay” and the “say-when-on-pay” shareholder votes. It should be noted that some or all of these questions may be clarified when the SEC issues its proposed rules related to these votes.

- a. The Act does not provide sufficient clarity as to the mechanics of the “say-when-on-pay” vote. Once the shareholders vote as to the frequency of the “say-on-pay” vote, does that mean that the “say-when-on-pay” vote will be voted upon by shareholders with the same frequency? What happens if shareholders want a “say-on-pay” vote more frequently than initially decided by the shareholders? On the other hand, if at the 2011 shareholder meeting the shareholders vote to have a “say-on-pay” vote every year, does the company have to put the “say-when-on-pay” proposal on every annual proxy statement, together with the “say-on-pay” vote?

- b. The Act is unclear as to the binding nature of shareholder vote on “say-when-on-pay.” Is the vote merely advisory and will ultimately be determined by the company (as is the case with the “say-on-pay” vote) or is it binding? It should be noted that many commentators believe it to be binding.

- c. The Act is silent as to how the “say-on-pay” and the “say-when-on-pay” votes are to be determined. Will the votes be decided by a plurality of shares, with the greatest number of affirmative votes cast carrying the decision, or will they be decided by the affirmative vote of a majority of the outstanding shares?

ix. **Pros.** The “say-on-pay” and “say-when-on-pay” votes may prove to be, at worst, harmless and, at best, beneficial to companies by giving

shareholders a voice that may even be in line with the interests of the companies.

- a. “Say-on-pay” votes provide increased shareholder input on executive compensation and the overall performance of companies. Based upon the results of “say-on-pay” votes, companies are able to gauge shareholders’ views about the direction of the companies without actually being bound by the decisions of the shareholders with respect to executive compensation.
  - b. “Say-on-pay” votes have shown to be mostly favorable for companies and companies have voluntarily adopted them prior to the passage of the Act. These votes have already been required for those companies receiving TARP funds. In addition, companies such as Apple, CVS Caremark and ConocoPhillips have already voluntarily implemented non-binding “say-on-pay” shareholder votes in their proxy statements. For these companies voluntarily implementing “say-on-pay” votes, all but three “say-on-pay” proposals were approved by shareholders.<sup>1</sup>
- x. **Cons.** “Say-on-pay” votes could present a number of problems for companies, especially if significant emphasis is placed on the results of these votes. Additionally, the inclusion of “say-on-pay” votes in proxies, according to current SEC rules, would lengthen the timing of the proxy process.
- a. “Say-on-pay” votes, even though they are non-binding, may be considered as votes of confidence for the management. In an effort to win the confidence of shareholders on an annual basis, management of companies may focus on short term gains, in order to show a good year to shareholders, which could come at the expense of long-term value-building for the company.
  - b. Likewise, if “say-on-pay” votes are taken seriously as votes of confidence for management, proxy voting firms may be able to exert a disproportionate influence on companies through their recommendations to institutional investors. Institutional investors, usually the largest shareholders of public companies, by and large rely upon proxy voting firms for recommendations on how to vote on shareholder proposals, which would also include “say-on-pay” proposals.

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<sup>1</sup> Motorola, KeyCorp and Occidental Petroleum were the three companies whose shareholders did not approve “say-on-pay” votes in regards to executive compensation packages.

- c. As it is currently written, Rule 14a-6 of the Exchange Act requires any proxy statement containing a “say-on-pay” proposal to be filed in preliminary form with the SEC at least 10 calendar days prior to the mailing of the definitive proxy. This would add almost two weeks to the proxy process timeline for proxy statements that include “say-on-pay” proposals.
- xi. **Practice Points.** Management should consider the following recommendations in order to best manage the “say-on-pay” and “say-when-on-pay” proposals that will be required for the 2011 proxy season.
- a. In order to avoid a negative “say-on-pay” vote, prior to the annual shareholders meeting, company management should identify elements of executive compensation programs and CD&A disclosures that could be controversial to shareholders. Management should then evaluate the advantages of either modifying such controversial elements or formulating a plan to justify the executive compensation in question (such as hiring independent compensation consultants to review the executive compensation packages) prior to the annual meeting.
  - b. In order to best manage the “say-when-on-pay” proposal, company leadership should consider its company’s recommendation as to frequency of the “say-on-pay” vote, and provide explanations if its recommendations are for a biennial or triennial vote, as opposed to the annual vote that will likely be more popular with shareholders. Management for those companies with multi-year incentive compensation plans should consider recommending a biennial or triennial “say-on-pay” vote, in order to avoid a shareholder vote on an incomplete view of the executive compensation package, though it should be noted that, given the non-binding nature of the vote, companies are free increase compensation plans in the interim years between “say-on-pay” votes.
  - c. Company management should recognize that proxy voting firms may likely recommend “say-on-pay” votes on an annual basis and consider planning its compensation structures accordingly by modifying or eliminating multi-year incentive compensation plans.
  - d. RiskMetrics Group, in its 2010 U.S. Proxy Voting Guidelines, recommends that shareholders cast a negative vote in the “say-on-pay” proposal for companies with unsatisfactory executive compensation packages, as opposed to voting against the members of the compensation committee. By encouraging a negative “say-on-pay” vote, as opposed to voting against committee members, RiskMetrics appears to be using the “say-on-pay” vote as a warning sign to companies that they will have a year to improve

their executive compensation plans, and failing to do so may result in RiskMetrics recommending votes against committee members and directors the following year.

C. **“Golden Parachute Say-on-Pay”**

- i. Section 951 of the Act adds a new Section 14A to the Exchange Act that provides that any person soliciting votes in connection with any acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of a company’s assets will be required to give shareholders a non-binding vote on any type of compensation (i.e., “golden parachute”) that will be paid to any named executive officer that is based on or otherwise relates to the transaction described in the related proxy statement or consent solicitation.
- ii. If a golden parachute payment has already been voted upon as part of a “say-on-pay” vote, no such vote is necessary as part of a merger or similar transaction.
- iii. *Disclosure of Aspects of Golden Parachute:*
  - a. Soliciting persons will be required to disclose in the proxy statement or consent solicitation (1) any type of compensation (whether present, deferred or contingent) based on or related to the transaction, (2) the aggregate amount of such compensation, and (3) the conditions upon which the compensation may be paid.
  - b. It is possible that the SEC rules for this disclosure could take an approach similar to that required under Item 402(j) of Regulation S-K, but as of a recent date (rather than the end of the year) and also require tabular presentation.
- iv. *Smaller Reporting Companies Exemption:*
  - a. The Act authorizes the SEC to create an exemption from “golden parachute say-on-pay” votes for smaller reporting companies, if it determines that the implementation of the vote would be too burdensome on such companies.
  - b. However, all soliciting persons, regardless of size, will be required to disclose the details of golden parachute payments.
- v. *Effectiveness:*
  - a. The golden parachute disclosure and related “golden parachute say-on-pay” vote must be included in any proxy statement or consent solicitation in connection with a merger, acquisition or

similar transaction subject to a shareholder vote occurring after January 21, 2011.

- b. No further action is required by the SEC to put this requirement into effect, though the SEC will be issuing rules to instruct on proper compliance.

vi. *SEC Timetable:*

- a. The SEC plans to issue proposed rules regarding the “golden parachute say-on-pay” shareholder votes between October and December 2010.

vii. **Questions Remaining.** The Act has provided most of the pertinent details related to the “golden parachute say-on-pay” vote and golden parachute disclosure, though at least a few questions remain as to de minimis payments and determination of the shareholder vote.

- a. The Act does not articulate whether disclosure and a shareholder vote are necessary for de minimis executive retention awards and continuity agreements related to a merger or similar transaction. According to a strict reading of Section 951 of the Act, all compensation paid to named executive officers as a result of a merger or similar transaction must be disclosed; however, de minimis payments related to executives continuing in their current positions after a merger may not be applicable.

- b. The Act is silent as to how the “golden parachute say-on-pay” vote is to be determined. Will it be decided by a plurality of shares or by the affirmative vote of a majority of the outstanding shares?

- c. It remains to be seen how the rules regarding disclosure of golden parachute payments promulgated under new Section 14A will differ from Item 402(j) of Regulation S-K, which also requires disclosure of payments to named executive officers upon changes of control, other than as to timing of the disclosure (current golden parachute package as compared to that in place as of the end of the fiscal year).

viii. **Pros.** “Golden parachute say-on-pay” votes will likely occur infrequently, which should lessen any negative effects it could have on companies and their decisions regarding golden parachute payments.

- a. Because golden parachute payments are part of the executive compensation package, they will be voted upon as part of the first “say-on-pay” vote covering general executive compensation, which will take place during the 2011 proxy season. Therefore, future “golden parachute say-on-pay” votes, unlike “say-on-pay”

votes which must occur on a regular basis, likely will only occur for named executive officers that are appointed after the 2011 proxy season or if new compensation packages are put into effect for existing named executive officers.

- ix. **Cons.** The inclusion of “golden parachute say-on-pay” votes in proxies, according to current SEC rules, would lengthen the timing of the proxy process.
  - a. As it is currently written, Rule 14a-6 of the Exchange Act requires any proxy statement containing a “say-on-pay” proposal to be filed in preliminary form with the SEC at least 10 calendar days prior to the mailing of the definitive proxy. This would add almost two weeks to the proxy process timeline for proxy statements that include “golden parachute say-on-pay” proposals.
- x. **Practice Points.** Management should consider change-of-control payments in advance of a transaction, especially because, under certain circumstances, both the acquirer and the target would be required to include “golden parachute say-on-pay” votes in their proxy statements or consent solicitations to their respective shareholders.
  - a. Companies should consider establishing change-of-control compensation arrangements in advance of entering into a merger or similar transaction. By doing so, the golden parachute arrangements will be viewed by shareholders as part of the entire compensation package in a “say-on-pay” vote, as opposed to being voted on separately as part of a proxy statement or consent solicitation related to a change-of-control transaction.
  - b. In that the “golden parachute say-on-pay” requirements apply to all soliciting persons in a transaction, the golden parachute payments to be paid to the executives of the target company will be subject to a vote by the shareholders of both the acquirer and target companies for certain transactions.

D. **Disclosure of Institutional Investment Managers’ Voting Records on Executive Compensation Matters**

- i. Section 951 of the Act adds a new Section 14A to the Exchange Act that provides that institutional investment managers that exercise investment discretion over \$100 million or more and that are subject to Section 13(f) of the Exchange Act must disclose how they voted on “say-on-pay,” “say-when-on-pay” and “golden parachute say-on-pay” proposals on an annual basis.
- ii. *Effectiveness:*

- a. Institutional advisors must disclose how they voted with respect to any “golden parachute say-on-pay” vote occurring after January 21, 2011 in connection with a merger or similar transaction.
- iii. *SEC Timetable:*
  - a. The SEC plans to issue proposed rules related to these disclosures by institutional investment managers between October and December 2010.
- iv. **Questions Remaining.** The Act does not provide much detail with respect to this disclosure requirement by institutional investment managers, and therefore large practical questions regarding this disclosure remain.
  - a. Section 951 of the Act is silent as to how institutional investment managers should disclose how they voted on the proposals related to executive compensation, as well as the format that the investment managers should employ to make this disclosure. In addition, while the Act notes that the disclosure should be made on an annual basis, it does not specify any time or period during which to make the disclosure.
- v. **Pros.** By requiring disclosure by institutional investment managers of their voting records on shareholder votes on executive compensation, the Act is providing information to individual investors that would have otherwise been inaccessible.
  - a. On account of the voting disclosures by institutional investment managers, individual investors will have a more meaningful understanding of shareholder votes related to compensation matters. Individual investors that are usually not able to communicate with large holders can get a better sense if certain investment managers are influencing compensation-related shareholder votes.
- vi. **Cons.** The required disclosures by institutional investment managers could, among other things, result in these managers being targeted by various outside interests, such as proxy voting firms and activist investors, looking to influence companies.
  - a. The disclosure by institutional investment managers of their voting records in regards to executive compensation may make it more difficult for companies to engage in meaningful dialogue with institutional investors when proxy voting firms have recommended against these executive compensation proposals. Institutional investors may not want to publicly contradict proxy voting firms

and thus will vote along the lines of the firms' recommendations, without speaking with the company.

E. **Limitations on Broker Discretionary Voting**

- i. Section 957 of the Act amends Section 6(b) of the Exchange Act to require exchanges to prohibit brokers from granting a proxy to vote securities to elect a director to the board or to determine executive compensation or "other significant matters," including "say-on-pay" and "golden parachute say-on-pay" votes, unless the beneficial owner of the securities has instructed the broker how to vote with regards to each of the above.
- ii. This requirement codifies and expands upon NYSE Rule 452, which was approved by the SEC in July 2009. Under the current NYSE rule, brokers are prohibited from discretionary voting on "non-routine" matters, such as contested director elections, but are permitted to vote in their discretion on "routine" matters, such as certain executive compensation proposals.
- iii. *Exception:*
  - a. This limitation on brokers voting shares without the instruction of the beneficial owner of the shares does not apply to an uncontested board election for an investment company registered under the Investment Company Act of 1940.
- iv. *Effectiveness:*
  - a. The Act does not set a deadline for exchanges to put this rule into effect, which could be understood as an immediate obligation on the part of the exchanges.
- v. *SEC Timetable:*
  - a. The SEC plans to issue proposed rules that define "other significant matters" between April and July 2011.
- vi. **Pros.** For institutional investors, the increase in limitations on broker discretionary voting represents an opportunity to exert further control over companies in light of brokers not being able to vote all of the shares that they hold. In turn, retail investors could ultimately become more engaged in shareholder votes, as brokers will more actively court them in order to obtain their voting instructions.
  - a. Institutional investor votes will become more significant because brokers will not be able to vote their shares on board elections, executive compensation proposals and other significant matters without direction from retail investors.

- b. If brokers are limited in their ability to vote the shares they hold on behalf of retail investors, those retail investors may become more involved in the voting of their shares held by brokers because brokers will insist that retail investors provide voting instructions for the shares so that those shares can be voted.
- vii. **Cons.** Until brokers succeed, if at all, in obtaining voting instructions from a significant amount of retail investors whose shares they hold, institutional investors will have a disproportionate amount of power in significant shareholder votes. Generally, for companies, it is more advantageous to have voting power in the hands of management-friendly brokers, as opposed to in the hands of institutional investors who often have interests at odds with those of company management.
  - a. With the Act placing limitations on the voting of brokers, retail investors (who generally own shares through brokers) could become disenfranchised. Retail investors are passive and, by and large, do not provide voting instructions for shares to their brokers. If this situation continues, brokers will be prevented from voting those shares on executive compensation and other significant matters. This, in turn, will shift further influence to institutional investors who are more focused on the short-term profits of the company as compared to retail investors and brokers, who both consider the long-term value of the company and are also more likely to follow board recommendations for shareholder votes. Approximately 18% of S&P 500 companies' stock is held in "street name" by retail holders.
  - b. For companies whose directors are elected by a majority of the outstanding company shares, the disenfranchisement of a significant number of outstanding shares held by retail investors could make the vote for the election of directors more of a challenge than in previous elections.
- viii. **Practice Points.** Companies should prepare themselves for shareholder votes on director nominees and executive compensation that will not have significant broker participation.
  - a. Broker votes can account for 10-20% of the total shareholder vote. Companies should consider possible outcomes of director elections and compensation-related votes, such as "say-on-pay," without the typically board-friendly broker vote.

### III. LEGISLATION INTENDED TO SCRUTINIZE AND POSSIBLY LIMIT EXECUTIVE COMPENSATION

#### A. Executive Compensation and Financial Performance

- i. Section 953 of the Act adds a new Section 14(i) to the Exchange Act that directs the SEC to enact rules that provide that annual proxy statements will be required to include information that “shows the relationship between executive compensation actually paid and the company’s financial performance.” The presentation should “tak[e] into account any change in the value of the shares of stock and dividends of the issuer and any distributions.”
- ii. *Application:*
  - a. The disclosure of the relationship between executive compensation and the financial performance of the company applies to all named executive officers and compensation that is required to be disclosed pursuant to Item 402 of Regulation S-K.
- iii. *SEC Timetable:*
  - a. The SEC plans to issue proposed rules directing the requirements for this disclosure between April and July 2011.
- iv. **Questions Remaining.** The Act is silent as to many of the details related to the disclosure for companies under this requirement, which leaves companies waiting for the SEC to provide guidance as to their obligations.
  - a. The SEC will have to identify the metrics that companies should employ in presenting the relationship between executive compensation and the financial performance of the company.
  - b. Item 201(e) of Regulation S-K requires a stock price performance graph to be included in companies’ annual reports to shareholders. The SEC will have to clarify whether this new disclosure requirement will be able to be incorporated into the existing rule or whether a separate graphical or narrative presentation of the link between executive compensation and financial performance is necessary.
- v. **Pros.** Though the Act does not provide many details related to this disclosure, the concept alone could prove valuable to shareholders by giving them another tool to evaluate executive compensation.
  - a. The disclosure of the relationship between executive compensation and the financial performance of the company could assist shareholders in understanding if executives were accurately compensated for their contributions to the company, as illustrated by the overall financial performance of the company.

- vi. **Cons.** While this disclosure may become valuable to shareholders, it could also prove to be less than advantageous to companies by oversimplifying matters.
  - a. An attempt to provide a simple graphical or narrative presentation of the connection between executive compensation and the financial performance of companies could skew shareholder perception. Through this disclosure, shareholders will evaluate executive compensation in a single year vacuum, as opposed to multi-year picture of executive compensation in the context of the long-term performance and growth of companies.
- vii. **Practice Points.** Company management will need to re-evaluate this disclosure after the SEC releases its rules setting forth the requirements of the disclosure. However, in the meantime, management can examine and assess methods that best present executive compensation to shareholders.
  - a. Management should review compensation programs and consider supplementing the company's proxy statement with additional disclosures or explanations, especially in sections such as Compensation Discussion and Analysis, in order to effectively communicate the company's compensation philosophy and rationale to shareholders. This could have the effect of deemphasizing the disclosure of the relationship between executive compensation and the financial performance of the company, and placing greater emphasis on the decision-making behind the company's executive compensation decisions.

**B. CEO Internal Pay Ratio**

- i. Section 953 of the Act directs the SEC to amend Item 402 of Regulation S-K to require Companies to disclose (1) the median of the total annual compensation of all employees other than the CEO, (2) the total annual compensation of the CEO, and (3) the ratio of (1) to (2).
- ii. The total annual compensation to be included in this disclosure is to be calculated in accordance with Item 402(c) of Regulation S-K.
- iii. *SEC Timetable:*
  - a. The SEC plans to issue proposed rules regarding the disclosure of the CEO internal pay ratio between April and July 2011.
- iv. **Questions Remaining.** The Act provides no details as to how to calculate the total annual compensation for all employees of a company, which will present questions that go beyond the scope of Item 402 of Regulation S-K, which relates to total annual compensation for named executive officers.

- a. The Act is silent as to how to realistically calculate the total annual compensation for all employees other than the CEO. This undertaking is further complicated by attempting to determine the appropriate treatment of foreign and part-time employees and employees on leave, as well as the status of pension and other benefits.
- v. **Pros.** This disclosure represents an attempt to provide shareholders with another tool to assess CEO-specific compensation, in addition to the other tools provided by the Act to evaluate executive compensation.
  - a. The disclosure of the CEO internal pay ratio may put CEO compensation in greater perspective for shareholders and allow them to better evaluate the compensation of the CEO.
- vi. **Cons.** As noted above, the CEO internal pay ratio disclosure could prove to be a burden to calculate for all companies. In addition, the importance of the ratio may be questionable.
  - a. As drafted, this disclosure is a particularly burdensome requirement and it may be difficult for affected companies to calculate the total annual compensation for all of their employees.
  - b. Similar to the disclosure of executive compensation as compared to financial performance of the company, the CEO internal pay ratio may yield a figure that does not contain great value to shareholders. In addition, it may inaccurately shift the focus of shareholders from the long-term performance and growth of the company to evaluating the CEO and CEO's compensation in a vacuum consisting only of the prior year.
  - c. As currently contemplated by the Act, this disclosure would be required to be disclosed in all statements and reports subject to Regulation S-K, including proxy statements, registration statements and annual, quarterly and current reports.
- vii. **Practice Points.** Companies should wait until the SEC issues its rules related to this disclosure due to the ambiguity found in the Act itself.

C. **Clawbacks**

- i. Section 954 of the Act adds a new Section 10D to the Exchange Act that requires the SEC to direct the exchanges to prohibit the listing of companies that do not adopt policies that recapture executive compensation in certain circumstances. Such policies will provide that (1) listed companies must disclose their policies concerning incentive-based compensation that is based on publicly reported financial information, and (2) incentive-based compensation paid to any present or former executive

officer of the company will be recaptured (“clawback”) if such incentive-based compensation is determined to be in excess of the accurately calculated compensation of the company after a restatement of the company’s financial statements due to material non-compliance by the public company.

- ii. The clawback policies to be adopted by companies under Section 10D are to be “no-fault” on the part of the executive. The clawback of compensation does not require any executive misconduct, only material non-compliance by the company in its reporting of its financial statements.
- iii. The clawback of incentive-based compensation applies only to the excess amount of incentive-based compensation paid to executives based on the previously reported financial statements, as compared to the amount that should have been awarded based on the restated financials.
- iv. The clawback of compensation can be applied to any incentive-based compensation awarded to present and former executive in the previous three years from the date on which the company is required to restate its financials.
- v. The clawback of incentive-based compensation pertains to all executive officers, not just named executive officers.
- vi. There are no exemptions from clawbacks of executive compensation for smaller issuers, foreign private issuers or controlled companies.
- vii. The new rule as contemplated by the Act expands upon the clawback provision in the Sarbanes-Oxley Act, which is applicable only (i) to incentive-based compensation of the CEO and the CFO, (ii) on compensation from the 12 month period prior to the restatement of the financial statements, and (iii) if restatement of financials was on account of misconduct.
- viii. *SEC Timetable:*
  - a. The SEC plans to issue proposed rules related to the clawback provision between April and July 2011.
- ix. **Questions Remaining:** The clawback provision contemplated by the Act is significant but it leaves open questions as to the application of a clawback to certain types of incentive-based compensation, as well as possibilities of enforcement against former executives.
  - a. The Act does not provide details as to any methods of enforcement against the executives, especially former executives that are no longer with the company, for whom pay cannot be withheld.

- b. It is not clear whether the clawback can be applied to recapture discretionary incentive-based payments or other forms of incentive-based compensation that are not calculated from a specific formula, and therefore may not easily be differentiated from a payment determined after the company has restated its financials.
  - c. The Act is silent as to whether the clawback policies are applicable only for awards paid based on achievement of certain levels of financial goals by the company, or whether a clawback could also apply to all forms of equity awards, such as stock options. It should be noted that institutional investors generally do not consider options and other time-vested awards to be incentive compensation.
- x. **Pros.** The clawback provision of the Act, which likely will be unpopular with executives, provides shareholders with a method under which executives will not unfairly profit from the mistakes made in their companies' financial statements. In addition, such clawback provisions are already in place for some companies.
- a. The clawback provision benefits shareholders in that they are not further penalized for non-compliance with financial reporting requirements by companies. Often when companies restate their financials, the shareholders are those most affected by the decline in the stock price; however, with the clawback provision, shareholders are not further punished by companies paying incentive-based compensation in excess of the proper amounts, as some of these costs will be shifted to the executives that previously benefited.
  - b. Many large companies, such as Cisco, DuPont and Microsoft, have already voluntarily adopted similar measures, often at the request of activist investors. There are a variety of clawback policies in place at these companies that range from penalizing executives only if they have committed fraud against the company to recovering compensation if there was an error in the financial metrics that determined the executive compensation, even if the company did not have to restate its financials. The most common clawback policy by large companies is similar to that required by the Act, which requires a clawback upon a restatement of financials by the company.
- xi. **Cons.** Although the clawback provision of the Act may provide some comfort to shareholders, it could prove to have a negative ancillary effect on the relationship among companies, executives and shareholders.

- a. The clawback provision could discourage companies from paying incentive-based compensation to executives. Typically, incentive-based compensation efficiently aligns the interests of management with those interest of shareholders and effectively rewards executives for the superior performance of companies.
  - b. Most restatements of financial statements are due to accounting errors, not intentional non-compliance by companies, and hundreds of companies restate their financial statements on an annual basis. Clawback rules could dis-incentivize executives from restating their companies' financial statements, even just to correct for plain errors, because they know they could face personal monetary loss. If companies are discouraged from filing restated financials, shareholders will ultimately lose out on accurate publicly available financial information for their companies.
- xii. **Practice Points.** Companies should hesitate from making any drastic changes to their compensation packages with executives until the SEC issues its rules relating to the clawback provision, but it is also prudent for companies to understand that incentive-based compensation practices may be substantially altered.
- a. Companies should include clauses in compensation arrangements notifying executives that these arrangements may be subject to clawbacks in the future pursuant to SEC rules. However, companies should avoid inserting mandatory clawback provisions in their compensation arrangements with executives prior to the SEC formally issuing the related rules.
  - b. On the other hand, companies should consider avoiding incentive-based compensation until the SEC issues formal rules related to the clawback provision.

D. **Hedging Disclosures**

- i. Section 955 of the Act adds a new Section 14(j) to the Exchange Act that directs the SEC to adopt rules that will require a company to disclose its policies concerning whether its directors and employees are permitted to purchase financial instruments designed to hedge decreases in the value of the company's securities that they hold, whether or not such securities are granted to the directors or employees as compensation or are directly or indirectly held by them.
- ii. Companies are currently required to disclose hedging policies concerning named executive officers in the CD&A section of proxy statements under Item 402 of Regulation S-K.
- iii. *SEC Timetable:*

- a. The SEC plans to issue proposed rules concerning the disclosure of the policy for the purchase by directors and employees of hedging instruments against decreases in company stock between April and July 2011.
- iv. **Question Remaining.** The Act does not address the fact that a company is already required to disclose its policy concerning hedging instruments held by named executive officers.
  - a. It remains to be seen whether the SEC will expand the scope of the hedging instrument disclosure to include those policies affecting directors, employees and other executive officers under Item 402 of Regulation S-K or whether the SEC will create a new disclosure obligation to address the requirements set forth by the Act.
- v. **Practice Points.** Company management should turn its attention to refining or establishing, as the case may be, its policies regarding the purchase by its directors and employees of hedging instruments against decreases in the value of company shares.
  - a. Companies should review or consider adopting a formal policy addressing whether their directors and employees can hedge against the loss in value of the company shares that they hold.
  - b. Companies should also review existing trading and compliance policies and programs to determine any necessary modifications in order to ensure the proper identification of hedging transactions, so that the hedging policies can be properly implemented.
  - c. The Act does not eliminate the option of a company having policies regarding hedging instruments that are different for employees and officers and directors. However, management should wait to see whether the SEC elects to prohibit such multi-dimensional policies.

E. **Compensation Committee Independence**

- i. Section 952 of the Act creates a new Section 10C of the Exchange Act that directs exchanges to adopt listing standards that require listed companies to have independent members of their compensation committees. Each stock exchange will have the discretionary authority to exempt companies from the independence requirements for compensation committee.
- ii. While the New York Stock Exchange and NASDAQ currently require compensation committees of listed companies to be solely comprised of independent directors, the Act now requires the SEC to direct all exchanges to have independence requirements for the compensation committees of their listed companies.

- iii. *Effectiveness:*
  - a. The Act requires that, by July 16, 2011, the SEC adopt rules that prohibit the exchanges from listing securities of companies not in compliance with compensation committee independence standards.
- iv. In order to formulate its listing standards regarding the independent status of compensation committee members, the exchanges should consider the following:
  - a. The advisory and consultant fees paid to the director by the company, as well as the other sources of the director's total compensation. Portfolio companies of private equity firms will likely be the most affected by this consideration due to the generally substantial advisory fees paid by the company to the principals or other employees of the private equity firm that sit on the company's board.
  - b. The affiliate status of the director to the company or any subsidiaries of the company.
- v. *Exemptions:*
  - a. Controlled companies, limited partnerships, companies in bankruptcy, registered open-ended investment management companies and certain foreign private issuers do not require an independent compensation committee.
- vi. *Compensation consultants and other consultants, advisors and legal counsel.*
  - a. New Section 10C of the Exchange Act also gives the compensation committee the authority over and responsibilities concerning the retention of compensation consultants and other advisors, consultants and legal counsel.
  - b. The compensation committee may, at its discretion, retain or obtain the advice of compensation consultants and other independent consultants, advisors and legal counsel. If it does so, the compensation committee must have the authority to engage, appoint and be responsible for the compensation and oversight of the independent consultants, legal counsel and other advisors.
  - c. The compensation committee may, but will not be required to, consider the independence of the consultants, advisors and legal

counsel prior to engaging them. The independence factors are to be established by the SEC.

- d. However, the company must disclose the factors considered by the compensation committee related to the independence of the consultants, advisors and legal counsel prior to engaging them.
- e. The SEC, in formulating its factors concerning the independence of outside consultants, advisors and counsel, should consider: (i) the provision of other services by the advisor to the company, (ii) the fees paid to the advisor compared to the total revenue of the advisor, (iii) the conflict of interest policies and procedures of the company, (iv) the business or personal relationships between the advisor and the compensation committee members, and (v) if any company stock is owned by the advisor.
- f. Specifically for compensation consultants, companies, in proxy statements for annual meetings occurring on or after July 22, 2011, must disclose (i) whether the compensation committee has retained or obtained the advice of compensation consultants, (ii) whether the work of such compensation consultants has raised any conflicts of interest and (iii) how such conflicts have been or are being addressed .

vii. *SEC Timetable:*

- a. The SEC plans to issue proposed rules concerning compensation committee independence and the independence factors for outside consultants, advisors and counsel between October and December 2010.

viii. **Questions Remaining.** The independence requirements for the compensation committee are largely similar to the requirements for an independent audit committee. However, questions remain regarding the factors for determining the independence of outside consultants, advisors and counsel.

- a. In the formulation of factors to determine the independence of outside consultants, advisors and legal counsel, it remains to be seen whether the SEC will establish set standards of independence or advise compensation committees to employ a facts-and-circumstances test.

ix. **Pros.** As compared to the standard practices for companies regarding compensation committees, the Act generally does not introduce any new substantive requirements for companies.

- a. The Act does not appear to require companies to have compensation committees. Rather, if a company has a compensation committee, the members of such committee must be independent.
- b. In addition, it is already near standard practice for compensation committees to be allocated funds by their companies, have sole control over these own funds and have the authority to engage their own advisors, so the Act's requirements will not present a significant change in corporate behavior for many companies.
- x. **Cons.** For companies with a small board, it may prove difficult to have both a compensation committee and an audit committee made up of only independent directors.
- xi. **Practice Points.** Even prior to the exchanges issuing rules setting forth the independence requirements for compensation committees, companies can take steps to ensure compliance with the new requirements.
  - a. Prior to the issuance by the exchanges of rules setting forth the guidelines for independent compensation committees, companies should review the independence of their compensation committee members using the same standards as those for audit committee members.
  - b. When the rules are issued by the exchanges, companies should revise their compensation committee charters and director questionnaires to account for the new independence standards.

#### IV. **LEGISLATION CONCERNING OTHER SIGNIFICANT RULES RELATED TO CORPORATE GOVERNANCE AND AREAS OF CONCERN FOR PUBLIC COMPANIES**

Most of the provisions in the Act that are of interest to public companies concern either measures to increase shareholder participation in companies or methods of limiting or scrutinizing executive compensation. However, the Act also contains a number of other significant provisions, such as increased incentives for whistleblowers and disqualifying bad actors from use of the private offering safe harbor under Regulation D, that could have a substantial impact on public companies.

##### A. **Whistleblower Rewards and Protections**

- i. *Rewards.*
  - a. Section 921 of the Act adds a new Section 21F to the Exchange Act which provides for enhanced incentives for corporate whistleblowers.

- b. The Act directs the SEC to pay a reward to whistleblowers who provide original, independently derived information to the SEC that leads to a successful enforcement action, which, in turn, results in a recovery of more than \$1 million.
  - c. The SEC will pay these whistleblowers a reward of between 10% to 30% of the monetary sanctions collected from or in connection with the related enforcement action. The SEC will determine the exact amount at its own discretion, factoring in, among other things, the significance of the provided information and the amount of whistleblower assistance.
  - d. The Act prohibits granting whistleblower rewards to, among others, employees of governmental and regulatory agencies, persons convicted of a crime related to the activities being reported and persons who obtained information through a required financial audit.
- ii. *Protections.*
- a. Section 21F to the Exchange Act also expands the protections available to whistleblowers.
  - b. The Act makes it illegal for whistleblowers to be discharged, demoted, suspended, threatened, harassed, or discriminated against by their employers.
  - c. Whistleblowers that have been subjected to retaliation by their companies may bring federal private rights of action against the companies. Remedies for the whistleblowers include (i) double back pay owed to the whistleblower with interest, (ii) reinstatement of the whistleblower with the same seniority status if there had been no retaliation, and (iii) compensation for attorney fees and other litigation-related costs.
- iii. *Expansion of the Time Frame in which to Bring a Civil Suit.*
- a. Whistleblowers may bring private rights of actions related to the claims of retaliation within three years of the discovery of the material facts or within six years of the date of the retaliation incident.
- iv. *SEC Timetable:*
- a. The SEC plans to issue proposed rules concerning whistleblower protections and rewards between October and December 2010.

- v. **Pros.** The increased rewards and protections for whistleblowers could prove beneficial by creating an environment where companies are more fearful of being caught committing fraud. Companies will then be less likely to engage in questionable practices that could jeopardize the long-term health of the company and, by extension, shareholder value.
  - a. The Act's whistleblower legislation could create greater oversight of SEC reporting companies and also ease the cost of enforcement for the SEC. By providing greater incentives and protections to whistleblowers, the SEC will be creating a scenario where both the number of whistleblowers and the possibility of whistleblowing will increase, which should further dis-incentivize companies from wrongdoing.
  - b. Whistleblowers are more effective than external auditors: whistleblower tips lead to the identification of 54.1% of uncovered acts of fraud in public companies, compared to external auditors who caught only 4.1% of such acts, in 2008.<sup>2</sup>
- vi. **Cons.** While encouraging whistleblowing may be beneficial to the SEC, it also could create an atmosphere that leads to unfounded claims being reported and companies being wrongfully accused and investigated.
  - a. The Act's robust financial rewards for whistleblowers could result in the rapid reporting of violations. This would preclude the opportunity for companies to do internal investigations or efficiently correct lapses in internal controls without first involving the SEC.
  - b. Similarly, by making whistleblowing lucrative, the Act could unintentionally provoke a proliferation of unfounded or tenuous claims of wrongdoing. Third parties are helping to make this worry become a reality by launching websites, e.g., [www.SECsnitch.com](http://www.SECsnitch.com), and targeting the general public through attorney advertisement for lawyers who represent whistleblowers.
  - c. Likewise, the Act may discourage employees from reporting incidents of wrongdoing to their superiors, which would result in the company internally addressing the problem. Instead, employees are more likely to immediately report the violation to the SEC, which will increase costs for and divert the attention of the company.

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<sup>2</sup> 2008 Report to the Nation on Occupational Fraud & Abuse, Association of Certified Fraud Examiners, available at <http://www.acfe.com/documents/2008-rttn.pdf>.

- d. The Act does not provide the SEC with sufficient discretion to award less than 10% of collected penalties to whistleblowers. Additionally, the whistleblower legislation diverts the attention of the SEC to award-giving, as opposed to enforcement.
- vii. **Practice Points.** Companies should take affirmative steps to prevent premature whistleblowing on the part of their employees.
  - a. A company can conduct refresher courses for employees to make them aware of the current complaint systems that the company employs in order to both avoid premature whistleblowing to the SEC and providing the company with an opportunity to correct the problem before an SEC investigation.

**B. Extending, Aiding and Abetting Liability**

- i. Section 929 of the Act adds a new Section 15 to the Securities Act which expands upon the SEC's enforcement authority under the Securities Act and the Exchange Act.
- ii. As to the Securities Act, for any action brought by the SEC under subsections (b) or (d) of Section 20 (relating to actions for injunction or criminal prosecution in district court and money penalties in civil court), any person that "knowingly or recklessly provides substantial assistance to another person" in a violation of a provision of or rule promulgated under the Securities Act "shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided."
- iii. As to the Exchange Act, the SEC can bring suit against an individual who "recklessly" aids and abets a violation of the Exchange Act, even if the individual is unaware of the wrongdoing.
- iv. *Recent Developments:*
  - a. On October 5, 2010, President Obama signed a bill that repealed SEC exemptions from the Freedom of Information Act ("FOIA") contained in the Act. The Act had previously permitted the SEC to refuse to disclose information it obtained while conducting surveillance, risk assessment or other oversight work.
  - b. With this new bill, only investigations involving financial institutions will be provided with protection under exemption 8 of FOIA.
- v. **Practice Points.** The inclusion of a standard of recklessness for aiding and abetting liability for violations of the Securities Act and the Exchange Act could be of particular import for companies.

- a. The SEC can sue senior officers, directors or other people directly or indirectly accountable for fraud, even if they are unaware of the fraudulent activity, so long as they acted recklessly. Companies should make all directors, officers and employees aware that knowledge is no longer a requirement for aiding and abetting liability for violations of the Securities Act and the Exchange Act.
- b. However, Companies should note that the Act did not create a private right of action against persons who knowingly or recklessly aid or abet violations of federal securities laws.

C. **Regulation D Offerings – Disqualifying Bad Actors**

- i. Section 926 of the Act requires the SEC to issue rules that will disqualify certain “bad actors” from the private offering safe harbor found in Rule 506 of Regulation D under the Securities Act.
- ii. *Bad Actors:*
  - a. The SEC is required to issue rules similar to those in Rule 262 of Regulation A of the Securities Act.
  - b. Rule 262 disqualifies offers or sales of securities by issuers; directors, officers, general partners and ten percent (10%) owners of issuers; and underwriters who have been convicted of certain offenses, enjoined by a court of certain securities-related misconduct concerning false filings or are subject to a suspension from or barred from association with a securities brokerage firm or investment advisor by the SEC or one of the exchanges.
  - c. The Act sets forth that the SEC rules on this matter should also disqualify the offering of a person that is subject to a final order by a state securities commission, banking or insurance authority, a federal banking agency, or the National Credit Union Administration that (i) bars such person from association with any entity regulated by such authority from engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities, or (ii) constitutes final order based on violation of law or regulation that prohibits fraudulent, manipulative or deceptive conduct.
  - d. The disqualification under the Act does not apply to offerings of a person subject to SEC cease and desist orders or suspensions.
- iii. *SEC Timetable:*
  - a. The SEC plans to issue proposed rules regarding these bad actors between October and December 2010.

iv. **Pros:**

- a. Historically, there has been very little regulatory scrutiny of Regulation D offerings because they are exempt from registration, so even promoters or broker-dealers with criminal records could use this private offering safe harbor. The proposed rules goes in the right direction of ensuring some standards of these private offerings, if only through the legitimacy of the offering party.

v. **Cons:**

- a. The proposed rule to be issued by the SEC inhibits the safe harbor aspect of Regulation D and, furthermore, prevents second chances for reformed wrongdoers.

D. **Changes in Beneficial Ownership Reporting in Section 13 and Section 16 of the Exchange Act**

- i. Section 929R of the Act amends Section 13(d) of the Exchange Act to authorize, but not require, the SEC to issue rules shortening the initial Schedule 13D filing deadline (the deadline is currently 10 days after acquisition of more than 5% of a registered equity).
- ii. Section 929R also amends Section 16 of the Exchange Act to authorize, but not require, the SEC to issue rules shortening the Form 3 filing deadline (the deadline is currently 10 days after becoming a director, officer or greater than 10% shareholder)
- iii. The Act also amends Section 13(d) of the Exchange Act to include beneficial ownership of security-based swaps, pending the SEC issuing a rule clarifying if a purchase or sale of a security-based swap constitutes beneficial ownership of the underlying security.
- iv. The Act also eliminates the obligations to send filed Schedule 13Ds to the issuer and to submit copies of the filed Schedule 13Ds and Forms 3, 4 and 5 to the pertinent exchange, pending further clarification from the SEC rule-making.

E. **Board Leadership Structure**

- i. Section 972 of the Act amends Section 14B of the Exchange Act to direct the SEC to adopt rules that require a company to disclose in its annual proxy statement the reasoning behind the company's decision to combine or separate the roles of CEO and chairman of the board.
- ii. *Effectiveness:*

- a. The SEC is supposed to adopt the related rules to this section of the Act within 180 days of enactment of the Act.

iii. **Questions Remaining:**

- a. This new requirement in the Act is seemingly identical to the disclosure rules in Item 407 of Regulation S-K that was adopted by the SEC on December 16, 2009 for the 2010 proxy season. Item 407 of Regulation S-K requires companies to explain the appropriateness of their leadership structure, including the separation or combination of the roles of CEO and chairman of the board. It is unclear whether any additional disclosures are necessary beyond what is already required under the existing disclosure rule.

iv. **Practice Points:**

- a. Companies should take no action on this issue until the SEC issues further guidance, if any.

F. **Non Large Accelerated Filers and Non-Accelerated Filers Do Not Have to Obtain Annual Audits of Internal Control Over Financial Reporting**

- i. Section 989G of the Act amends Section 404 of the Sarbanes-Oxley Act of 2002 (“SOX”) to exempt nonaccelerated filers from annual audits of the company’s internal control over financial reporting.
- ii. Section 404 of SOX requires company management and the external auditor of the company to report on the adequacy of the company’s internal control over financial reporting. This requirement has proven very costly to smaller reporting companies as there is a significant fixed cost involved in completing the assessment. The Act has created an exemption to ease the burden on smaller companies of disclosing assessments of their control over financial reporting.
- iii. The exemption applies to smaller public companies and larger companies whose only public securities are debt securities.
- iv. *Future Exemptions for Some Accelerated Filers:*
  - a. The Act directs the SEC to study and determine methods for easing the burden of compliance with Section 404 of SOX for companies with market capitalizations between \$75 million and \$250 million.

- v. **Pros.** By creating an exemption for smaller companies, the Act is recognizing that the federal regulatory regime for public companies often disproportionately burdens smaller reporting companies.
  - a. The exemption illustrates the recognition that the financial burden on affected companies far outweighs public benefit of audit of internal controls.

## V. CONCLUDING REMARKS

- A. The Act already has had an impact on public companies, and its effects will only be felt further as the SEC, as directed by the Act, will continue to issue rules that place additional requirements and limitations on companies and give additional rights to shareholders.
- B. Supporters of the Act may point to the additional disclosures and trumpet how shareholders will be further empowered with the new knowledge that they will have about the companies in which they own shares and how companies will be required to make enhanced disclosures regarding their executive compensation packages. While this may be accurate, some of the required disclosures present compensation figures in ways that can be easily misunderstood or misconstrued by shareholders, such as the CEO internal pay ratio, and there will also be significant costs borne by the companies alone to comply with these disclosures.
- C. Supporters of the Act may point to the clawback and whistleblower provisions and claim that executives should not benefit from the non-compliance of their companies and that companies should always be held accountable for their actions. While steps should be taken to insure companies' compliance with the law, the clawback provision could ultimately lead to companies attempting to hide the errors in their financial statements and the whistleblower provision could result in large numbers of false or exaggerated reports of corporate wrongdoing.
- D. Supporters of the Act may point to provisions intended to increase the participation and influence of shareholders in public companies. While it may be beneficial for shareholders to have some influence to accompany their ownership stake in a company, the provisions could leave much of the influence in the hands of funds and institutional investors and not in the hands of individual investors.
- E. The Act and its provisions are far from being settled. The SEC has yet to issue most of the rules enforcing the Act. The proxy access rules have been stayed pending resolution of litigation and the FOIA exemption for SEC investigations has already been seriously limited by other legislation.
- F. The Act, at best, is a mixed bag for corporate America, and it remains to be seen how Congress, the SEC and American corporations will react to it.

# Clients & Friends Memo

## An Analysis of the Dodd-Frank Act's Volcker Rule

October 15, 2010

On Friday, October 1, 2010, the federal "Financial Stability Oversight Council" ("FSOC" or "Council") convened for the first time.<sup>1</sup> The FSOC, created by Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act"), is comprised of the heads of the federal financial regulatory agencies and two presidential appointees, and is tasked with establishing recommendations regarding certain of the regulations that the financial regulatory agencies are required to adopt under the Dodd-Frank Act.<sup>2</sup> One of the purposes of this initial meeting was to approve the issuance of a Request for Public Input (the "Request") soliciting comment regarding certain definitions contained in, and the general content of, Section 619 of the Dodd-Frank Act, popularly known as the "Volcker Rule."<sup>3</sup> Public comments are due by November 5, 2010.<sup>4</sup>

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<sup>1</sup> Details on the composition of the FSOC can be found on the Council's website at <http://www.treas.gov/FSOC/>. The FSOC has also provided some detail on the recommendations that regulated entities may expect the Council to issue, and the time frames in which to expect them, in an "Integrated Roadmap," which you may find on the FSOC's website at the following address: <http://www.treas.gov/FSOC/docs/FSOC%20Integrated%20Roadmap%20-%20October%201.pdf>.

<sup>2</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203, 124 Stat. 1376 (2010) (H.R. 4173).

<sup>3</sup> Section 619 of the Dodd-Frank Act requires the Council to conduct a study and make recommendations to the financial regulatory agencies as to implementation of the prohibitions of the Volcker Rule. The study is required to be completed by January 2011, and a joint agency rulemaking implementing the Volcker Rule is due within nine months thereafter. See *Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds*, 75 Fed. Reg. 61758 (Oct. 6, 2010), available at [http://www.treas.gov/FSOC/docs/2010-25320\\_PI.pdf](http://www.treas.gov/FSOC/docs/2010-25320_PI.pdf). The Volcker Request is reprinted in its entirety at the end of this Memorandum.

<sup>4</sup> The FSOC also issued an Advanced Notice of Public Rulemaking calling for comment regarding the Council's standards for designating a "nonbank" firm as systemically significant under Section 113 of the Dodd-Frank Act. See *Advance Notice of Proposed Rulemaking Regarding Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 75 Fed. Reg. 61653 (Oct. 6, 2010), available at [http://www.treas.gov/FSOC/docs/2010-25321\\_PI.pdf](http://www.treas.gov/FSOC/docs/2010-25321_PI.pdf). A series of Cadwalader Memoranda analyzing various aspects of the Dodd-Frank Act is at the following address: [http://www.cadwalader.com/dodd\\_frank\\_act\\_memo.php](http://www.cadwalader.com/dodd_frank_act_memo.php).

For further detail regarding designation of nonbank firms as systemically significant, please refer to Cadwalader's memo on Title I of the Dodd-Frank Act, which you may find at the following address: [http://www.cadwalader.com/assets/client\\_friend/072010\\_DF4.pdf](http://www.cadwalader.com/assets/client_friend/072010_DF4.pdf).

The Dodd-Frank Act left much of the detail of the Volcker Rule prohibitions to be determined via regulation, and accordingly the Request solicits input regarding some of the most basic terms used in the Rule, such as the meaning of “proprietary trading.” In light of the open-ended scope of the Request, and given the complexity of the Rule and the potential disruptions that its implementation may cause, this Memorandum discusses the history, legal requirements, and very significant unresolved issues posed by the Volcker Rule.

### **Summary of the Volcker Rule**

The Volcker Rule (§ 619 of the Dodd-Frank Act), is one of the most controversial and sweeping provisions of the Act. The Rule eliminates a broad variety of securities powers (*i.e.*, fund investing and proprietary trading), some of which had been conferred on U.S. financial holding companies in 1999, others of which had been permissible since the inception of the Bank Holding Company Act in 1956 (the “**BHC Act**”), and some of which had been permissible even before that. The Volcker Rule draws no distinction between domestic and overseas activities of U.S. entities, notwithstanding prior U.S. policy (exemplified by Glass-Steagall and the International Banking Act) that generally authorized broader securities activities abroad; the Rule therefore places U.S. entities at a competitive disadvantage with their overseas competitors that may not be subject to the Rule’s prohibitions. The Rule not only impacts U.S. bank holding companies (“**BHCs**”) (including their broker-dealer and unregistered subsidiaries) and banks, but also foreign holding companies with either U.S. branches or U.S. bank subsidiaries, as well as nonbank bank or thrift holding companies (*e.g.*, GE Capital) – and all of their respective affiliates, wherever located.

With respect to non-U.S. activities, the Rule not only disadvantages many U.S. financial service companies, but also non-U.S. financial service companies that happen to have a U.S. banking presence, including a branch. As to non-U.S. financial companies, a significant number of issues may arise because the various exemptions in the Volcker Rule are generally specific to the U.S. markets; for example, an exemption is provided for trading in the securities issued by the U.S. government, but not in securities issued by other national governments; similarly, an exemption is provided for investments in small business investment companies registered with the SEC, but not for any similar vehicle that may exist outside of the United States.

### **Background of the Volcker Rule**

The policy underlying the Volcker Rule is that U.S. banks, U.S. nonbank banks, and foreign branches operating in the U.S. enjoy an implied subsidy by virtue of their bank status and deposit-taking authority and play a special role in maintaining the stability of the U.S. financial system, and should not use that subsidy to engage in, and should be sheltered from, proprietary trading and fund investing activities, both of which are deemed to be risky activities. Further, the theory goes, proprietary trading and private fund investing are considered to place a financial institution in

potential conflicts of interest because such proprietary transactions are, by their nature, self-interested and may conflict with certain advisory or agency functions in which a banking entity is acting on behalf of a customer.

Some commentators have suggested that the Rule is also designed to prevent a repeat of the recent financial crisis. However, there is little evidence that the conduct regulated by the Volcker Rule – proprietary trading and fund investing – were causes of the crisis. The policy behind the Rule was seemingly accepted by Congress at face-value; the Rule was adopted without any apparent evidence that proprietary trading or fund investing activities had posed any material risk to the U.S. or international financial system or had played any role in triggering the recent financial crisis. Likewise, the Rule was adopted with apparently little consideration of the costs to entities engaged in these activities or of its competitive impact, which may be considerable.

The Volcker Rule emerged with little warning and without any material public debate. It originated in January 2009, when the Group of Thirty issued a white paper, *Financial Reform: A Framework for Financial Stability*, containing 18 recommendations for changes in global financial regulation. The Group of Thirty, an influential international consultative group chaired by Paul Volcker (formerly the Chairman of the Board of Governors of the Federal Reserve System and the current chairman of the President's Economic Recovery Advisory Board), includes many former foreign central bankers or treasury executives. Recommendation 1 of the white paper calls for limits on proprietary securities trading and private fund investing activities by large banks, citing the risk of these activities on the stability of the international banking system, as well as the potential for conflicts of interest when a bank trades for its own account.

Yet, restrictions on proprietary trading and fund investing were neither considered in the House version of financial reform legislation (HR 4173) which passed the House in December 2009, nor in the original Senate version (referred to as “**the Chairman's Mark**”) circulated by Senate Banking Committee Chairman Dodd in the fall of 2009. After adoption of the Volcker Rule was endorsed by President Obama as part of the Administration reform plan in early 2010, the Rule was included in the April version of the Senate bill (S. 3217), but with little debate or legislative history to provide guidance as to its meaning or motivation. At this stage of the legislative proposal, the Volcker Rule applied only to banks, bank holding companies, and their subsidiaries, and some latitude was conferred on the banking agencies to determine its reach and exemptions. The Volcker Rule was not debated in the Senate and was largely unchanged when financial reform legislation passed the Senate in May 2010.

In the House-Senate conference process, a number of changes were made to the Volcker Rule. The language was relaxed somewhat to allow a small basket of fund investments, but the latitude conferred on the agencies to create further exemptions was narrowed. The Rule was expanded to capture “affiliates” of banks and bank holding companies, as well as affiliates of foreign entities that

operate a branch in the United States. In Congressional conference, provisions were included exempting certain proprietary trading by insurance companies, and adding a limited authority for banking entities to organize and sponsor funds in connection with pre-existing trust, advisory, or fiduciary services. Also added were broad mandates to the agencies to issue regulations barring “material conflicts of interest,” “high risk assets,” and “high risk trading strategies.” Again, in conference, little light was shed as to the Rule’s meaning or application. As a result, the final Volcker Rule contains sweeping prohibitions, with ambiguous carve-outs, and the material details were largely left for the FSOC and the banking agencies to resolve.

### ***What Entities are Subject to the Volcker Rule?***

The Rule applies primarily to “**banking entities**,” a term that is broadly defined to mean: (1) FDIC-insured depository institutions (*i.e.*, U.S. banks and thrifts, including nonbank banks, but excluding certain uninsured trust banks); (2) entities that control an FDIC-insured depository institution (including a BHC, a financial holding company, a savings & loan holding company, or a holding company of a nonbank bank), wherever located; (3) entities that are treated as if they are a BHC for purposes of the International Banking Act (including a foreign holding company of a non-U.S. bank with a U.S. branch office, or a foreign holding company that has a U.S. commercial lending subsidiary operating in the United States), wherever located; and (4) any affiliate of any of the foregoing, wherever located. Thus, non-U.S. entities that are “affiliated” (*i.e.*, under 25% common control) with a U.S. bank or with a non-U.S. bank that has a U.S. branch are subject to the Volcker Rule, and these foreign entities’ proprietary trading and fund investing activities are subject to the restrictions of the Rule.

The Volcker Rule does not directly restrict the trading and investing activities of systemically significant nonbank companies that are involuntarily subjected to Federal Reserve supervision under Section 113 of the Act. However, the Rule authorizes the Federal Reserve to adopt regulations imposing capital requirements and quantitative limits on these nonbank entities, which may make proprietary trading or fund investing by these entities prohibitive as well.<sup>5</sup>

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<sup>5</sup> The Request specifically solicits input regarding the extraterritorial application of the Volcker Rule, including its impact on affiliates of U.S. entities operating abroad.

***What Activities of Banking Entities are Regulated by the Volcker Rule?***

The Rule has five principal elements applicable to banking entities:

- A ban on proprietary trading, subject to certain limited exceptions;
- A ban on investing in hedge funds or private equity funds or sponsoring such funds, subject to certain limited exceptions;
- Imposition of additional capital requirements and quantitative limits on entities engaged in proprietary trading or fund investing;
- Restrictions on certain transactions between an entity that serves as an organizer, sponsor, investment advisor, or investment manager of a private equity fund or hedge fund (or any affiliate of such entity) and the fund itself; and
- Prohibitions on any proprietary trading or fund investing that will result in a “material conflict of interest” or “high risk.”

***The Ban on Proprietary Trading***

The Volcker Rule prohibits a banking entity from engaging in “proprietary trading.” “**Proprietary trading**” is defined as

engaging as a principal for the trading account of the banking entity ... in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, option, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the [SEC] and the [CFTC] may, by rule ... determine.

As indicated above, “proprietary trading” requires that the activity occur with respect to a “trading account” of a banking entity. “**Trading account**” is defined as

any account used for acquiring or taking positions in the securities and instruments [listed above] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts that the appropriate Federal banking agencies, the [SEC] , and the [CFTC] may ... determine.

The language suggests that *motives* of the banking entity when *initially* acquiring the security or instrument are highly relevant in determining whether impermissible proprietary trading is occurring. For example, if the banking entity originally acquired the security or instrument with the intent to hold it and without the principal purpose of selling the instrument in the near term, but later decides to dispose of the security, the trading is arguably not prohibited by the Rule. Likewise, given that the required intent must be to sell in “**the near term**,” banking entities may not be subject to the

ban when holding a security or instrument for longer than some specified period of time, e.g., 30 days, that is beyond “the near term.” Similarly, it may be the case that the occasional trade in an account not principally used for trading activities would not be considered “proprietary trading” within the meaning of the Act, since such trading is not within a “trading account.” These questions were left for the FSOC and the various agencies to address.

This ban on proprietary trading reflects a significant rollback in the authority of banks, BHCs and their affiliates, including some longstanding authority. Following the enactment of the Gramm-Leach-Bliley Act (“GLBA”) in 1999, bank holding companies were expressly authorized to engage in largely unrestricted securities activities, provided the bank holding company satisfied the eligibility requirements of being a “financial holding company.” Prior to 1999, banks and BHCs had the authority to engage in proprietary trading, provided that the form of security was a permissible investment for the bank or holding company. For example, national banks were free to engage in proprietary trading in the “bank eligible securities” authorized by Section 24 (Seventh) of Title 12 (including U.S. government, agency, and GSE securities; securities issued by certain foreign governments or international development banks; state, state agency or state subdivision securities; highly rated marketable debt securities; and asset backed securities). BHCs were free to engage in proprietary trading in any form of debt or equity security under Section 4(c)(6) of the Bank Holding Company Act, provided only that the bank holding company did not acquire 5% or more of a voting class of any issuer, and could engage in proprietary trading of “bank eligible securities” as well. Overseas entities that had U.S. branches in general had no U.S. restrictions on offshore proprietary trading activities. Many of these longstanding powers are eliminated or curtailed by the Volcker Rule.

### ***Exemptions from the Ban on Proprietary Trading***

The Volcker Rule contains a few express exemptions to its general ban:

(1) ***Transactions involving only a subset of “bank-eligible securities,” limited to:***

- *U.S. Treasuries or U.S. Agency obligations;*
- *Obligations issued by Fannie, Freddie, Ginnie, FHLB, GNMA, FNMA, Farmer Mac, or a Farm Credit Bank; and*
- *Obligations of any State or political subdivision.*

The subset does *not* include securities issued by a *foreign* government. Thus, an overseas branch of a U.S. bank would be permitted to engage in proprietary trading of U.S. Treasury securities but would not be permitted to engage in proprietary trading in the governmental securities of its host country. Likewise, a non-U.S. financial services company with a U.S. bank affiliate or affiliated U.S. branch could not rely on this exemption to trade in its home

country's government securities (although it might be able to rely on a separate exemption under Sections 4(c)(9) and 4(c)(13), discussed *infra*). This subset of bank eligible securities does not include other types of securities in which a national bank may invest, such as highly rated marketable debt securities or asset backed securities, and the Volcker Rule makes it clear that its provisions are designed to supersede existing law. Thus, while a national bank may *invest* in debt securities or asset backed securities, it may not engage in *proprietary trading* in such securities. The subset also does not include any exception comparable to Section 4(c)(6) of the BHC Act, which authorizes a BHC to hold almost any form of debt or equity shares provided the BHC does not thereby hold 5% or more of a voting class of the shares; again, this means that while a bank holding company (or its affiliate) *may invest* in such shares, it *may not engage in proprietary trading* in such securities.

**(2) *Transactions in connection with underwriting or market-making-related activities***  
*"to the extent that any such activities ... are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties"*

This provision, originally embedded within the Rule's definition of "proprietary trading" but later modified as a freestanding exception to the ban, remains one of the most discussed aspects of the Rule. While in concept the drafters intended to exclude market-making activity from the ban, it is unclear what amount of trading activity in any one security is necessary to rise to the level of permissible "market-making" for clients. Two U.S. Senators instrumental in the passage of the Volcker Rule, Senators Jeff Merkley (D-Ore.) and Carl Levin (D-Mich.), explained their view of (and rationale for) permissible "market-making" in an August 3<sup>rd</sup> letter to the banking agency heads as follows:

*Done properly, market-making is not a speculative enterprise, and firms' revenues should largely arise from bid-ask spreads and associated fees, rather than from changes in the prices of the financial instruments being traded. Regulations seeking to distinguish market-making from proprietary trading activities will require routine data from banks on the volume of trading being conducted, the size of the accumulated positions, the length of time positions remain open, average bid-ask spreads, and the volatility of profits and losses, among other information.<sup>6</sup>*

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<sup>6</sup> Letter from Senators Jeff Merkley and Carl Levin to Ben Bernanke, Chairman of the Federal Reserve Board et al. (August 3, 2010).

Notwithstanding the various criteria recommended by Senators Merkley and Levin, it seems the banking agencies will undoubtedly face challenges in drafting clear, industry-useful regulations that draw a bright line between impermissible “proprietary trading” and permissible “market-making.”

(3) ***“Risk-mitigating hedging activities in connection with and related to individual or aggregate positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings”***

This exemption once again underscores that the Volcker Rule focuses on the *intent* of the banking entity when acquiring the security. Acquisitions and sales of securities made with the *intent* of mitigating existing position risk to the banking entity is permissible, while acquisitions and sales of securities with the *intent* of making a profit (in the near term) is impermissible. In other words, a banking entity is free to buy and sell securities and instruments if the intent is to mitigate risk (*i.e.*, to prevent a potential loss) resulting from an existing position, although the banking entity is not permitted to trade the exact same securities and instruments if the intent is to achieve a profit.

(4) ***Transactions “on behalf of customers”***

This exemption was narrowed in the conference process. The original language, embedded within the definition of “proprietary trading,” effectively excluded transactions “on behalf of a customer ... *or otherwise in connection with or in facilitation of customer relationships.*” The latter clause was dropped in conference due to the belief that the language created a loophole in the Rule. The remaining language – “on behalf of customers” – was retained, although it remains unclear how broad this exemption is, for example, whether it permits only customer-directed trades or brokerage transactions, or whether some lesser connection with the customer is within the scope of the provision.

(5) ***Investments in SBICs, public welfare investments, or investments in qualified rehabilitation or certified historic structure projects***

This exception to the ban on proprietary trading is likely to have limited application, inasmuch as these instruments are rarely actively traded. Regardless, the language of this provision (*i.e.*, its use of the word “investments”) suggests that it was intended more as an exemption from the fund investment restrictions than as an exemption from the trading restrictions.

***(6) Transactions by a regulated insurance company (and its affiliates) for its general account, if such transactions are conducted in compliance with state insurance laws and the Federal banking agencies and the insurance commissioners have not determined that such laws are insufficient to protect the safety and soundness of the banking entity or the financial stability of the U.S.***

This exemption was added in recognition that a few banking entities may have affiliated insurance companies that are subject to state supervision and that maintain securities positions in its “general account” – *i.e.*, the portfolio of assets that is available to pay claims and benefits to which insureds or policyholders are entitled. The exemption merely reflects that this portfolio may involve trading activity that meets the definition of “proprietary trading,” and that it was not the intent of Congress to prohibit such trading activity if it is otherwise satisfactorily regulated by state insurance law to the extent that such trading is necessary to conduct the ordinary business of insurance.

***(7) Transactions in connection with the sale or securitization of loans***

This exception was also added in conference due to concerns that a strict application of the Volcker Rule (in particular, the restriction in private fund investments) could be construed to impede traditional securitization structures used by banks and BHCs.

***(8) Trading by a banking entity under the exemption of Section 4(c)(9) of the BHC Act, provided that the proprietary trading occurs solely outside the U.S. and provided further that the banking entity is not directly or indirectly controlled by a banking entity organized under U.S. Federal law or the law of any State.***

BHC Act Section 4(c)(9) applies to qualifying foreign banking organizations (“QFBOs”) – foreign entities engaged primarily in banking activities outside the United States and engaged in the United States only in activities incidental to its foreign activities. Under Section 4(c)(9), a QFBO may invest in a company not doing any business in the United States (other than activities incidental to its foreign activities), and may hold a noncontrolling (<50%) investment in a company doing business in the United States provided the company predominantly does business outside the United States. The Volcker Rule exempts a QFBO’s proprietary trading activities from the ban, provided the trading “occurs solely outside the United States.” While it is not clear exactly how this applies to a QFBO, it seems likely that the agencies will require that both the entity engaged in proprietary trading and the entity whose shares are the subject of the trade must be located outside the United States – thus requiring a QFBO to know the geographic footprint of a target company before acquiring *any* shares for proprietary trading purposes.

*(9) Trading by a banking entity under the exemption of Section 4(c)(13) of the BHC Act, provided that the proprietary trading occurs solely outside the U.S. and provided further that the banking entity is not directly or indirectly controlled by a banking entity organized under U.S. Federal law or the laws of any State*

Section 4(c)(13) generally authorizes a registered BHC to invest in a company not doing any business in the United States (other than activities incidental to its foreign activities). Inasmuch as Section 4(c)(13) permits investments solely in entities not doing any business in the United States, this exemption would require the trading entity to know the geographic footprint of a target company before acquiring any shares for proprietary trading purposes. It is unclear what is meant by the requirement that the proprietary trading occur “solely outside,” but arguably the intent is that the trading entity also be situated overseas. While Section 4(c)(13) ordinarily is available to U.S. BHCs, the Volcker Rule limits this exemption to banking entities “not directly or indirectly controlled by a banking entity organized under U.S. Federal law or the laws of any State.” Thus, this exemption is applicable only to the overseas proprietary trading by subsidiaries of a top-tier company organized under non-U.S. law.

*(10) Other activity determined by regulation issued by the Federal banking agencies, the SEC, and the CFTC, that would “promote and protect the safety and soundness of the banking entity and the financial stability of” the U.S.*

While this provision on its face grants latitude to the agencies to create further exceptions to the Volcker Rule, it seems unlikely that the agencies will use this clause to grant new, wholesale exemptions. Rather, the agencies will likely use this provision to eliminate some of the unintended consequences of a literal application of the statutory language or to soften the overseas impact of the Volcker Rule. That said, the Volcker Rule is drafted in a very U.S.-centric way. By its terms, the Rule's prohibitions apply to non-U.S. banks; yet the Rule allows the agencies to create other exceptions that advance the financial stability of the United States but not exceptions that advance the economic interests of a foreign bank's home country or that are neutral to United States economic considerations.

### ***Ban on Hedge Fund / Private Equity Fund Investing***

The Volcker Rule prohibits a banking entity from “acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or private equity fund.” “**Hedge fund**” and “**private equity fund**” are collectively defined as

an issuer that would be an investment company, as defined in the Investment Company Act ... but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the [SEC], and the [CFTC] may, by rule ... determine

To “**sponsor**” a fund is defined as any of the following:

- (i) to serve as the general partner, managing member, or trustee of the fund;
- (ii) in any manner to select or to control (or to have employees, officer, or directors who constitute) a majority of the directors, trustees, or management of the fund; or
- (iii) to share with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

As is the case with the ban on proprietary trading, the ban on private equity fund or hedge fund investing reflects a significant rollback in the powers of U.S. financial institutions, in particular, BHCs. Historically, even prior to the enactment of GLBA in 1999, BHCs were free to invest in funds, provided that the BHC did not acquire more than 4.9% of the voting interests in the fund, or otherwise control or obtain a controlling interest in the fund (such as serving as, or controlling the appointment of, the fund managers or by holding a substantial non-voting stake in the fund). In addition, BHCs were permitted to invest in overseas funds subject to the restrictions of the International Banking Act and Regulation K (which allows a BHC to hold up to 19.9% of the voting interests in a fund, provided the amount of the investment is within the BHC’s dollar-based consent limit). After enactment of GLBA, BHCs that were able to elect “financial holding company” status were permitted to hold significantly larger investments under the newly conferred merchant banking authority. Prior to the Volcker Rule, the fund investing activities of foreign banking entities and their affiliates were largely unregulated, provided that the investing activity was by an entity operating outside the United States.

It should be noted that the Volcker Rule prohibits a banking entity from organizing or sponsoring a fund – even if the banking entity acquires no financial interest in the fund. Thus, a banking entity allowing the fund to use a variant of the banking entity’s name, or a banking entity serving as the trustee, managing member or having the authority to appoint such persons, would be generally barred by the Volcker Rule, unless an exemption applied.

**Exemptions from the Fund Investing / Sponsorship Ban**

With respect to fund investing activities, the Volcker Rule lists generally the same exemptions as applicable to proprietary trading:

- (1) **Transactions involving only a subset of “bank-eligible securities”**
- (2) **Transactions in connection with underwriting or market-making-related activities** “to the extent that any such activities ... are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties”
- (3) **“Risk-mitigating hedging activities** in connection with and related to individual or aggregate positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings”
- (4) **Transactions “on behalf of customers”**
- (5) **Investments in SBICs, public welfare investments, or investments in qualified rehabilitation or certified historic structure projects**
- (6) **Transactions by a regulated insurance company (and its affiliates) for its general account**, if such transactions are conducted in compliance with state insurance laws and the Federal banking agencies and the insurance commissioners have not determined that such laws are insufficient to protect the safety and soundness of the banking entity or the financial stability of the U.S.
- (7) **Transactions in connection with the sale or securitization of loans**
- (8) **Investments or sponsorship by a banking entity under the exemption of Section 4(c)(9) of the BHC Act** solely outside the U.S., provided further that the banking entity is not directly or indirectly controlled by a banking entity organized under U.S. Federal law or the law of any State, and provided further, no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the U.S.

While the precise scope of the exemption is not clear, it is apparent that a fund in which a QFBO invests cannot be offered or sold to U.S. residents. One such affect of this prohibition will be to bar U.S. investors from being able to participate in funds organized by major non-U.S. institutions, which may be viewed as detrimental to the interests of U.S. investors.

What is unclear is whether the fund itself is prohibited from holding securities of U.S. issuers or companies doing business in the U.S. Strictly speaking, it is not inconsistent with Section 4(c)(9) for a QFBO to take a noncontrolling investment in a fund organized and operating solely outside the United States even if the fund itself takes noncontrolling positions in U.S. issuers. However, the Volcker Rule's use of the phrase "solely outside" the United States could be read to argue that Congress meant to establish greater limitations than are normally found under Section 4(c)(9). Thus, before investing in a fund under this exemption, the QFBO may need to understand the geographic footprint (or potential footprint) of the portfolio companies within the fund.

***(9) Investments or sponsorship by a banking entity under the exemption of Section 4(c)(13) of the BHC Act solely outside the U.S., provided further that the banking entity is not directly or indirectly controlled by a banking entity organized under U.S. Federal law or the laws of any State, and provided further, no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the U.S.***

As in the case above, it is unclear whether the intent of Congress was to prohibit a noncontrolling investment in a fund that itself has invested noncontrolling positions in U.S. issuers. If so, the foreign bank holding company or its affiliate would need to understand the geographic footprint of the portfolio companies within the fund, in addition to obtaining assurances that the fund will not offer its shares to U.S. residents. Again, this exemption is not available to U.S. BHCs, U.S. banks, or their subsidiaries.

***(10) Other activity determined by regulation issued by the Federal banking agencies, the SEC, and the CFTC, that would "promote and protect the safety and soundness of the banking entity and the financial stability of" the U.S.***

It should be noted that, with the exception of the Section 4(c)(9) and 4(c)(13) exemptions, the above-listed exemptions authorize only *investing in* (or retaining the investment in) the fund – and do not expressly authorize *sponsorship* of the fund. Thus, for example, while a banking entity in could invest in a fund comprised solely of the narrow range of bank-eligible investment or the SBIC investments listed above, it is unclear whether the banking entity could in fact *sponsor* such a fund.

The Volcker Rule creates several additional exemptions applicable only to fund investments:

***(11) A banking entity may organize and offer a private equity fund or hedge fund as part of its trust, investment advisory, or fiduciary operations.***

This provision was added in conference, and authorizes a banking entity to organize and offer a private equity fund or hedge fund (including serving as the general partner,

managing member, or trustee, or having the ability to select or control a majority of directors, trustees, or management of the fund) if all of the following conditions are met:

- (a) *Trust / fiduciary / advisory purposes*: The banking entity provides *bona fide* trust, fiduciary, or investment advisory services;
- (b) *Marketing to trust / fiduciary / investment advisory clients*: The fund is organized and offered in connection with such services and, further, the fund is offered **only** to persons that are customers of such services;
- (c) *No ownership interest*: The banking entity does not acquire or retain an equity, partnership, or other ownership interest, other than a “*de minimis* interest” (discussed *infra*);
- (d) *No covered transactions*: The banking entity complies with the restrictions of the Volcker Rule barring certain transactions with the fund (discussed *infra*);
- (e) *No guarantees*: The banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations of the hedge fund or private equity fund (or any fund in which such hedge fund or private equity fund invests);
- (f) *No related names*: The banking entity does not share with the hedge fund or private equity fund, for corporate, marketing, promotional purposes, the same name or a variation of the same name;
- (g) *No ownership interest by bank individuals*: No director or employee of the banking entity retains any equity, partnership, or other interest in the hedge fund or private equity fund except for those directors or employees directly engaged in providing investment advisory or other services to the fund; and
- (h) *Bank disclosure*: The banking entity discloses to its prospective and actual investors in the fund, in writing, that any losses of the fund are borne solely by the investors in the fund and not by the banking entity.

No guidance is provided regarding these requirements, in particular, how the fund is to be marketed. However, this provision on its face would seem to confer substantial latitude on a banking entity to continue to organize and offer private or hedge funds to its clients, provided it transfers these functions to its trust, fiduciary, or investment advisory units.

(12) *A banking entity may make and retain a **de minimis investment** in a hedge fund or private equity fund if all of the following conditions are met:*

- (a) **Organize and Offer**. The exemption is available only with respect to funds that are **organized and offered** by the banking entity;
- (b) **Purpose**: The banking entity makes the investment for the purposes of either
  - (i) establishing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or
  - (ii) making a *de minimis* investment;

- (c) **Must Seek Other Investors:** The banking entity actively seeks unaffiliated investors to reduce or dilute the investment by the banking entity to the *de minimis* amounts described below;
- (d) **De Minimis Portion of the Fund:** Not later than one year after the establishment of the fund, the banking entity's investment in that fund must be reduced to an amount that is no more than 3% of the total ownership interests of the fund (although this one-year period may be extended for up to two additional years, upon application to the Fed);
- (e) **De Minimis Portion of Banking Entity Assets:** The banking entity's investment in any one fund must be "immaterial to the banking entity" (a term required to be defined by rule), but in no case may the aggregate of all private equity fund or hedge fund investments by that banking entity exceed 3% of the banking entity's Tier 1 capital; and
- (f) **Capital Deduction:** For purposes of complying with the capital standards to be adopted by the Federal banking agencies, the SEC, and the CFTC (discussed *infra*), the banking entity deducts from its total assets and tangible equity the aggregate amount of its investments in private equity funds or hedge funds, with the amount of the deduction increasing commensurate with the leverage of the fund(s).

The requirement that the *de minimis* investment be limited to funds "**organized and offered**" by the banking entity severely limits the scope of the *de minimis* exemption. Thus, under a strict reading of the Rule, a banking entity would not be entitled make or maintain investments in any fund it wishes, even if it stays beneath the *de minimis* thresholds. The phrase "**organized and offered**" is not defined in the Volcker Rule, but it seems clear that the intent was to limit a banking entity's *de minimis* authority only to those funds in which the banking entity had a role in establishing.

In a letter to the banking agency heads, Senators Merkley and Levin contend that the exemption should be read even more narrowly, and should allow investments solely for the purpose of aligning the banking entity's interests with those of its clients:

This *de minimis* allowance is permitted only to enable banks or their affiliates to provide asset management services to clients, and not to open the door to proprietary trading. However, these investments, and the banks' relationships with them, cannot be allowed to jeopardize the banks. Accordingly, regulations implementing these provisions should only allow for a bank investment as necessary to seed the fund or align the interests of the bank with the fund investors. Seeding funds should be limited to the minimum amount necessary to attract investors to the investment strategy of the fund and must not serve

principally as a proprietary investment. Regulators should issue rules treating hedge and private equity funds with large initial investments from the sponsoring banks and funds that are not effectively marketed to investors as evasions of the Merkley-Levin restrictions. Similarly, co-investments designed to align the firm with its clients must not be excessive, and should not allow for firms to evade the intent of the restrictions of this section.

Regardless, it is very likely that the scope of the *de minimis* exemption, and whether the exemption will be limited only to funds “organized and offered” by the banking entity, and the meaning of that condition, will be a focus of the public comment and rulemaking process.

As noted above, the capital requirements applicable to *de minimis* investments require that the banking entity deduct from its capital the amount of its investments made under this exemption, with the amount of the deduction increasing “commensurate with” the leverage of the fund. “**Commensurate**” is not defined by the Rule and it remains unclear how this will be applied, although the purpose of the provision is to discourage investments in highly leveraged funds.

Last, it is worth noting that there is no general exemption afforded to ***insurance company general accounts*** from the private equity and hedge fund restrictions. The special exemption afforded insurance company general accounts is limited to the “purchase, sale, acquisition or disposition of securities or other [listed] instruments,” and appears limited only to proprietary trading activities. Thus, with respect to fund investing activities, the Volcker Rule appears to afford no preferential treatment to insurance entities.

### ***What are the Compliance Deadlines?***

The Volcker Rule becomes effective two years after enactment of the Dodd-Frank Act (*i.e.*, by July 21, 2012) or nine months following the joint agency rulemaking, whichever occurs first. Banking entities are expected to have ceased proprietary trading and fund investing activities, and have divested any impermissible investments, within two years thereafter (*i.e.*, by July 21, 2014 or 33 months after rulemaking). The Federal Reserve will likely treat any proprietary trading or fund investment as a grandfathered impermissible activity during this conformance period, and may prohibit the *expansion* of any existing trading or investing activities or the making of any *new* investments during that period, unless prior Federal Reserve consent is obtained – similar to the practice used by the Federal Reserve for other impermissible activities under Section 4(a) of the BHC Act.

The Federal Reserve may, by rule or order, extend this two-year conformance period for not more than one year at a time, if the Federal Reserve deems such an extension to be consistent with the purposes of the Act and not detrimental to the public interest – but no more than three one-year extensions may be granted. This language – “by rule or order” – suggests that the Federal Reserve is authorized to grant one-year extensions that are either entity-specific or industry-wide. Prior versions of the Volcker Rule required that the one-year extension be conferred on an individual banking entity “upon application by such” banking entity, but the prior language was broadened in conference, and which now appears to allow the Federal Reserve to grant an industry-wide extension upon its own initiative.

The Federal Reserve may, upon application by a banking entity, extend the compliance period with respect to any impermissible hedge fund or private equity investment that is deemed an “illiquid fund,” if the investment was made by the banking entity pursuant to a contractual commitment in effect on May 1, 2010 – but in any case, the banking entity must divest the investment when the contractual commitment lapses or the extension expires, whichever occurs first. “**Illiquid fund**” is defined as

a hedge fund or private equity fund that (i) as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments, and (ii) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

Although some authors have suggested that the three one-year extensions and the one five-year extension will necessarily be stacked to run consecutively (for a total of eight years from the effective date of the Volcker Rule or ten years from enactment), this seems unlikely to be the case except in rare circumstances. The purposes of the two extensions are different. The three one-year extensions are, in theory, available to the industry as a whole or to a specific institution upon a showing of hardship. The one five-year extension is limited only to certain forms of investments – illiquid funds – on a case-by-case basis.<sup>7</sup>

### ***What are Capital Requirements and Quantitative Limits?***

The Volcker Rule requires the Federal banking agencies, the SEC, and the CFTC to adopt regulations imposing additional capital requirements and quantitative limitations on banking entities

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<sup>7</sup> The Request specifically solicits public input regarding the divestiture period for illiquid assets and the implications for banking entities.

engaged in proprietary trading or hedge or private equity fund investing. No guidance was provided by in the Rule itself for these additional requirements.

In addition, the Federal banking agencies, the SEC, and the CFTC must adopt regulations imposing additional capital requirements and quantitative limitations on proprietary trading and fund investing by systemically significant nonbank financial companies that are subjected to Federal Reserve supervision under Section 113 of the Dodd-Frank Act. Again, no guidance was provided, although Congress did insert a clause requiring a limited level playing field between banking entities and Section 113 entities: if the systemically significant nonbank financial company engages in proprietary trading or fund investing within any of the listed exemptions allowed to banking entities, then the capital requirements and quantitative restrictions shall be the same as imposed on banking entities operating within the exemptions.

The Federal banking agencies, the SEC, and the CFTC must adopt separate regulations regarding capital requirements and quantitative limitations during any extended divestiture period. Thus, a banking entity could be subjected to different capital and quantitative limitations for grandfathered investments subject to divestiture, as compared with its ongoing investments made under an exemption from the ban.<sup>8</sup>

### ***What are the Restriction on Transactions with Funds?***

The Volcker Rule establishes special restrictions on transactions between a private equity fund or hedge fund and any banking entity that serves as an investment manager, investment adviser, organizer, or sponsor to that fund (or transactions between the fund and any affiliate of such banking entity) – *regardless* whether the banking entity has invested in the fund (either under an exemption, such as the de minimis rule, or on a grandfathered basis). These restrictions are fairly onerous:

(a) **No Covered Transactions.** The Volcker Rule flatly bars any transaction between such fund and the banking entity (or its affiliate) if such a transaction would be considered a “covered transaction” within the meaning of Section 23A of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a “bank” and the fund treated as if it were a nonbank “affiliate.” Generally speaking, this provision effectively bars the ability of the banking entity (or its affiliate) to purchase assets from, extend credit to, or invest in, the private equity fund or hedge fund. This prohibition is seemingly at odds with other provisions of the Volcker Rule that expressly permit a banking entity to invest in a fund, in

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<sup>8</sup> The Request solicits comments generally on factors and considerations that should be weighed when promulgating the capital and quantitative limits.

particular, the *de minimis* exemption, which authorizes a banking entity to invest in a fund that it has “organized.” The inconsistency between these provisions will need to be resolved in the rulemaking process.

(b) **Arms’ Length.** The Volcker Rule requires that all transactions between such fund and the banking entity (or its affiliate) comply with Section 23B of the Federal Reserve Act, with the banking entity (or its affiliate) treated as if it were a “bank” and the fund treated as if it were a nonbank “affiliate.” Generally speaking, this provision requires all transactions between the fund and the banking entity (or its affiliate) to be on arms’ length terms.

Unlike the restrictions on proprietary trading and fund investing, this aspect of the Volcker Rule contains no express exemption for banking entities operating overseas and not affiliated with a BHC or bank organized under U.S. law. Thus, the restriction on transactions with funds appears to apply to non- U.S. entities operating solely outside the United States, if the non- U.S. entity is merely affiliated with a foreign bank with a branch in the U.S. or with a U.S. registered BHC.

Notwithstanding the foregoing prohibition on covered transactions, the Volcker Rule establishes a limited exemption for prime brokerage arrangements between (i) a banking entity that serves as an investment adviser, investment manager, or sponsor, to a private equity fund or hedge fund; and (ii) another private equity fund or hedge fund in which such fund has taken a equity, partnership, or other ownership interest, if the following conditions are met:

- (a) **Organized and Offered Funds.** If the private equity fund or hedge fund is organized and offered by the banking entity, the banking entity is in compliance with the applicable restrictions of the Volcker Rule (see *supra*);
- (b) **CEO Certification.** The CEO of the banking entity certifies in writing annually that the banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations of the hedge fund or private equity fund (or any fund in which such hedge fund or private equity fund invests);
- (c) **Determined to be Safe and Sound.** The Federal Reserve concludes that such transaction is consistent with the safe and sound operations of the banking entity;
- (d) **Arms’ Length Terms.** The prime brokerage arrangement complies with Section 23B of the Federal Reserve Act as if the counterparty were an “affiliate” of the banking entity.

### **Catch-All Prohibitions**

The Volcker Rule contains a “catch-all” clause designed to enable the agencies to prohibit trading or fund investing activities that technically fall within a statutory exemption but otherwise are inconsistent with the purposes of the Volcker Rule, namely, eliminating perceived risky proprietary trading and investing activities in banking entities and preventing conflicts of interest that can arise

from such proprietary activities. Thus, notwithstanding any exemption, the Volcker Rule instructs the agencies to promulgate regulations prohibiting any proprietary trading or hedge or private equity fund investment if the transaction:

- (a) would involve or result in a *material conflict of interest* between the banking entity and its clients, customers, or counterparties;
- (b) would result in a *material exposure* by the banking entity to *high risk-risk assets* or *high-risk trading strategies*;
- (c) would pose a threat to the safety and soundness to the banking entity; or
- (d) would pose a threat to the financial stability of the United States.

The terms *material conflict of interest*, *material exposure*, *high risk-risk assets*, and *high-risk trading strategies* are to be defined by regulation.<sup>9</sup>

### **Study and Rulemaking**

No later than January 21, 2011, the FSOC is required to study and make recommendations regarding implementation of the Volcker Rule. Pursuant to this mandate, the FSOC issued the Request, a copy of which is attached. Within nine months after the completion of the FSOC study (*i.e.*, no later than October 21, 2011), the Federal banking agencies, the SEC, and the CFTC shall consider the findings of the FSOC study and shall adopt regulations, on a coordinated basis, implementing the Volcker Rule. However, notwithstanding these other deadlines, by January 21, 2011, the Federal Reserve is required to issue separate regulations regarding the availability of extensions (including extensions for any illiquid funds). Thus, Federal Reserve regulations applicable to extensions may in fact precede the issuance of the FSOC study on the Volcker Rule itself.

### **Key Dates**

By **January 21, 2011**, the FSOC must complete its study and recommendations, and the Federal Reserve is required to issue regulations regarding extensions.

Within nine months following completion of the study (*i.e.*, **no later than October 21, 2011**), the Federal banking agencies, the SEC, and the CFTC are required to issue general implementing regulations.

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<sup>9</sup> The Request specifically seeks input on how these catch-all provisions should be crafted.

By the earlier of (i) **July 21, 2012**, or (ii) one year after the issuance of final agency regulations, the Volcker Rule becomes effective.

Within two years following the effective date (*i.e.*, **no later than July 21, 2014**), but subject to the possibility of extensions, banking entities are required to come into full compliance with the Volcker Rule.

\* \* \* \*

We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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**FSOC Request for Public Input:**

## FINANCIAL STABILITY OVERSIGHT COUNCIL

Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds

## AGENCY:

Financial Stability Oversight Council.

## ACTION:

Notice and request for information.

## SUMMARY:

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”) prohibits banking entities from engaging in proprietary trading and from maintaining certain relationships with hedge funds and private equity funds. These prohibitions, commonly known as the “Volcker Rule,” are contained in Section 619 of the Dodd-Frank Act. Section 619 of the Dodd-Frank Act requires the Financial Stability Oversight Council (“**FSOC**”) to study and make recommendations on implementing the Volcker Rule. Under Section 619, the Office of the Comptroller of the Currency (“**OCC**”), the Federal Deposit Insurance Corporation (“**FDIC**”), the Board of Governors of the Federal Reserve System (“**Board**”), the Securities and Exchange Commission (“**SEC**”) and the Commodity Futures Trading Commission (“**CFTC**”) must consider the recommendations of the FSOC study in developing and adopting regulations to implement the Volcker Rule. To assist the FSOC in conducting the study and formulating its recommendations, the FSOC is issuing this request for information through public comment.

## DATES:

Comment Due Date:

November 5, 2010.

## ADDRESSES:

Interested persons are invited to submit comments regarding this notice according to the instructions for “Electronic Submission of Comments” below. All submissions must refer to the document title and one of the above docket numbers. The FSOC encourages the early submission of comments.

Electronic Submission of Comments.

Interested persons must submit comments electronically through the Federal eRulemaking Portal at <http://www.regulations.gov>.

Electronic submission of comments allows the commenter maximum time to prepare and submit a comment, ensures timely receipt, and enables the FSOC to make them available to the public. Comments submitted electronically through the <http://www.regulations.gov> Web site can be viewed by other commenters and interested members of the public. Commenters should follow the instructions provided on that site to submit comments electronically.

**Note:**

To receive consideration as public comments, comments must be submitted through the method specified above. Again, all submissions must refer to the docket number and title of the notice.

**Public Inspection of Public Comments.**

All properly submitted comments will be available for inspection and downloading at <http://www.regulations.gov>.

**Additional Instructions.**

Please note the number of the question to which you are responding at the top of each response. Though the responses will be screened for obscenities and appropriateness, in general comments received, including attachments and other supporting materials, are part of the public record and are immediately available to the public. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

**FOR FURTHER INFORMATION CONTACT:**

For further information regarding this interim final rule contact the Office of Domestic Finance, Treasury, at (202) 622-1703. All responses to this Notice and Request for Information should be submitted via <http://www.regulations.gov> to ensure consideration.

**SUPPLEMENTARY INFORMATION:**

**I. Background**

The Dodd-Frank Act was enacted on July 21, 2010.<sup>1</sup> Under section 619 of the Dodd-Frank Act, banking entities<sup>2</sup> are prohibited from engaging in proprietary trading and from maintaining certain

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> The term "banking entity" is defined in section 13(h)(1) of the Bank Holding Company Act, as amended by section 619 of the Dodd-Frank Act. The term generally means any insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company for the purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity.

relationships with hedge funds and private equity funds. These prohibitions and other provisions of section 619 are commonly known, and referred to herein, as the “Volcker Rule.” Section 619 of the Dodd-Frank Act requires the FSOC to study and make recommendations on implementing the Volcker Rule. Under Section 619, the OCC, the Board, the FDIC, the SEC and the CFTC must consider the findings of the FSOC study in developing and adopting regulations to carry out the Volcker Rule.

Section 619(b) provides certain specific guidance with respect to the FSOC study and recommendations, stating as follows:

“(1) STUDY.—Not later than 6 months after the date of enactment of this section, the Financial Stability Oversight Council shall study and make recommendations on implementing the provisions of this section so as to—

“(A) promote and enhance the safety and soundness of banking entities;

“(B) protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities;

“(C) limit the inappropriate transfer of Federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the Federal Government to unregulated entities;

“(D) reduce conflicts of interest between the self-interest of banking entities and nonbank financial companies supervised by the Board, and the interests of the customers of such entities and companies;

“(E) limit activities that have caused undue risk or loss in banking entities and nonbank financial companies supervised by the Board, or that might reasonably be expected to create undue risk or loss in such banking entities and nonbank financial companies supervised by the Board;

“(F) appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system; and

“(G) appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under subsection (a).”

## II. Solicitation for Comments on the Volcker Rule Study

To assist the FSOC in conducting the study and formulating its recommendations concerning the Volcker Rule, the FSOC seeks public comment on the following questions:

1. Commenters are invited to submit views on ways in which the implementation of the Volcker Rule can best serve to:

- (i) Promote and enhance the safety and soundness of banking entities;
- (ii) Protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities;
- (iii) Limit the inappropriate transfer of federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the federal government to unregulated entities;
- (iv) Reduce conflicts of interest between the self-interest of banking entities and nonbank financial companies supervised by the Board,<sup>3</sup> and the interests of the customers of such entities and companies;
- (v) Limit activities that have caused undue risk or loss in banking entities and nonbank financial companies supervised by the Board, or that might reasonably be expected to create undue risk or loss in such banking entities and nonbank financial companies supervised by the Board;
- (vi) Appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system; and
- (vii) Appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under the Volcker Rule.

2. What are the key factors and considerations that should be taken into account in making recommendations on implementing the proprietary trading provisions of the Volcker Rule?

3. What are the key factors and considerations that should be taken into account in making recommendations on implementing the provisions of the Volcker Rule that restrict the ability of banking entities to invest in, sponsor or have certain other covered relationships with private equity and hedge funds?

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<sup>3</sup> The term "nonbank financial companies supervised by the Board" refers to those nonbank financial companies that may be designated by the FSOC under section 113 of the Act to be supervised by the Board and subject to enhanced prudential standards.

4. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should inform decisions on the definitions of:

- (i) "Banking entity" [§ 619(h)(1)];
- (ii) "Hedge fund" [§ 619(h)(2)];
- (iii) "Private equity fund" [§ 619(h)(2)];
- (iv) "Such similar funds" [§ 619(h)(2)];
- (v) "Proprietary trading" [§ 619(h)(4)];
- (vi) "Sponsor" [§ 619(h)(5)];
- (vii) "Trading account" [§ 619(h)(6)];
- (viii) "Short term" [§ 619(h)(6)];
- (ix) "Illiquid fund" [§ 619(h)(7)];
- (x) A transaction "in connection with underwriting or market making related activities \* \* \* designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties" [§ 619(d)(1)(B)];
- (xi) "Risk-mitigating hedging activities" [§ 619(d)(1)(C)];
- (xii) "The purchase, sale, acquisition, disposition of securities or other instruments `on behalf of customers' " [§ 619(d)(1)(D)];
- (xiii) Investments in "small business investment companies" and certain "public welfare" investments [§ 619(d)(1)(E)];
- (xiv) A permitted activity by an insurance company [§ 619(d)(1)(F)]; and
- (xv) Such other activities as "would promote and protect the safety and soundness of banking entities and the financial stability of the United States" [§ 619(d)(1)(J)];?

5. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should be taken into account as indicative that a transaction, class of transactions or activity:

- (i) Would involve or result in a material conflict of interest between a banking entity (or a nonbank financial company supervised by the Board) and its clients, customers or counterparties;
- (ii) Would result, directly or indirectly, in a material exposure by a banking entity (or a nonbank financial company supervised by the Board) to high-risk assets or high-risk trading strategies; or
- (iii) Would pose a threat to the safety and soundness of a banking entity (or a nonbank financial company supervised by the Board)?

6. What factors and considerations should be taken into account in making recommendations on whether additional capital and quantitative limitations are appropriate to protect the safety and

soundness of banking entities or nonbank financial companies supervised by the Board engaged in activities permitted under the Volcker Rule?

7. With respect to proprietary trading and hedge fund and private equity fund activities, which practices, types of transactions or corporate structures in general have historically accounted for or involved increased risks or may account for or involve increased risks in the future?

8. With respect to proprietary trading and hedge fund and private equity fund activities, what practices, policies or procedures have historically been utilized that may have mitigated or exacerbated risks or losses? What practices, policies or procedures might be useful in limiting undue risk or loss in the future?

9. What factors and considerations should be taken into account in making recommendations to safeguard against evasion of the Volcker Rule?

10. How should the international context be considered when implementing the Volcker Rule? Are there any factors or considerations that should be taken into account regarding the application of the Volcker Rule to banking entities or nonbank financial companies that operate outside the United States? What issues does implementation of the Volcker Rule present with respect to the following:

- (i) Domestic banking entities that have access to foreign exchanges,
- (ii) foreign affiliates of domestic banking entities, and
- (iii) foreign non-bank financial companies

11. What timing issues are raised in connection with the divestiture of illiquid assets affected by the prohibitions of the Volcker Rule, and how might such issues be appropriately addressed?

12. Commenters are generally invited to submit views with respect to any qualitative or quantitative factors that should be considered in connection with the Council's study of the Volcker Rule, as well as any analogous areas of law, economics, or industry practice, and any factors specific to the commenter's experience. Please comment generally and specifically, and please include empirical data and other information in support of such comments, where appropriate and available.

Dated: October 1, 2010.

Alastair Fitzpayne,  
Deputy Chief of Staff and Executive Secretary, Department of the Treasury.

# Clients & Friends Memo

## SEC Proposes New Disclosure Requirements Regarding Representations and Warranties in Asset-Backed Securities Offerings

October 18, 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) was signed into law by President Obama on July 21, 2010.\* Section 943 of the Act requires the Securities and Exchange Commission (the “SEC”) to prescribe regulations in the use of representations and warranties in the market for asset-backed securities.<sup>1</sup> Such regulations must set forth new disclosure requirements for issuers, originators and depositors and nationally recognized statistical rating organizations (“NRSROs”) in securitization transactions where the transaction documents require the repurchase or replacement of underlying assets in connection with a breach of asset-level representations and warranties.

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act’s application to specific industries, entities and transactions. To see these other memoranda, please see *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

<sup>1</sup> Section 943 of the Act reads as follows:

### REPRESENTATIONS AND WARRANTIES IN ASSET-BACKED OFFERINGS.

Not later than 180 days after the date of enactment of this Act, the Securities and Exchange Commission shall prescribe regulations on the use of representations and warranties in the market for asset-backed securities (as that term is defined in section 3(a)(77) of the Securities Exchange Act of 1934, as added by this subtitle) that—

(1) require each national (*sic.*) recognized statistical rating organization to include in any report accompanying a credit rating a description of—

(A) the representations, warranties, and enforcement mechanisms available to investors; and

(B) how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities; and

(2) require any securitizer (as that term is defined in section 15G(a) of the Securities Exchange Act of 1934, as added by this subtitle) to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies.

On October 4, 2010, the SEC released its proposed rule<sup>2</sup> (the “**Proposed Rule**”) pursuant to Section 943 of the Act. The Proposed Rule would require (a) new disclosures applicable to any “securitizer” with respect to “asset-backed securities” (each as defined in the Act and described below), (b) modifications to disclosure requirements under Regulation AB and (c) new disclosure requirements for NRSROs rating new issues of asset-backed securities. The SEC has requested comments on the Proposed Rule, which must be provided by November 15, 2010.<sup>3</sup>

### **New Disclosure Requirements Applicable to Securitizers of Exchange Act-ABS**

#### Overview

The SEC explains that Section 943(2) of the Act was a response to a perceived lack of effectiveness of the buy-back covenants in asset-backed securities transaction documents where breaches of underlying asset-level representations and warranties were alleged. The SEC believes that by mandating detailed reporting requirements of all repurchase requests and the ultimate results thereof to investors in both registered and unregistered asset-backed securities offerings, investors would have sufficient information to identify asset originators “with clear underwriting deficiencies.”

To that end, the SEC proposes new Rule 15Ga-1 to the Securities Exchange Act of 1934, as amended (the “**Exchange Act**”) to satisfy the requirements of Section 943(2).

#### Applicability of disclosure requirements of proposed Rule 15Ga-1

The new disclosure requirements of proposed Rule 15Ga-1 would apply to asset-backed securities, as defined in the Act (“**Exchange Act-ABS**”), which is substantially broader than the definition set forth in Regulation AB. Exchange Act-ABS includes securities that are typically sold in transactions that are exempt from the registration requirements of the Securities Act of 1933, as amended (the “**Securities Act**”).<sup>4</sup>

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<sup>2</sup> *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC Release Nos. 33-9148; 34-63029 (October 4, 2010).

<sup>3</sup> Proposed Rule, pages 1, 40.

<sup>4</sup> “Asset backed security (A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including— (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and (B) does not include a security issued by a

The new disclosure requirements apply to any “securitizer”, which is broadly defined in the Act to include issuers, sponsors, originators and depositors.<sup>5</sup> The SEC states that this definition is intended to apply to any entity or person that issues or organizes an Exchange Act-ABS transaction, including asset-backed securities issued or guaranteed by government-sponsored enterprises, such as Fannie Mae and Freddie Mac, or municipal issuers.<sup>6</sup>

The scope of proposed Rule 15Ga-1 is limited to Exchange Act-ABS transactions where the underlying documents contain a covenant to repurchase or replace assets in the event of a breach of a representation or warranty. Within the context of such transactions, both the applicability of the rule and the scope of the new reporting requirements are quite broad. However, it is important to note that proposed Rule 15Ga-1 would have no application to any transaction that does not require repurchase or replacement of assets as a remedy for breaches of representations and warranties. As such, traditional CDO and CLO transactions and other second and third-level securitizations that do not have repurchase requirements would not be impacted by proposed Rule 15Ga-1. Issuers and originators should note, however, that if such a feature were added to any new CDO or CLO products as part of a revitalization of the CDO/CLO market, issuers and originators would be required to comply with the proposed disclosure requirements, even if such offerings are conducted under Rule 144A or Regulation S of the Securities Act or are otherwise structured to be exempt from the registration requirements of the Securities Act.<sup>7</sup>

#### **Disclosures required under proposed Rule 15Ga-1; proposed Form ABS-15G**

Proposed Rule 15Ga-1 would require any securitizer of Exchange Act-ABS to disclose all fulfilled and unfulfilled requests for asset repurchases or replacements based on breach of representation or warranty across all trusts aggregated by the securitizer. This disclosure is required regardless of whether or not there is any merit to the request, whether or not the request is fulfilled or unfulfilled and regardless of whether the request is made by the transaction trustee at its own initiative or pursuant to a request received by the trustee from investors. The disclosure would be required for all assets originated or sold by the securitizer that are included in outstanding Exchange Act-ABS

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finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.” See Section 3(a)(77) of the Exchange Act, as amended by the Act.

- <sup>5</sup> “Securitizer means (A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.” See Section 15G(a)(3) of the Exchange Act, as amended by the Act.
- <sup>6</sup> See Proposed Rule, page 10. The Commission specifies that the Proposed Rule would apply to Fannie Mae, Freddie Mac and municipal entities, as well as entities engaged in private offerings under Rule 144A and other exemptions from the registration requirements of the Securities Act.
- <sup>7</sup> Concerns with the applicability of the Proposed Rule to offshore transactions are discussed below.

transactions, regardless of asset class, where any such securities are held by non-affiliates of the securitizer and where a repurchase covenant for breaches of representations and warranties exists.<sup>8</sup>

The disclosures would be made on proposed Form ABS-15G, which would be filed with the SEC on EDGAR. The form must be signed by the senior officer of the securitizer in charge of the securitization.<sup>9</sup> Because disclosure is required of all repurchase requests, whether or not the repurchase is consummated, the SEC proposes allowing securitizers to footnote information included in Form ABS-15G to provide explanatory information (e.g., to explain why repurchase requests were not satisfied).<sup>10</sup>

As discussed above, disclosure is required of all repurchase demands, whether initiated by the trustee on its own or by investor demands upon a trustee, irrespective of the trustee's determination to make a repurchase demand on a securitizer based on such investor demand. In this regard, the SEC acknowledges its concern that a securitizer may not be able to obtain complete information from trustees that did not keep track of investor requests for repurchase received by the trustee prior to the effective date of the Proposed Rule. The SEC is therefore proposing that a securitizer be permitted, in such a case, to disclose in a footnote, if true, that the securitizer requested and was able to obtain only partial information or was unable to obtain any information with respect to investor demands to a trustee that occurred prior to the effective date of the Proposed Rule.<sup>11</sup>

Proposed Form ABS-15G would require reporting in tabular format of the following information: (a) name of each issuing entity of Exchange Act-ABS, organized by asset class, (b) name of each originator, (c) assets subject to a demand for repurchase or replacement, by issuing entity and originator, (d) assets repurchased or replaced, by issuing entity and originator, (e) assets not repurchased or replaced, by issuing entity and originator, (f) assets pending repurchase or replacement (relevant, for example, where repurchase or replacement was demanded but a cure period that is longer than the one-month reporting period has not expired), by issuing entity and originator and (g) a "check the box" column to denote a registered transaction.<sup>12</sup> A copy of the tabular format to be used in proposed Form ABS-15G is attached as an annex to this memorandum.

Securitizers would be required to file Form ABS-15G at the time a securitizer first offers Exchange Act-ABS or organizes or initiates an offering of Exchange Act-ABS after the effective date of the

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<sup>8</sup> Proposed Rule, pages 12-13.

<sup>9</sup> Proposed Rule, page 27.

<sup>10</sup> Proposed Rule, page 14.

<sup>11</sup> Proposed Rule, pages 14-15.

<sup>12</sup> Proposed Rule, page 15, and proposed Form ABS-15G.

Proposed Rule.<sup>13</sup> The initial filing must include all information required by proposed Rule 15Ga-1, even if there had been no demands to repurchase or replace any assets for all of the applicable Exchange Act-ABS transactions containing a repurchase covenant for breaches of representations and warranties. The initial filing must cover all applicable Exchange Act-ABS transactions going back five years from the date of the initial filing. In addition, updated monthly reporting on Form ABS-15G is required to be filed within 15 calendar days after the end of each calendar month.<sup>14</sup> Proposed Rule 15Ga-1 makes no efforts to link the timing for monthly reports to the underlying payment dates under the transactions reported on Form ABS-15G.

### **Considerations for exempt transactions**

The SEC notes that the disclosures required by the Proposed Rule do not fit neatly within the framework of the existing Securities Act and Exchange Act forms because there are currently no filing requirements for unregistered transactions. Therefore, the SEC proposes that Form ABS-15G be filed on EDGAR, even for unregistered transactions.<sup>15</sup> Securitizers of Exchange Act-ABS offerings that are unregistered should note that, although the SEC states that filing Form ABS-15G would not foreclose reliance of an issuer on the private offering exemption and the safe harbor for offshore transactions from the registration requirements of Section 5 of the Securities Act, the SEC also notes that inclusion in a Form ABS-15G filing of information beyond what is required by proposed Rule 15Ga-1 may jeopardize such reliance by constituting a public offering or conditioning the market for the securities being offered under an exemption.<sup>16</sup>

*Note: Securitizers involved in unregistered offerings should be mindful of this issue and should limit disclosures to the strict requirements of proposed Rule 15Ga-1.*

The SEC also recognizes that requiring a five-year look-back and updated monthly filings may chill the marketing of offshore exempt transactions to U.S. investors. Nevertheless, the SEC notes that the Proposed Rule would apply to offshore transactions and requests comments on ways to mitigate the impact on offshore transactions so that foreign issuers and underwriters would not be unduly discouraged from selling to U.S. investors.

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<sup>13</sup> Proposed Rule, page 18.

<sup>14</sup> Proposed Rule, page 20.

<sup>15</sup> Proposed Rule, page 26.

<sup>16</sup> Proposed Rule, page 18, fn 34.

### Re-proposal of certain Regulation AB proposals

The SEC notes that there is overlap between its proposal to update the disclosure requirements of Regulation AB pursuant to the SEC's release of April 7, 2010<sup>17</sup> and the disclosure requirements of Section 943 of the Act. However, the requirements of Section 943(2) go beyond the SEC's prior Regulation AB proposals. The prior Regulation AB proposals would impose similar disclosure obligations for fulfilled and unfulfilled repurchase requests, but only for registered offerings and only if the amount of publicly securitized assets subject to repurchase or replacement is material.

Under the Proposed Rule, the SEC re-proposes its previous Regulation AB proposal to amend Items 1104 and 1121 of Regulation AB. These amendments would now require disclosures, within prospectuses and ongoing reports on Form 10-D, of securitized assets subject to repurchase or replacement to be reported in the format set forth in proposed Rule 15Ga-1; provided that disclosure would be limited to the same asset class as the registered securities that are the subject of the offering.<sup>18</sup> The SEC did not change the three-year look-back on repurchase history required by sponsors under Item 1104 of Regulation AB, but is removing the materiality threshold it proposed in its April 7, 2010 release. In addition, the Proposed Rule requires all prospectuses in registered offerings to reference the Form ABS-15G filings made by the securitizer (*i.e.* the sponsor) of the transaction and disclose the CIK number of the securitizer so that investors may easily locate Form ABS-15G filings of such securitizer on EDGAR.

### Proposed disclosure requirements for NRSROs

Section 943(1) of the Act requires each NRSRO to include, in any report accompanying a "credit rating" for an Exchange Act-ABS, a description of the representations, warranties and enforcement mechanisms available to investors and of how such rights and remedies differ from the representations, warranties and enforcement mechanisms in issuances of similar securities. The Proposed Rule would add Rule 17g-7 to the Exchange Act to implement the requirements of Section 943(1). This part of the Proposed Rule simply restates the statutory requirements of Section 943(1) and contains no mandate and little guidance on how NRSROs may comply with the requirements of Section 943(1) of the Act. The SEC notes that it "anticipates" one way NRSROs could fulfill this requirement would be to review previous issuances on both an initial and ongoing basis in order to establish "benchmarks" for various types of securities and revise them as

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<sup>17</sup> See *Asset Backed Securities*, SEC Release No. 33-9117 (April 7, 2010) [75 FR 23328]. Cadwalader has prepared a memorandum summarizing and discussing these proposed amendments to Regulation AB. See *SEC Announces Proposal to Significantly Enhance the Regulation of Asset-Backed Securities* (April 20, 2010), which may be accessed on our website at [http://www.cadwalader.com/assets/client\\_friend/042010SEC\\_Enhancements.pdf](http://www.cadwalader.com/assets/client_friend/042010SEC_Enhancements.pdf).

<sup>18</sup> Proposed Rule, pages 30-31 and fn 53.

appropriate.<sup>19</sup> The SEC also indicates it is proposing a note that would clarify that the term “credit rating” for purposes of the Proposed Rule would include any expected or preliminary credit rating issued by an NRSRO, including any indications of a rating used prior to the assignment of an initial credit rating for a new issuance.<sup>20</sup> Pre-sale reports typically issued by NRSROs in connection with an offering would be considered a “credit rating” for purposes of the Proposed Rule.

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<sup>19</sup> Proposed Rule, pages 35-36, fn 63.

<sup>20</sup> Proposed Rule, page 36, fn 65.

Annex A

Tabular Format for Proposed Form ABS-15G

Name of Issuing Entity	Check if Registered	Name of Originator	Assets That Were Subject of Demand			Assets That Were Repurchased or Replaced			Assets That Were Not Repurchased or Replaced			Assets Pending Repurchase or Replacement		
			(#)	(\$)	(% of pool)	(#)	(\$)	(% of pool)	(#)	(\$)	(% of pool)	(#)	(\$)	(% of pool)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)	(m)	(n)	(o)
<b>Asset Class X</b>														
Issuing Entity A CIK #	X	Originator 1												
		Originator 2												
Issuing Entity B		Originator 3												
Total			#	\$		#	\$		#	\$		#	\$	
<b>Asset Class Y</b>														
Issuing Entity C		Originator 2												
		Originator 3												
Issuing Entity D CIK #	X	Originator 1												
Total			#	\$		#	\$		#	\$		#	\$	

# Clients & Friends Memo

## SEC Proposes New Rules Regarding Diligence and Disclosure in ABS Offerings

October 26, 2010

As part of what is expected to be a wave of proposed rulemaking under The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**"),<sup>1</sup> the Securities and Exchange Commission (the "**SEC**") issued proposed rules to implement the provisions of Section 945 and a portion of Section 932 of the Act (the "**Proposed Rules**"). Section 945 of the Act added Section 7(d) to the Securities Act of 1933, as amended (the "**Securities Act**"), directing the SEC to issue rules requiring an issuer of asset-backed securities ("**ABS**") to perform a review of the assets underlying an ABS offering and disclose the nature of that review. Section 932 of the Act added Section 15E(s)(4)(A) to the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), which requires an issuer or underwriter of ABS to make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.

### Highlights:

The Proposed Rules would:

- require an issuer of registered (public) ABS to review the assets underlying an ABS offering, either directly or via a third-party;
- require an issuer of registered (public) ABS to disclose the nature, findings and conclusions of such review;
- require an issuer of non-registered ABS and underwriter of both registered and non-registered ABS to file Form ABS-15G with the SEC to disclose the findings and conclusions of any report of a third-party engaged to review the pool assets; and

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<sup>1</sup> Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda, please see *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

- require an ABS issuer to provide additional disclosure regarding assets that deviate from disclosed underwriting criteria (would apply to registered and 144A offerings).<sup>2</sup>

**Discussion:****1. Issuer Required to Review Underlying ABS Assets**

In order to implement the provisions of Section 7(d) of the Securities Act, which was adopted pursuant to Section 945 of the Act, the SEC has proposed Rule 193, which would require issuers of registered ABS to perform a review of the underlying pool assets.

Details of Rule 193:

- (a) Applies Only to Registered Offerings. Rule 193 would apply only to registered offerings.
- (b) Nature of Required Review. The release does not include any information regarding the level or type of review that would be required. Recognizing that the level and type of review would vary based on circumstances and asset type, the SEC is instead relying on the disclosure requirements described below, reasoning that investors could evaluate for themselves whether the issuer's level of review was adequate.<sup>3</sup>
- (c) Persons Required to Perform the Review. The asset review is required to be performed by either:
  - (i) the ABS issuer, which for this purpose would be the depositor or the sponsor; or
  - (ii) a third-party engaged for purposes of performing the review, provided that the third-party is named in the registration statement and consents to being named as an expert in accordance with Rule 436 of the Securities Act. Note that the third-party would thus be subject to liability under Section 11 of the Securities Act.

Note: The SEC requested comments as to what entities should be considered a "third-party engaged for purposes of performing

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<sup>2</sup> Although the proposed requirement would be part of Regulation AB, which mandates disclosure in offering documents for registered offerings, the SEC's proposed revisions to Regulation AB, dated May 3, 2010, would require issuers relying on the safe harbor provided by Rule 144A to make the same information "available" to investors in 144A offerings.

<sup>3</sup> The SEC requested comments as to whether the SEC should mandate a minimum level of review that must be performed. The SEC also asked whether the Proposed Rules should require that the review, at a minimum, provide "reasonable assurance" that the disclosure in the prospectus regarding the assets is accurate in all material respects.

a review” and asked whether it should include accountants that perform agreed-upon procedures or lawyers that provide security interest opinions.

Reviews by unaffiliated originators would not qualify.

- (d) Expanded Scope of ABS. Rule 193 relates to asset-backed securities as defined in new Section 3(a)(77)<sup>4</sup> of the Exchange Act, which is broader than the definition provided in Regulation AB and includes securities typically sold in private transactions such as CDOs.
- (e) Disclosure. The SEC is proposing to revise Item 1111 of Regulation AB by adding clause (a)(7), which would require disclosure regarding (i) the nature of an issuer's or third-party's review of the assets under proposed Rule 193 and (ii) the findings and conclusions of the review.

*Note: Although Item 1111(a)(7) of Regulation AB, as proposed, would only apply to (i) registered offerings and (ii) the narrower definition of ABS that appears in Regulation AB, non-registered offerings and offerings of securities that are ABS within the broader definition that appears in Section 3(a)(77) of the Exchange Act would still be subject to the disclosure requirements discussed below with respect to the findings and conclusions of third-party asset reviews.*

## 2. Disclosure Regarding the Findings and Conclusions of Third-Party Due Diligence Reports

In order to implement the provisions of Section 15E(s)(4)(A) of the Exchange Act, which was adopted pursuant to Section 932 of the Act, the SEC proposed Rule 15Ga-2. This rule would require issuers and underwriters of ABS to file Form ABS-15G disclosing the findings and conclusions of any report of a third-party engaged by an issuer or underwriter to perform a review of pool assets. Unlike Section 7(d) of the Securities Act discussed above, Section 15E(s)(4)(A) is not limited to registration statements and therefore applies to both registered and non-registered offerings.

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<sup>4</sup> “Asset backed security (A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including— (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if non of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.” See Section 3(a)(77) of the Exchange Act, as amended by the Act.

## Details of Rule 15Ga-2:

- (a) Types of Reports Covered. The Proposed Rule does not specifically describe the types of third-party reports that would be covered by this Rule, nor does it address the form in which the findings and conclusions may be presented. However, in its request for comments, the SEC noted that the scope of third-party diligence providers is broad enough to include appraisers and engineers but did not address the potential privacy and confidentiality concerns that this rule could raise.

*Note: Although the text of proposed Rule 15Ga-2 addresses reports obtained by an issuer or underwriter, the accompanying release and request for comment refers to findings and conclusions of third-parties that were hired by the issuer or underwriter.*

- (b) Timing. Issuer and/or underwriter would be required to file Form ABS-15G via EDGAR five business days before the first sale in the offering.
- (c) Signature Requirement. Form ABS-15G would need to be signed by the senior officer in charge of securitization of the depositor, if filed by an issuer, or by a duly authorized officer, if filed by an underwriter.
- (d) Issuer Exemption for Registered Offerings. An issuer that complied with the new disclosure requirements of Item 1111(a)(7) of Regulation AB and disclosed the findings and conclusions of any third-party asset review in its prospectus will not be required to file that same information via Form ABS-15G.

*Note: Although an issuer in a registered offering may not need to file a Form ABS-15G, an underwriter that separately hired third-parties to review pool assets would be required to file its own Form ABS-15G.*

- (d) Impact on Private Placements. The SEC indicated that merely filing a Form ABS-15G will not jeopardize reliance on exemptions and safe harbors from registration under the Securities Act as long as (i) the only information made publicly available is that which is required under the Proposed Rule and (ii) the issuer or underwriter does not use the filing to condition the market for sales of the securities.
- (e) Foreign Transactions. ABS issued in the U.S. and offered in a foreign jurisdiction would be subject to Rule 15Ga-2. In addition, ABS issued in a foreign jurisdiction, even if primarily offered to foreign investors, would also be subject to the filing requirements of Rule 15Ga-2 if offers are made in the U.S.

- (f) Expanded Scope of ABS. Rule 15Ga-2 relates to asset-backed securities as defined in new Section 3(a)(77) of the Exchange Act, which is broader than the definition provided in Regulation AB and includes securities typically sold in private transactions such as CDOs.

### 3. Disclosure Regarding Exceptions to Underwriting Criteria

The SEC also re-proposed its proposal to amend Regulation AB disclosure requirements regarding assets that deviate from disclosed underwriting criteria to add the following additional disclosure item:

- the identity of the entity that determined to include such assets in the pool.

The other Regulation AB disclosure items previously proposed remain unchanged and are listed below:

- address how the assets in the pool deviate from the disclosed underwriting standards;
- include data on the amount and characteristics of those assets;
- describe factors that were used to make such determinations (which could include compensating factors); and
- provide data regarding the compensating factors that were considered by the issuer and data on the amount of assets in the pool that met such compensating factors.

\* \* \* \*

We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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# Clients & Friends Memo

## SEC Proposes New Rules Regarding Shareholder Approval of Executive Compensation and Golden Parachute Arrangements

November 29, 2010

The Securities and Exchange Commission (the “SEC”) recently issued proposed rules (the “Proposed Rules”) to implement the provisions of Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”).<sup>1</sup> Section 951 of the Act requires publicly traded companies to provide for non-binding shareholder votes on executive compensation (“say on pay” and “say when on pay” votes) and golden parachute packages (“say on golden parachutes”) of named executive officers.

Because “say on pay” votes are generally required for the upcoming proxy season, companies should (1) begin to review their executive compensation arrangements and Compensation Discussion and Analysis (“CD&A”) disclosure to identify any issues that might be seen as controversial; (2) in light of the review of their executive compensation arrangements and CD&A disclosure, determine in consultation with their counsel and compensation advisors how best to comply with the mandated “say on pay” votes in their proxies; and (3) determine whether an annual, biennial or triennial “say on pay” vote best fits with their executive compensation program, and whether such determined frequency will be recommended to shareholders in their proxies.

### Highlights:

Under the Act and the Proposed Rules:

- the shareholder votes for “say on pay”, “say when on pay” and “say on golden parachutes” mandated by the Act may not be construed as (1) overruling a decision by an issuer or an issuer’s board of directors; (2) creating or implying any change to the fiduciary duties of such issuer or board of directors; (3) creating or

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<sup>1</sup> Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act’s application to specific industries, entities and transactions. To see these other memoranda, please see Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php). A copy of the Proposed Rules can be found at <http://www.sec.gov/rules/proposed/2010/33-9153.pdf>.

implying any additional fiduciary duties for such issuer or board of directors; or (4) restricting or limiting the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation;

- while a proxy, consent or authorization for the first annual (or other) shareholder meeting occurring on or after January 21, 2011 (*i.e.*, at least 6 months after enactment of the Act) must include a non-binding “say on pay” vote to approve executive compensation packages and a separate non-binding shareholder vote to determine the frequency of such “say on pay” voting, a non-binding shareholder vote on golden parachute packages will not be required until the SEC finalizes its proposed “say on golden parachutes” rules;
- at least once every six years, shareholders must be given four choices with respect to when (the “say when on pay” vote) the non-binding “say on pay” vote will occur: whether the “say on pay” vote will occur every 1, 2 or 3 years, or to abstain from voting on the matter, with the “say when on pay” vote itself being non-binding, if so determined by the issuer;
- the “say on pay” and “say when on pay” votes do not apply to an issuer’s director compensation or compensation policies and practices as they relate to risk management and risk-taking incentives as they relate to employee compensation generally;
- the “say on pay” and “say when on pay” votes required by the Act would be added to the list of items that do not trigger a preliminary filing and, until the Proposed Rules are finalized, the SEC will not object if issuers do not file proxy materials in preliminary form and the only matters that would require a filing in preliminary form are such “say on pay” and “say when on pay” votes;
- if the Proposed Rules are adopted as final, once effective, in accordance with a new proposed Item 402(t) of Regulation S-K, issuers would be required to disclose specified information with respect to golden parachute compensation arrangements in proxy or consent solicitations in connection with an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets, as required by the Act, as well as in information statements filed pursuant to Regulation 14C, proxy or consent solicitations that do not contain merger proposals but require disclosure of information under Item 14 of Schedule 14A pursuant to Note A of Schedule 14A, registration statements on Form S-4 and F-4 containing disclosure relating to mergers and similar transactions, going private transactions on Schedule 13E-3, and third-party tender offers on Schedule TO and Schedule 14D-9;

- issuers would only be required to provide shareholders a “say on golden parachutes” vote in proxy statements for meetings at which shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets,<sup>2</sup> and not the broader set of circumstances in which proposed Item 402(t) disclosure will be required, such as proxy or consent solicitations that do not contain merger proposals, going private transactions and third party tender offers;
- broker discretionary voting of uninstructed shares would not be permitted for “say on pay” or “say when on pay” votes;
- issuers that have received financial assistance under the Troubled Asset Relief Program (“TARP”) will not be required to include a separate “say on pay” and “say when on pay” vote under the Act until the first annual meeting of shareholders after the issuer has repaid all outstanding indebtedness under the TARP;<sup>3</sup> and
- if proxy service providers are not able to reprogram their systems to enable shareholders to vote among four choices in time for the “say when on pay” votes required by the Act, the SEC will not object if the form of proxy for a “say when on pay” vote provides means whereby the person solicited is afforded an opportunity to specify by boxes a choice among 1, 2 or 3 years, and proxies are not voted on the “say when on pay” votes matter in the event the person solicited does not select a choice among 1, 2 or 3 years.

#### Discussion:

#### 1. “Say on Pay” and “Say When on Pay” Voting

**A. “Say on Pay”.** The Act requires publicly traded companies to provide for a non-binding shareholder vote to approve executive compensation packages at least once every three years. The voting must be provided for in any proxy or consent or authorization for an annual (or other) shareholder meeting for which SEC proxy solicitation rules require compensation disclosure.

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<sup>2</sup> Such a vote would not be required on golden parachute compensation if disclosure of such compensation has been included in the executive compensation disclosure that was subject to a prior advisory vote of shareholders under the Act’s “say on pay” requirements.

<sup>3</sup> Non-binding “say on pay” votes are already mandatory for companies that received government assistance through TARP. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(e) (2008) (as amended by the American Recovery and Reinvestment Act of 2009); 31 C.F.R. § 30.13 (2009). See also 17 C.F.R. Part 240 (2010) (SEC amendments to the proxy rules under the Securities Exchange Act of 1934 requiring TARP recipients to include a “say on pay” vote in their proxies).

Under the Proposed Rules, shareholders would separately vote to approve the compensation of the issuer's named executive officers, as such compensation is disclosed in Item 402 of Regulation S-K.<sup>4</sup> Issuers would be required to disclose that they are providing such a vote on executive compensation and to briefly explain the general effect of the vote (such as whether the vote is non-binding).

The Proposed Rule for "say on pay" votes would not require issuers to use any specific language or form of resolution to be voted on by shareholders, though the SEC notes that the vote must relate to all executive compensation disclosure set forth pursuant to Item 402 (and not merely be a vote to approve "only compensation policies and procedures" generally).

Under the Proposed Rules, issuers would generally be required to address in their CD&A whether and, if so, how their compensation policies and decisions have taken into account the results of shareholder advisory votes on executive compensation.<sup>5</sup> While this proposed disclosure is not required by the Act, the SEC believes that this mandate to provide disclosure on these issues will "facilitate better investor understanding of issuers' compensation decisions."

**B. "Say When on Pay".** The Act requires a non-binding shareholder vote at least once every 6 years to determine whether the non-binding votes to approve executive compensation packages described above will occur every 1, 2 or 3 years. Under the Proposed Rules, this "say when on pay" frequency vote would be required only in a proxy statement solicited for an annual or other meeting of shareholders for which compensation disclosure is required.

The Proposed Rules for "say when on pay" votes do not provide the specific language to be used with respect to such votes and do not require issuers to frame the vote in the form of a resolution. Issuers would be required to disclose that they are providing a separate shareholder advisory vote on the frequency of the "say on pay" vote on executive compensation and to briefly explain the general effect of the vote (such as whether the vote is non-binding).

The Proposed Rules permit the exclusion of shareholder proposals that would provide a say-on-pay vote or seek future say-on-pay votes or that relates to the frequency of say-on-pay votes, provided the issuer has adopted a policy on the frequency of say-on-pay votes that is consistent with the

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<sup>4</sup> Because smaller reporting companies are subject to scaled executive compensation disclosure requirements and are not required to include a CD&A, the shareholders of a smaller reporting company would vote to approve the compensation of the named executive officers, as disclosed under Item 402(m) through 402(q) of Regulation S-K. The Proposed Rules clarify that this requirement for smaller reporting companies does not change the scaled disclosure requirements applicable to such entities and that smaller reporting companies would not be required to provide a CD&A in order to comply.

<sup>5</sup> Because smaller reporting companies are not required to include a CD&A as part of their Item 402 disclosure, this proposed new disclosure requirement would not apply to smaller reporting companies.

plurality of votes cast in the most recent “say when on pay” vote in accordance with the Proposed Rules. For example, if in the first “say when on pay” vote the largest number of votes were cast for a two-year frequency for future shareholder votes on executive compensation, and the issuer discloses that it has approved a policy to hold the vote every two years, a shareholder proposal seeking a different frequency could be excluded so long as the issuer seeks votes on executive compensation every two years and provides a “say when on pay” vote at least every six years as required by the Act.

Under the Proposed Rules, an issuer would be required to disclose, in the quarterly report on Form 10-Q covering the period during which the “say when on pay” vote occurs, or in the annual report on Form 10-K if the “say when on pay” vote occurs during the issuer’s fourth quarter, its decision regarding how frequently it will conduct “say on pay” advisory votes in light of the results of the “say when on pay” vote on frequency and whether it determines that the “say when on pay” vote by the shareholders is binding on it.

## 2. Disclosure and Approval of Golden Parachutes

**A. Disclosure of Golden Parachutes.** The Act requires all persons making a proxy or consent solicitation seeking shareholder approval of an acquisition, merger, consolidation or proposed sale or disposition of all or substantially all of an issuer’s assets to provide disclosure of any agreements or understandings that the soliciting person has with its named executive officers (or that it has with the named executive officers of the acquiring issuer) concerning compensation that is based on or otherwise relates to the merger transaction. In addition, the Act requires disclosure of any agreements or understandings that an acquiring issuer has with its named executive officers and that it has with the named executive officers of the target company in transactions in which the acquiring issuer is making a proxy or consent solicitation in seeking shareholder approval of an acquisition, merger, consolidation or proposed sale or disposition of all or substantially all of an issuer’s assets. The Act requires that this disclosure be in a “clear and simple form in accordance with regulations” to be promulgated by the SEC and to include “the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer.” The Act does not consider whether such compensation would trigger penalty taxes and loss of tax deductibility under Sections 280G and 4999 of the Internal Revenue Code.

In order to implement these “say on golden parachutes” provisions of the Act, the SEC is proposing to require disclosure with respect to golden parachute compensation arrangements in proxy or consent solicitations in connection with an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets, in accordance with a new proposed Item 402(t) of Regulation S-K.

As proposed, Item 402(t) would require disclosure of named executive officers' golden parachute arrangements in both tabular and narrative formats. The table proposed under Item 402(t) would present quantitative disclosure of the individual elements of compensation that an executive would receive that are based on or otherwise relate to the merger, acquisition, or similar transaction, and the total for each named executive officer. Elements that would be separately quantified and included in the total would be any cash severance payment (e.g., base salary, bonus and pro-rata non-equity incentive plan compensation payments; the dollar value of accelerated stock awards, in-the-money option awards for which vesting would be accelerated, and payments in cancellation of stock and option awards; pension and nonqualified deferred compensation benefit enhancements; perquisites and other personal benefits and health and welfare benefits; and tax reimbursements (such as Internal Revenue Code Section 280G tax gross-ups)). Issuers would also be required to quantify any additional elements of compensation not specifically includable in the other columns of the table. The table would require separate footnote identification of amounts attributable to "single-trigger" arrangements (for example, amounts payable upon consummation of the transaction) and amounts attributable to "double-trigger" arrangements (for example, amounts payable upon a qualifying termination of employment within a specified period of time following consummation of the transaction).

In a proxy statement soliciting shareholder approval of a merger or similar transaction, the tabular quantification of dollar amounts based on issuer stock price would be required to be based on the closing price per share as of the latest practicable date.<sup>6</sup> The SEC has asked for comments as to whether this measurement date is appropriate – while in the context of a corporate transaction it would seem more relevant to use the transaction's deal price per share for quantifications based on issuer stock price, as drafted, Item 402(t) specifically requires the use of the closing price per share of issuer stock as of the latest practicable date.

Item 402(t) would require quantification with respect to any agreements or understandings, whether written or unwritten, between each named executive officer and the acquiring company or the target company, concerning any type of compensation, whether present, deferred or contingent, that is based on or otherwise relates to an acquisition, merger, consolidation, sale or other disposition of all or substantially all assets. As described above, the table would quantify cash severance, equity awards that are accelerated or cashed out, pension and nonqualified deferred compensation enhancements, perquisites, tax reimbursements and the value of any other compensation related to the transaction.

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<sup>6</sup> Where Item 402(t) disclosure is included in an annual meeting proxy statement, such amounts would be calculated based on the closing market price per share of the issuer's securities on the last business day of the issuer's last completed fiscal year, consistent with quantification standards used in Item 402(j).

Item 402(t) would not require separate disclosure or quantification with respect to compensation otherwise required to be disclosed in the Pension Benefits Table and the Nonqualified Deferred Compensation Table, and Item 402(t) would also not require disclosure or quantification of previously vested equity awards. Item 402(t) would also not require disclosure and quantification of compensation from bona fide post-transaction employment agreements to be entered into in connection with the merger or acquisition transaction – the SEC notes that it does not view future employment arrangements as compensation “that is based on or otherwise relates to” the transaction.

Item 402(t) would require issuers to describe any material conditions or obligations applicable to the receipt of payment, including but not limited to non-compete, non-solicitation, non-disparagement or confidentiality agreements, their duration, and provisions regarding waiver or breach. Issuers would also be required to provide a description of the specific circumstances that would trigger payment, whether the payments would or could be lump sum, or annual, and their duration, and by who the payments would be provided, and any material factors regarding each agreement.

In order to minimize the regulatory disparity that might otherwise result if Item 402(t) disclosure were only required in proxy or consent solicitations in connection with an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets, the Proposed Rules would require that Item 402(t) disclosure also be included in information statements filed pursuant to Regulation 14C, proxy or consent solicitations that do not contain merger proposals but require disclosure of information under Item 14 of Schedule 14A pursuant to Note A of Schedule 14A, registration statements on Form S-4 and F-4 containing disclosure relating to mergers and similar transactions, going private transactions on Schedule 13E-3, and third-party tender offers on Schedule TO and Schedule 14D-9. While a bidder in a third-party tender offer would be required to provide information in its Schedule TO about a target’s golden parachute arrangements, such information will only be required to the extent the bidder has made a reasonable inquiry about the golden parachute arrangements and has knowledge of such arrangements.

**B. “Say on Golden Parachutes”.** The Act generally requires a separate shareholder advisory vote on golden parachute compensation arrangements required to be disclosed in connection with mergers and similar transactions. A separate shareholder advisory vote would not be required on golden parachute compensation if disclosure of that compensation has been included in the disclosure that was subject to a prior advisory vote of shareholders under the Act’s “say on pay” requirements. Under the Proposed Rules, issuers would be required to provide a separate shareholder advisory vote on golden parachute compensation arrangements only in proxy statements for meetings at which shareholders are asked to approve an acquisition, merger,

consolidation, or proposed sale or other disposition of all or substantially all assets (and not in all circumstances in which Item 402(t) disclosure is otherwise required).

The Proposed Rules would not require issuers to use any specific language or form of resolution to be voted on by shareholders, and the shareholder vote would not be binding on the issuer or its board of directors.

In the event an issuer has disclosed its golden parachute compensation arrangements as part of the disclosure that was subject to a prior advisory vote of shareholders under the Act's "say on pay" requirements but new arrangements have been adopted and/or the terms of existing golden parachute arrangements have been revised prior to the "say on golden parachutes" vote required by the Act, these new and revised arrangements would be subject to a non-binding shareholder vote. Issuers providing for such a shareholder vote would provide two separate tables in merger proxy statements: one table would disclose all golden parachute compensation, including both arrangements and amounts previously disclosed and subject to a "say on pay" vote and the new arrangements or revised terms; the second table would disclose only the new arrangements or revised terms subject to the "say on golden parachutes" vote so that shareholders can clearly identify what is subject to the "say on golden parachutes" vote.

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If you have any questions regarding this memorandum, please contact the individuals listed below or any other member of the Cadwalader Tax Department.

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# Clients & Friends Memo

## The Lincoln Amendment: Banks, Swap Dealers, National Treatment and the Future of the Amendment

December 14, 2010

One of the most contentious provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>1</sup> (the “**Dodd-Frank Act**”) is Section 716 – commonly referred to either as the “Lincoln Amendment” after its principal proponent, Senator Blanche Lincoln of Arkansas, or alternatively by its functional name, the “swaps push-out rule.” The Lincoln Amendment effectively forbids FDIC-insured institutions and other entities that have access to Federal Reserve credit facilities – including banks, thrifts, and U.S. branches of foreign banks – from acting as a “swap dealer”<sup>2</sup> except in certain limited circumstances, thus requiring such institutions to “push out” most swap dealing activities into an affiliate that is not FDIC insured and that does not otherwise access Federal Reserve credit facilities. The Lincoln Amendment will become effective in July 2012 and will have a significant, and likely not wholly anticipated, impact on banks and U.S. branches of foreign banks that are swap dealers – unless it is modified in the interim.

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<sup>1</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203, 124 Stat. 1376 (2010) (H.R. 4173) (the “**Dodd-Frank Act**” or “**DF**”). For further detail regarding the implications of the Dodd-Frank Act, please refer to Cadwalader’s series of memos on the Act, which you may find at the following address: [http://www.cadwalader.com/dodd\\_frank\\_act\\_memo.php](http://www.cadwalader.com/dodd_frank_act_memo.php).

<sup>2</sup> Unless otherwise indicated, the term “swap dealer” is used in this memorandum generally to refer to both “swap dealers” (who will be regulated by the CFTC) and “security-based swap dealers” (who will be regulated by the SEC). For further detail on the distinction between the two categories, please refer to Cadwalader’s summary of Title VII of the Dodd-Frank Act. See *The New Scheme for the Regulation of Swaps* (Cadwalader, July 20, 2010), available at [http://www.cadwalader.com/assets/client\\_friend/072010\\_DF7.pdf](http://www.cadwalader.com/assets/client_friend/072010_DF7.pdf).

Generally, a “swap dealer” is “any person who – (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.” See Dodd-Frank Act § 721(a)(49).

On December 7, 2010, the CFTC and the SEC issued a joint proposed rulemaking to define various terms, including “swap dealer” and “security-based swap dealer.” See *Commodity Futures Trading Commission and Securities and Exchange Commission, Joint Proposed Rule & Joint Proposed Interpretations, Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” Major Swap Participant,” “Major Security-Based Swap Participant,” and “Eligible Contract Participant,”* \_\_\_ FED REG. \_\_\_ (Dec. 2010) (the “**Dealer Definition Release**”).

### History of the Lincoln Amendment

Neither the House version of the financial reform legislation, which passed the House in December 2009 (H.R. 4173), nor the initial version of the legislation introduced in the Senate in April 2010 (S. 3217) contained a provision comparable to the Lincoln Amendment. Both bills provided for the regulation and registration of over-the-counter swap dealers and major swap participants,<sup>3</sup> including banks acting in either capacity, and would not have required FDIC-insured entities to terminate their swap dealing activities. The first proposed prohibition on banks engaged in swap dealing was put forward by Senator Lincoln, then the Chair of the Senate Agriculture Committee, as part of an alternative version of derivatives legislation approved by the Senate Agriculture Committee in April 2010.

The Senate Agriculture Committee's alternative language, in particular the push-out rule, then became the subject of heated debate throughout April and May. Opponents of the Lincoln Amendment pointed out that there was no indication that swaps trading by insured depository institutions had been a material contributor to the financial crisis that the Dodd-Frank Act was intended to address. Both Federal Reserve Chairman Ben Bernanke and FDIC Chair Sheila Bair submitted letters opposing the push-out provision, arguing that the push-out of swaps activities would harm banks and would place swap dealing activities in a less regulated environment.<sup>4</sup> The Lincoln Amendment was also opposed by a number of Republican and Democratic Senators. In spite of this bipartisan opposition, and perhaps out of fear that removal of the provision would alienate Senator Lincoln and the provision's other proponents and therefore might undermine passage of the entire financial reform bill or might hurt Senator Lincoln's chances of re-election, the Lincoln Amendment survived and was included in the final bill approved by the Senate on May 20, 2010.

In the House-Senate conference, the debate over the Lincoln Amendment continued and threatened to delay the conference process. In conference, several changes were made to soften Section 716's impact, or at least delay the problems it might cause:

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<sup>3</sup> This memorandum will refer to "major swap participants" and "major security-based swap participants" under the general rubric of "major swap participants." See *The New Scheme for the Regulation of Swaps*, *supra*, fn. 2.

<sup>4</sup> See Letter from Sheila Bair, Chairman, Federal Deposit Insurance Corp., to Senators Christopher Dodd and Blanche Lincoln (Apr. 30, 2010), *reprinted in* 111 CONG. REC. S3069-70 (May 4, 2010) (Bair Letter); Letter from Chairman Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, to Senator Christopher Dodd (May 12, 2010). ("Forcing these [swap dealers and major participant] activities out of insured depository institutions would weaken both financial stability and strong prudential regulation of derivative activities").

- The effective date of Section 716 was postponed until July 2012 (instead of the July 2011 effective date applicable to the bulk of the swaps provisions – Title VII – of the bill),<sup>5</sup> and a discretionary two-year transition period was added.<sup>6</sup>
- The push-out clause of Section 716 was made prospective, thus allowing an insured depository institution to retain any swap arrangement that was executed prior to the end of the transition period.<sup>7</sup>
- Additional provisions were added to Section 716, providing that the push-out requirement would not preclude a *bank or thrift holding company* or *nonbank affiliate* from acting as a swap dealer, or preclude an insured depository institution from engaging in hedging activities or acting as a swap dealer involving certain bank-eligible securities.<sup>8</sup>
- In addition, a provision was added clarifying that the push-out did not preclude an insured depository institution from being merely a major swap *participant* rather than a swap *dealer*.<sup>9</sup>

As modified, Section 716 survived the conference process. The Dodd-Frank Act, including the modified Section 716, passed both the House and the Senate and was signed into law on July 21, 2010.

### How the Push-Out Works

Section 716 does not directly forbid a covered entity from engaging in swap dealing activities. Rather, in a somewhat circuitous fashion, Section 716 provides that, after the transition period, no “Federal assistance” may be provided to a “swaps entity” (a term that is itself defined to mean either a swap dealer or a major participant) other than an insured depository institution that is a *major swap participant*. For purposes of Section 716, *Federal assistance* is defined as including:

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<sup>5</sup> Compare DFA § 716(h) with DFA §§ 712, 754 & 774 (imposing an effective date of 360 days after enactment for other provisions of Title VII).

<sup>6</sup> DFA § 716(f). While Section 716 is somewhat ambiguous regarding when the two-year transition period begins, it appears to begin when the insured depository institution would otherwise be subject to the prohibition on Federal assistance, *i.e.*, in July 2012. The two-year discretionary transition period is extendable for up to one additional year. *Id.*

<sup>7</sup> See DFA § 716(e).

<sup>8</sup> See DFA § 716(c). This safe harbor for affiliates of insured depository institutions applies only to the extent the affiliate is part of a bank holding company or savings and loan holding company structure. Thus, under a strict reading of Section 716, an insured depository institution that is *not* part of a bank holding company or savings and loan holding structure – such as nonbank bank – would be required to cease swap and security-based swap dealing activity altogether and would be unable to push out these activities to an affiliate. It is not clear that this result was intended.

<sup>9</sup> See DFA § 716(b)(2)(B).

- Use of any advances from any Federal Reserve credit facility or discount window that is not part of a program with broad-based eligibility under Section 13(3)(A) of the Federal Reserve Act;<sup>10</sup> and
- Federal Deposit Insurance Corporation insurance or guarantees.<sup>11</sup>

Inasmuch as maintenance of FDIC insurance is a requirement for all national banks, all federal thrifts, all state Member banks, and all (if not virtually all) state non-Member banks and state thrifts, Section 716 effectively precludes a bank or thrift from being a “*swap dealer*” after the effective date of the Lincoln Amendment.

In a similar fashion, the push-out would apply to those branches of foreign banks operating in the U.S. that solicit retail deposits in the U.S. and therefore have obtained FDIC insurance: FDIC-insured branches of foreign banks are considered “insured depository institutions” under federal banking law.<sup>12</sup> These FDIC-insured foreign branches would be required also to push out any dealing activity into an affiliate (or alternatively forego Federal assistance, including FDIC insurance).

As described in greater detail below, the push-out would appear to apply as well to uninsured branches of foreign banks which, although not insured by the FDIC, have access to Federal Reserve credit facilities and the Federal Reserve discount window, both of which are “Federal assistance” prohibited to swap dealers.

### **What Activity is Prohibited?**

As stated above, Section 716 effectively prohibits an insured depository institution from acting as a *swap dealer* (or *security-based swap dealer*). In Section 721, a *swap dealer* is defined as any person who:

- holds itself out as a dealer in swaps;
- makes a market in swaps;
- regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

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<sup>10</sup> 12 U.S.C. § 343.

<sup>11</sup> DFA § 716(b).

<sup>12</sup> See 12 CFR Part 347 (requiring FDIC insurance coverage for nongrandfathered U.S. branches of foreign banks that solicit “retail deposits” – deposits in increments less than the FDIC insurance limit of \$250,000 – from U.S. residents). While “insured depository institution” is not defined in Section 716, for Federal Deposit Insurance Act purposes the term includes an FDIC-insured branch of a foreign bank. See 12 U.S.C. § 1813.

- engages in any activity causing it to be commonly known in the trade as a dealer or market maker in swaps.<sup>13</sup>

Section 721 excludes from the definition of *swap dealer*<sup>14</sup> an “insured depository institution” that offers to enter into swap with a customer in connection with originating a loan to that customer.<sup>15</sup>

The definitions of *swap dealer* (and *security-based swap dealer*) carve out swap and security-based swap transactions in which the entity is entering into transactions for its own account “but not as a part of a regular business.” Thus, an entity would be permitted to transact in swaps or security-based swaps provided it was not carrying on a “business” (for example, transacting swaps for any internal purpose) without regard to Section 716’s push-out requirement, because the entity would not be considered a *swap dealer* (or *security-based swap dealer*). Similarly, Section 716(b) states that an insured depository institution that is a major swap *participant* – but not a *swap dealer* – is not subject to the prohibition against Federal assistance.

Notwithstanding the foregoing, a separate provision – Section 716(d) – purports to limit the swaps activities of *insured depository institutions*:

The prohibition in subsection (a) [*i.e.*, the denial of Federal assistance] shall apply to any insured depository institution unless the insured depository institution limits its swap or security-based swap activities to . . . [h]edging and other similar risk mitigating activities directly related to the insured institution’s activities [or] [a]cting as a swaps entity for swaps or security-based swaps involving rates or reference assets that are permissible for investment by a national bank ....<sup>16</sup>

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<sup>13</sup> DFA § 721 (amending the Commodity Exchange Act).

<sup>14</sup> *Id.* A virtually identical definition is created for security-based swap dealer in Section 761 with respect to activities in which the underlying instrument is a security-based swap – although there is no exclusion for entities that offer to enter into security-based swaps in connection with a loan. See DFA § 761 (amending the Securities Exchange Act of 1934). For a discussion of the SEC’s and CFTC’s proposal with respect to swaps entered into “in connection with” a loan, see the Dealer Definition Release, *supra* n. 2, at 31-34.

<sup>15</sup> In the Dealer Definition Release, the CFTC, as part of its proposed definition of the term swap dealer, suggested that it would allow the excluded swap to relate to a “rate, asset, liability or other notional item” so long as the swap “directly related” to the financial terms of the loan. Further, the CFTC would define the term “originated” broadly so as to include almost any situation in which an insured depository institution extended credit to a customer, including where the bank had purchased a participation in a loan; however, the proposed rule expressly excludes swaps in connection with any “synthetic loan” including a loan CDS or a loan total return swap.

<sup>16</sup> DFA § 716(d)(1). A separate provision of Section 716 makes it clear that the Volcker Rule – Section 619 of DFA – applies to swap activities of insured depository institutions. See DFA § 716(m). Thus, insured depository institutions would be unable to engage in proprietary trading in swaps or security-based swaps unless an exemption can be found under Section 619. For an in-depth discussion of the Volcker Rule, please refer to Cadwalader’s Clients & Friends Memo, An Analysis of the Dodd-Frank Act’s Volcker Rule, [http://www.cadwalader.com/assets/client\\_friend/101510VolckerRuleAnalysis.pdf](http://www.cadwalader.com/assets/client_friend/101510VolckerRuleAnalysis.pdf).

To the extent Section 716(d) suggests that an insured depository institution must limit its non-dealing swaps activities to certain hedging activities and bank-eligible swaps, Section 716(d) appears to be inconsistent with an earlier provision, Section 716(b)(2)(B), which provides that an insured depository institution is *not* considered a *swaps entity* (and therefore *not* subject to the push-out) if it is merely a *major swap participant* rather than a *swap dealer*. Unfortunately Section 716(d) and Section 716(b)(2)(B) were not fully reconciled, and the exact scope of swaps activities that may remain in an insured depository institution remains unclear.<sup>17</sup>

### Exemptions

As mentioned above, Section 716 creates a few express exemptions to its push-out requirement:

*Interest Rate Swaps.* Section 716(d)(2) allows an *insured depository institution* to transact in swaps if the swap involves rates.<sup>18</sup> Thus, interest rate swaps are exempted from the push-out requirement entirely, and insured depository institutions are free to continue to transact in them.

*Swaps Involving Bank Eligible Assets.* Likewise, Section 716(d)(2) allows an *insured depository institution* to transact in swaps involving assets eligible for investment by a national bank,<sup>19</sup> which would include swaps referencing the following types of assets:

- loans;
- certain bank-eligible asset backed securities;
- U.S. government and agency securities;
- certain state and subdivision general obligation securities and certain municipal bonds;
- foreign currency;<sup>20</sup>

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<sup>17</sup> Provided that the activities of the insured depository institution do not rise to the level of being a swap dealer, it appears that Congress did not intend to require push-out. See 111 CONG. REC. S5922 (July 15, 2010) (statement by Sen. Lincoln that the Conference Committee “also clarified in Section 716 that banks which are major swap participants are not subject to the federal assistance bans”). However, this interpretation renders the hedging and bank-eligible swaps restrictions of Section 716(d) as somewhat superfluous.

<sup>18</sup> DFA § 716(d)(2).

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

<sup>20</sup> Although a full discussion of the issue is outside the scope of this memorandum, entities within the potential scope of the Lincoln Amendment should also be aware that Title VII affects foreign currency transactions in a variety of complicated, and still to-be-determined, ways. Most significantly, the Dodd-Frank Act includes both foreign exchange swaps and forwards in the definition of the term “swap,” and therefore subjects both types of transactions to the Commodity Exchange Act (“CEA”),

- bullion;
- marketable corporate grade debt securities;
- certain international development bank securities; and
- certain Canadian federal and provincial securities.<sup>21</sup>

Notwithstanding the foregoing, the bank-eligibles exemption does not permit an insured depository institution to transact in credit default swaps (“CDS”), including CDS referencing the credit risk of asset backed securities, unless the swap is cleared by a registered derivatives clearing organization or clearing agency.<sup>22</sup>

*Hedging Activities.* Under Section 716(d)(1), an exemption is created for “hedging and other similar risk mitigating activities directly related to the insured depository institution’s activities.” As mentioned earlier, this exemption seemingly was added in conference to address concerns raised by FDIC Chairman Bair and Federal Reserve Chairman Bernanke that Section 716 would be harmful to banks by forbidding them to use swaps to hedge the bank’s risk. Unfortunately, there is no guidance as yet on what would constitute a “direct” relationship between swap dealing activities and the bank’s other activities, so the meaning of 716(d)(1) is not yet clear.<sup>23</sup>

### Implications of the Push Out Requirement

Because of the limited exemptions afforded certain categories of swaps in Section 716, U.S. banks and U.S. branches of foreign banks will be required either

- (i) to bifurcate their swaps desks between (x) interest rate swaps and other bank-eligible swaps, which may remain in the bank or branch, and (y) all other swaps, which must be pushed to the holding company or another affiliate; or

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unless the Secretary of the Treasury makes a written determination that such transactions should not be regulated as swaps and are not structured with an improper purpose. In making this determination, the Secretary is required to consider *inter alia* the adequacy of supervision by bank regulations. However, foreign exchange transactions that receive this treatment nevertheless must comply with reporting requirements for swaps and business conduct standards. DFA § 721 (to be codified at CEA § 1a(47)(E)).

<sup>21</sup> See 12 U.S.C. § 24 (Seventh); see also 12 C.F.R. Part 1.

<sup>22</sup> As not all CDS can currently be cleared, this limitation on banks entering into CDS could significantly inhibit banks’ ability to hedge lending risk. Either banks would be forced to retain commercial lending risk or they will be limited to distributing that risk through loan syndications and participations, arguably far more cumbersome and expensive hedging processes than buying credit protection by entering into a CDS. However, inasmuch as the CDS clearing requirement applies solely to the bank-eligibles exemption and does not apply to the hedging exemption, it appears that a bank may continue to transact in non-cleared CDS provided that the activity is part of the bank’s hedging or risk management activities.

<sup>23</sup> DFA § 716(d)(1).

(ii) to push their entire swaps desks into the holding company or affiliate.

Neither alternative is attractive. The latter alternative would require clients to conduct swaps business with two separate entities within the bank holding company structure and would deprive the client of the netting privileges and other efficiencies that are inherent in doing business with a single legal entity. The former alternative would require the bank holding company to conduct all of its swaps desk activities outside the bank in an entity that typically carries a much higher internal cost of funds, and to maintain a large pool of capital – separate from the capital maintained at the bank – in order to support the pushed-out swap dealing activities.

Either alternative will also make banks less attractive counterparties to commercial and financial customers. Customers who are effectively pushed out of the bank will be effectively forced to transact with an entity that is smaller and likely less creditworthy than the bank itself. Customers whose business is split between the bank and another affiliate will now have to deal with double the documentation, additional operational issues, and the increases in credit risk (e.g., loss of netting) that result from an inability to consolidate transactions with a single counterparty.

Regardless which alternative is adopted, U.S. banks and bank holding companies will be less competitive with entities not subject to Section 716, such as foreign banks without a U.S. banking presence.

### **Application to U.S. Branches of Foreign Banks**

The reach of Section 716 to U.S. branches of foreign banks is unclear, largely due to ambiguous drafting. Section 716's denial of Federal assistance was written quite broadly, and applies to any *swaps entity*, presumably including any foreign bank that maintains an insured or uninsured branch in the United States engaged in swaps activities. To the extent such entities receive "Federal assistance", either in the form of FDIC insurance or access to Federal Reserve credit facilities (such as the discount window) – which they often do – Section 716 would require push-out of the swaps activities.

However, the *exemptions* to Section 716 were written much more narrowly, and apply only to an *insured depository institution*. For example, the *major swap participant* definition, and the hedging, interest rate, and bank-eligible assets exemptions, are available only to "insured depository institutions." The exclusion for swaps offered in connection with a loan, embedded in the definition of *swap dealer*, also applies only to insured depository institutions. Likewise, the transition period as well as the provision carving out swaps entered into prior to the expiration of the transition period, are available only to insured depository institutions. The safe harbor (clarifying that affiliates may continue to engage in swaps activities) is available only to affiliates of an insured depository institution that is "part of bank holding company" or "savings and loan holding company."

*Application to FDIC-Insured Branches.* The FDIC-insured branches of a foreign bank are considered “insured depository institutions” for purposes of the Federal Deposit Insurance Act,<sup>24</sup> and therefore insured U.S. branches of a foreign bank would be permitted to act as a *major swap participant* and would remain eligible for the hedging, interest rate, and bank-eligible assets exemption, and the exclusion for swaps originated in connection with a loan. Likewise, insured U.S. branches of foreign banks may be comfortable that swaps entered into between now and the end of the transaction period are not subject to the prohibition. However, insured U.S. branches of foreign banks are typically not part of a “bank holding company” or “savings and loan holding company,” and the safe harbor provision therefore would not seem to apply. In short, FDIC-insured branches of foreign banks would be treated much like a U.S. bank in terms of the push-out purposes, but would not have the benefit of the safe harbor, which also raises questions of fair national treatment. In this regard, it is also notable that the exclusions as to bank-eligible swaps in Section 716 encompass a variety of U.S. assets, such as U.S. governments and state obligations, but there are no comparable exemptions for swaps on assets of governmental entities outside the United States other than Canada.

*Application to Uninsured Branches.* Uninsured branches of a foreign banks are *not* considered insured depository institutions for most purposes. Read literally, none of Section 716’s swaps exemptions would be available to uninsured branches. To the extent that an uninsured branch is deemed a *swaps entity*, which could happen as early as July 2012, the uninsured branch would be required to cease its swaps activities or forego access to the Federal Reserve credit facilities (including the discount window). This cessation would be required to occur *immediately*, because the transition period – which delays the application of the push-out – also is available only to insured depository institutions. Thus, uninsured branches of foreign banks would be treated in a dramatically harsher fashion from their FDIC-insured counterparts.

In light of the various inconsistencies in the treatment of insured and uninsured branches by the Lincoln Amendment, after the Conference Committee voted out the bill but before full Senate approval, on July 15, 2010 Senator Lincoln made a statement on the floor of the Senate, stating that it was not the intent of the Senate to exclude uninsured branches of foreign banks from the exemptions and safe harbors, and that they should be treated under Section 716 in the same fashion as insured branches of foreign banks. At the same time, Senator Dodd indicated that this would likely be addressed on a technical corrections bill.<sup>25</sup>

Given the ambiguities within Section 716, it seems likely that some form of technical corrections bill should be entered to resolve some of the significant drafting errors – although any technical

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<sup>24</sup> See 12 U.S.C. § 1813(a)(1), (c)(2).

<sup>25</sup> 111 CONG. REC. S 5903-5904 (July 15, 2010).

corrections bill will not likely be introduced by Senator Lincoln, who did not win her re-election bid in November 2010. Regardless, it remains to be seen whether Congress will go further and attempt to scale back a provision of Dodd-Frank that was introduced late in the process, not widely supported at the time, raises significant questions of fair national treatment, and remains controversial to this date.

\* \* \* \*

We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this Memorandum.

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# Clients & Friends Memo

## SEC Issues Final Rules for New Disclosure Requirements Regarding Representations and Warranties in Asset-Backed Securities Offerings

February 1, 2011

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) was signed into law by President Obama on July 21, 2010.\* Section 943 of the Act requires the Securities and Exchange Commission (the “SEC”) to prescribe regulations on the use of representations and warranties in the market for asset-backed securities.<sup>1</sup> Such regulations must provide for disclosure by “securitizers,” as defined in the Act, of fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer. They also require a description by nationally recognized statistical rating organizations (“NRSROs”), in reports accompanying credit ratings of securitization transactions, of the representations, warranties and enforcement mechanisms contained in each transaction and how they differ from those contained in issues of similar securities.

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\* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act’s application to specific industries, entities and transactions. To see these other memoranda, please see [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

<sup>1</sup> Section 943 of the Act reads as follows:

REPRESENTATIONS AND WARRANTIES IN ASSET-BACKED OFFERINGS.

Not later than 180 days after the date of enactment of this Act, the Securities and Exchange Commission shall prescribe regulations on the use of representations and warranties in the market for asset-backed securities (as that term is defined in section 3(a)(77) of the Securities Exchange Act of 1934, as added by this subtitle) that—

(1) require each national (*sic.*) recognized statistical rating organization to include in any report accompanying a credit rating a description of—

(A) the representations, warranties, and enforcement mechanisms available to investors; and

(B) how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities; and

(2) require any securitizer (as that term is defined in section 15G(a) of the Securities Exchange Act of 1934, as added by this subtitle) to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies.

On October 4, 2010, the SEC released its proposed rule<sup>2</sup> (the “**Proposed Rule**”) pursuant to Section 943 of the Act.<sup>3</sup> On January 21, 2011, the SEC issued its [final rule](#) (the “**Final Rule**”) that requires (a) new disclosures applicable to any “securitizer” with respect to “asset-backed securities” (each as defined in the Act and described below) to be filed pursuant to a new Form ABS-15G, (b) new disclosures for prospectuses and reports on Form 10-D under Regulation AB and (c) new disclosures for NRSROs rating new issues of asset-backed securities.<sup>4</sup> The Final Rule becomes effective March 27, 2011.<sup>5</sup>

In order to allow the affected participants to set up their systems and gather and track the applicable data, the SEC has adopted the following transition period for compliance with the Final Rule:

- securitizers required to file first Form ABS-15G commencing February 14, 2012;<sup>6</sup>
- securitizer required to comply with new Regulation AB prospectus disclosure requirements commencing with first bona fide offering of registered Exchange Act ABS on or after February 14, 2012;
- securitizer required to comply with new Regulation AB Form 10-D requirements commencing with the first Form 10-D filing after December 31, 2011; and
- NRSROs required to comply with new disclosure requirements commencing six months after the effective date of the Final Rule.

### **New Disclosure Requirements Applicable to Securitizers of Exchange Act ABS**

#### **Overview**

The SEC explains that Section 943(2) of the Act was a response to a perceived lack of effectiveness of the buy-back covenants in asset-backed securities transaction documents where breaches of underlying asset-level representations and warranties were alleged. The SEC believes that by mandating detailed reporting requirements of all repurchase requests and the ultimate

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<sup>2</sup> *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC Release Nos. 33-9148; 34-63029 (October 4, 2010).

<sup>3</sup> See our Client & Friends Memo, [SEC Proposes New Disclosure Requirements regarding Representations and Warranties in Asset-Backed Securities Offerings](#), October 18, 2010.

<sup>4</sup> *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 76 Fed. Reg. 4489 (January 26, 2011) (amending 17 CFR pts. 229, 232, 240 and 249). See <http://www.sec.gov/rules/final/2011/33-9175fr.pdf>.

<sup>5</sup> Sixty days after its publication in the Federal Register.

<sup>6</sup> An additional three-year transition period was implemented for municipal securitizers, whose first filing is due February 14, 2015.

results of the requests to investors in both registered and unregistered asset-backed securities offerings, investors would have sufficient information to identify asset originators “with clear underwriting deficiencies, as mandated by Section 943 of the Act.”

To that end, the SEC is adopting new Rules 15Ga-1 and 17g-7 to the Securities Exchange Act of 1934, as amended (the “**Exchange Act**”), new Form ABS-15G and amendments to Regulation AB, in order to satisfy the requirements of Section 943(2).

#### **Applicability of disclosure requirements of new Rule 15Ga-1**

The disclosure requirements of new Rule 15Ga-1 would apply to asset-backed securities, as defined in the Act (“**Exchange Act ABS**”), which is substantially broader than the definition set forth in Regulation AB. The definition of Exchange Act ABS includes securities that are typically sold in transactions that are exempt from the registration requirements of the Securities Act of 1933, as amended (the “**Securities Act**”).<sup>7</sup>

The new disclosure requirements apply to any “securitizer”, which is broadly defined in the Act to include issuers, sponsors and depositors.<sup>8</sup> The SEC states that this definition is intended to apply to any entity or person that issues or organizes an Exchange Act ABS transaction, including asset-backed securities issued or guaranteed by government-sponsored enterprises, such as Fannie Mae and Freddie Mac, or municipal issuers.<sup>9</sup>

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<sup>7</sup> “Asset backed security (A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including— (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.” See Section 3(a)(77) of the Exchange Act, as amended by the Act.

<sup>8</sup> “Securitizer means (A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.” See Section 15G(a)(3) of the Exchange Act, as amended by the Act. The Final Rule allows affiliated sponsors and depositors to make only one filing, taking into account that “securitizers” is broad enough that affiliated sponsors and depositors could otherwise be required to separately file the same information. Note that this single filing is only available where multiple securitizers are affiliates. 76 Fed. Reg. 4491.

<sup>9</sup> 76 Fed. Reg. 4490-91. The Commission specifies that the Rule applies to Fannie Mae, Freddie Mac and municipal entities, as well as entities engaged in private offerings under Rule 144A and other exemptions from the registration requirements of the Securities Act, but the Final Rule provides for an additional three-year transition period for municipal securitizers, with an initial filing required on February 14, 2015 covering the three years ending on December 31, 2014 (76 Fed. Reg. 4505).

*Note: The SEC acknowledges that both sponsors and depositors fit within the statutory definition of securitizer, which could lead to duplicative filings by sponsors and affiliated depositors of a sponsor. In response, the SEC provides that if a sponsor files all disclosures required under Rule 15Ga-1, which includes disclosures of the activity of affiliated depositors, those affiliated depositors would not have to separately provide and file the same disclosures.<sup>10</sup> Similarly, if all depositors affiliated with a sponsor separately file disclosures with respect to all of their respective trusts, the sponsor would not have to separately provide and file the same disclosures.<sup>11</sup>*

The scope of Rule 15Ga-1 is limited to Exchange Act ABS transactions where the underlying documents contain a covenant to repurchase or replace assets in the event of a breach of a representation or warranty. Within the context of such transactions, both the applicability of the rule and the scope of the new reporting requirements are quite broad. It is important to note that Rule 15Ga-1 has no application to any transaction that does not require repurchase or replacement of assets as a remedy for breaches of representations and warranties.

*Note: Traditional CDO and CLO transactions and other second and third-level securitizations that do not have repurchase requirements would not be impacted by Rule 15Ga-1. Issuers and originators should note, however, that if such a feature were added to any new CDO or CLO products as part of a revitalization of the CDO/CLO market, issuers and originators would be required to comply with the new disclosure requirements, even if such offerings are conducted under Rule 144A or Regulation S of the Securities Act or are otherwise structured to be exempt from the registration requirements of the Securities Act.*

#### **Disclosures required under Rule 15Ga-1; Form ABS-15G**

Rule 15Ga-1 requires any securitizer of Exchange Act ABS to disclose all fulfilled and unfulfilled requests for asset repurchases or replacements based on breach of representation or warranty across all securitizations aggregated by the securitizer for the applicable periods as discussed below.<sup>12</sup> This disclosure is required regardless of whether or not there is any merit to the request, whether the representations and warranties relate specifically to underwriting standards, whether or not the request is fulfilled or unfulfilled and regardless of whether the request is made by the transaction trustee at its own initiative or pursuant to a request received by the trustee from

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<sup>10</sup> 76 Fed. Reg. 4491.

<sup>11</sup> 76 Fed. Reg. 4498, fn 82.

<sup>12</sup> 76 Fed. Reg. 4500.

investors. The disclosure is required for all assets securitized by the securitizer<sup>13</sup> that are included in outstanding Exchange Act ABS transactions, regardless of asset class, where any such securities are held by non-affiliates of the securitizer and where a repurchase covenant for breaches of representations and warranties exists.<sup>14</sup>

The disclosures must be made on Form ABS-15G, and filed with the SEC on EDGAR. The form must be signed by the senior officer of the securitizer in charge of the securitization.<sup>15</sup> Because disclosure is required of all repurchase requests, whether or not the repurchase is consummated, the Final Rule provides for columns in Form ABS 15-G for repurchase requests that have not been satisfied, with columns for repurchase demands that have been disputed, withdrawn or rejected.<sup>16</sup>

As discussed above, disclosure is required of all repurchase demands, whether initiated by the trustee on its own or by investor demands upon a trustee, irrespective of the trustee's determination to make a repurchase demand on a securitizer based on such investor demand. In this regard, the SEC acknowledges the concern that a securitizer may not be able to obtain complete information from trustees that did not previously keep track of investor requests for repurchase received by the trustee. The Final Rule provides that, to the extent a securitizer is unable initially to complete information on Form ABS 15-G, securitizers may include a footnote in the form if they are unable to obtain all information with respect to investor demands upon a trustee that occurred prior to July 22, 2010.<sup>17</sup>

In response to comments that historical data may not be readily available to securitizers who did not have systems in place at the time to track it, the Final Rule permits securitizers to omit information that is unknown or not reasonably available without unreasonable effort or expense, provided that the securitizer includes in the report a statement showing that unreasonable effort or expense would be required to obtain the omitted information.<sup>18</sup>

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<sup>13</sup> The Proposed Rule would have required disclosure of repurchase requests relating to assets "originated or sold" by a securitizer. The SEC agreed with commentators that the proposed wording could have required disclosure about transfers of assets that were not securitized so the Final Rule requires disclosure only as to assets securitized by securitizers. 76 Fed. Reg. 4492, 4496.

<sup>14</sup> 76 Fed. Reg. 4492, 4496.

<sup>15</sup> 76 Fed. Reg. 4500.

<sup>16</sup> 76 Fed. Reg. 4499. The Proposed Rule would have allowed securitizers to footnote explanatory information to explain why repurchase requests were not satisfied. Instead, this information will be included in the tabular reporting on Form ABS-15G.

<sup>17</sup> 76 Fed. Reg. 4514.

<sup>18</sup> 76 Fed. Reg. 4509.

Form ABS-15G requires reporting in tabular format of the following information with respect to the applicable Exchange Act ABS, organized by asset class and, within each asset class by issuing entity in order of the date of its formation:

- name of each originator,
- total assets in the securitization by each such originator,
- number, principal balance and percentage of assets subject to a demand for repurchase or replacement,
- number, principal balance and percentage of assets repurchased or replaced,
- number, principal balance and percentage of assets pending repurchase or replacement (relevant, for example, where repurchase or replacement was demanded but a cure period that is longer than the reporting period has not expired),
- number, principal balance and percentage of assets subject to repurchase demands that are in dispute,
- number, principal balance and percentage of assets subject to repurchase demands that have been withdrawn, and
- number, principal balance and percentage of assets subject to repurchase demands that have been rejected.

A “check the box” column is included to denote whether the issuing entity involved a registered transaction, in which case disclosure of its CIK number is also required.<sup>19</sup> Principal balances of assets and percentages of the asset pool they represent are required to be calculated based on asset and pool balances on the last day of the relevant period covered by the Form ABS-15G filing. A copy of the tabular format required to be used in Form ABS-15G is attached as an annex to this memorandum.

### **Filing Requirements**

#### **Initial Report**

Any securitizer that issued an Exchange-Act ABS during the three-year period ended December 31, 2011 that includes a covenant to repurchase or replace an underlying asset for breach of representation or warranty will be required to file an initial Form ABS-15G no later than

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<sup>19</sup> 76 Fed. Reg. 4498 and Form ABS-15G.

45 days after the end of the three-year period, or February 14, 2012.<sup>20</sup> The initial disclosures are limited to the last three years of activity.<sup>21</sup>

#### Quarterly Reports

Updated disclosures are required on a quarterly basis, by Filing Form ABS-15G on EDGAR<sup>22</sup> within 45 days of the end of each calendar quarter by any securitizer that:

- issued an Exchange Act ABS during the prior quarter;
- organized and initiated an Exchange Act ABS during the prior quarter by securitizing an asset, either directly or indirectly, including through an affiliate; or
- had outstanding Exchange Act ABS held by non-affiliates in the calendar quarter;

where, in each case, the underlying transaction agreements provide a covenant to repurchase or replace an underlying asset for breach of a representation or warranty.<sup>23</sup>

Quarterly reporting is not cumulative and only needs to present the information for the most recent quarter. Where a securitizer has had no repurchase or replacement demands during the previous calendar quarter, it may check a box on Form ABS-15G and then suspend quarterly reporting until there is such a demand. An annual filing would still be required to confirm that there has been no reportable activity since the previous filing. Securitizers are allowed to terminate reporting obligations with respect to an Exchange Act ABS when the last payment is made on such Exchange Act ABS outstanding held by a non-affiliate that was issued by the securitizer or an affiliate.<sup>24</sup>

*Note: Unlike the trigger for the initial filing, because the quarterly Form ABS-15G filing requirement applies to any securitizer that issued an Exchange Act ABS during the reporting period or had outstanding Exchange Act ABS held by non-affiliates during the reporting period, the obligation to file quarterly reports beginning with the quarter ending March 31, 2012 may apply to existing securitizers who are not required to make an initial*

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<sup>20</sup> 76 Fed. Reg. 4500. This is a change from the Proposed Rule, which proposed the initial filing be done in connection with securitizer's first offer of an Exchange Act-ABS. Note that, as discussed above, there is a further 3-year delay for municipal securitizers, with the first report due on February 14, 2015.

<sup>21</sup> 76 Fed. Reg. 4500. Activity during the three-year period is required to be reported, even if the initial demand occurred prior to such period. The Proposed Rule had proposed a five-year look-back.

<sup>22</sup> Municipal securitizers are allowed to file on EMMA instead of EDGAR.

<sup>23</sup> 76 Fed. Reg. 4514.

<sup>24</sup> 76 Fed. Reg. 4514-4515.

*filing covering the three-year period ending December 31, 2011. It is not clear from the release adopting the Final Rule whether the SEC intended this trap for the unwary, and industry clarification on this point prior to the compliance date is advisable.*

### **Considerations for exempt transactions**

The SEC has adopted Form ABS-15G for providing the disclosures required by new Rule 15Ga-1 and is requiring that it be filed on EDGAR, even for unregistered transactions.<sup>25</sup> Securitizers of Exchange Act ABS offerings that are unregistered should note that, although the SEC states that filing Form ABS-15G would not foreclose reliance by an issuer on the private offering exemption and the safe harbor for offshore transactions from the registration requirements of Section 5 of the Securities Act, the SEC also noted in the Proposed Rule that inclusion in a Form ABS-15G filing of information beyond what is required by Rule 15Ga-1 may jeopardize such reliance by constituting a public offering or conditioning the market for the securities being offered under an exemption.<sup>26</sup>

*Note: Securitizers involved in unregistered offerings should limit disclosures to the strict requirements of Rule 15Ga-1.*

In the Final Rule, the SEC repeated its view stated in the Proposed Rule that filing Form ABS-15G would not foreclose reliance by an issuer on the private offering exemption and safe harbor for offshore transactions.<sup>27</sup>

### **Certain Amendments to Regulation AB**

The SEC notes that there is overlap between its proposal to update the disclosure requirements of Regulation AB pursuant to the SEC's release of April 7, 2010<sup>28</sup> and the disclosure requirements of Section 943 of the Act. However, the requirements of Section 943(2) go beyond the SEC's prior Regulation AB proposals. The prior Regulation AB proposals would impose similar disclosure obligations for fulfilled and unfulfilled repurchase requests, but only for registered offerings and only if the amount of publicly securitized assets subject to repurchase or replacement is material.

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<sup>25</sup> 76 Fed. Reg. 4500-4501.

<sup>26</sup> Proposed Rule, page 18, fn 34.

<sup>27</sup> 76 Fed. Reg. 4499.

<sup>28</sup> See *Asset Backed Securities*, 75 Fed. Reg. 23328 (April 7, 2010). Cadwalader has prepared a memorandum summarizing and discussing these proposed amendments to Regulation AB. See *SEC Announces Proposal to Significantly Enhance the Regulation of Asset-Backed Securities* (April 20, 2010), which may be accessed on our website at [http://www.cadwalader.com/assets/client\\_friend/042010SEC\\_Enhancements.pdf](http://www.cadwalader.com/assets/client_friend/042010SEC_Enhancements.pdf).

Under the Final Rule, the SEC amended Items 1104 and 1121 of Regulation AB. These amendments will now require disclosures, within prospectuses and ongoing reports on Form 10-D, of securitized assets subject to repurchase or replacement to be reported in the tabular format set forth in Rule 15Ga-1. Prospectus disclosure is required for a three-year look-back period and is limited to the same asset class as the registered securities that are the subject of the offering, while Form 10-D reporting is limited to the period otherwise covered by the report and to the assets of the issuing entity that is the subject of the report.<sup>29</sup>

Because Section 943(2) of the Act does not contain a materiality threshold, the SEC removed the materiality thresholds it had proposed under Items 1104 and 1121 in its April 7, 2010 release. In addition, the Final Rule requires all prospectuses in registered offerings and all reports on Form 10-D to reference the most recent Form ABS-15G filing made by the securitizer and to disclose the CIK number of the securitizer so that investors may easily locate Form ABS-15G filings of such securitizer on EDGAR.

The Final Rule provides that information presented in a prospectus not be more than 135 days old, which the SEC believes will reduce the burdens on securitizers because it is consistent with the disclosure conventions for static pool and interim financial information.<sup>30</sup> In response to comments that older reliable information may not be available, the SEC is phasing in the disclosure requirement for prospectuses such that a prospectus filed in the first year after February 14, 2012 will be permitted to include a one-year look back period, and in the second year after February 14, 2012, a two-year look back period. Prospectuses filed in the third year after February 14, 2012 must include the full three-year look back period.<sup>31</sup>

### **Disclosure Requirements for NRSROs**

Section 943(1) of the Act requires each NRSRO to include, in any report accompanying a “credit rating” for an Exchange Act ABS, a description of the representations, warranties and enforcement mechanisms available to investors and of how such rights and remedies differ from the representations, warranties and enforcement mechanisms in issuances of similar securities. The Final Rule adds Rule 17g-7 to the Exchange Act to implement the requirements of Section 943(1). This part of the Final Rule simply restates the statutory requirements of Section 943(1) and contains no mandate and little guidance on how NRSROs may comply with the requirements of Section 943(1) of the Act.

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<sup>29</sup> 76 Fed. Reg. 4502.

<sup>30</sup> 76 Fed. Reg. 4502. The SEC noted, however, that more current information would need to be included in the prospectus if the securitizer had filed a quarterly report on Form ABS-15G within the 135-day period. See 76 Fed. Reg. 4505.

<sup>31</sup> 76 Fed. Reg. 4502-4503.

The SEC noted in its Proposed Rule that it “anticipates” one way NRSROs could fulfill this requirement would be to review previous issuances on both an initial and ongoing basis in order to establish “benchmarks” for various types of securities and revise them as appropriate.<sup>32</sup> In the Final Rule, the SEC declined to include definitions or interpretive rules, instead saying that it expects that NRSROs would draw upon their knowledge of industry standards, along with their own expertise with previously rated deals and their knowledge of the market in general in comparing representation and warranty provisions in different deals.<sup>33</sup>

The SEC also indicated in the Proposed Rule that it was proposing a note that would clarify that the term “credit rating” for purposes of the Proposed Rule would include any expected or preliminary credit rating issued by an NRSRO, including any indications of a rating used prior to the assignment of an initial credit rating for a new issuance.<sup>34</sup> Pre-sale reports typically issued by NRSROs in connection with an offering would be considered a “credit rating” for such purposes. The Final Rule adopted this approach and clarifies further that the Final Rule applies, without limitation, to “any report accompanying a credit rating”, including unsolicited ratings and ratings issued to foreign issuers that are not offering securities in the U.S. by NRSROs that are otherwise subject to the SEC’s oversight.<sup>35</sup>

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<sup>32</sup> Proposed Rule, pages 35-36, fn 63.

<sup>33</sup> 76 Fed. Reg. 4504-4505.

<sup>34</sup> Proposed Rule, page 36, fn 65.

<sup>35</sup> 76 Fed. Reg. 4504-4505.

Annex A  
Form ABS-15G

Name of Issuing Entity	Check if Registered	Name of Originator	Total Assets in ABS by Originator			Assets That Were Subject of Demand			Assets That Were Repurchased or Replaced			Assets Pending Repurchase or Replacement (within cure period)			Demand in Dispute			Demand Withdrawn			Demand Rejected		
			(#)	(\$)	(% of principal balance)	(#)	(\$)	(% of principal balance)	(#)	(\$)	(% of principal balance)	(#)	(\$)	(% of principal balance)	(#)	(\$)	(% of principal balance)	(#)	(\$)	(% of principal balance)	(#)	(\$)	(% of principal balance)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)	(m)	(n)	(o)	(p)	(q)	(r)	(s)	(t)	(u)	(v)	(w)	(x)
Asset Class X																							
Issuing Entity A CIK #	X	Originator 1																					
		Originator 2																					
<b>Total</b>			#	\$		#	\$		#	\$		#	\$		#	\$		#	\$		#	\$	
Asset Class Y																							
Issuing Entity B		Originator 3																					
<b>Total</b>			#	\$		#	\$		#	\$		#	\$		#	\$		#	\$		#	\$	
<b>Total</b>			#	\$		#	\$		#	\$		#	\$		#	\$		#	\$		#	\$	

# Clients & Friends Memo

## SEC Issues Final Rules Regarding Diligence and Disclosure in ABS Offerings

February 1, 2011

The Securities and Exchange Commission (the “SEC”) issued final rules (the “Final Rule”) on January 20, 2011, implementing the provisions of Section 945 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). Section 945 of the Act directed the SEC to issue rules that require an issuer of publicly offered asset-backed securities (“ABS”) to perform a review of the assets underlying an ABS offering and disclose the nature of that review. The Final Rule adopts the SEC’s earlier proposal<sup>1</sup> with one important change, which is the inclusion of a minimum standard of review. The SEC also adopted amendments to Regulation AB that would require an ABS issuer to disclose information regarding assets that deviate from disclosed underwriting criteria.

For the time being, the SEC has only adopted rules for registered public ABS offerings. The SEC had previously proposed rules for privately offered ABS as well, however, the adoption of those rules has been postponed to a later date.<sup>2</sup>

### Highlights:

The Final Rule:

- requires an issuer of registered (public) ABS to review the assets underlying an ABS offering, either directly or via a third party;
- requires an issuer of registered (public) ABS to disclose the nature, findings and conclusions of such review; and

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<sup>1</sup> See our Client & Friends Memo, *SEC Proposes New Rules Regarding Diligence and Disclosure in ABS Offerings*, October 26, 2010.

<sup>2</sup> The proposed rules regarding privately offered ABS were issued to implement sub-section (A) of Section 15E(s)(4) of the Securities Exchange Act of 1934, as amended (Section 15E(s)(4) was adopted pursuant to Section 932 of the Act). However, in response to several commentators who suggested that Section 15E(s)(4) should be read as a whole, the SEC postponed the adoption of rules under sub-section (A) of Section 15E(s)(4) until the SEC is able to implement rules for the rest of Section 15E(s)(4).

- requires an issuer of registered (public) ABS to provide disclosure regarding assets that deviate from disclosed underwriting criteria.

**Discussion:****1. Issuer Required to Review Underlying ABS Assets**

In order to implement the provisions of Section 7(d) of the Securities Act of 1933, as amended (the “**Securities Act**”), which was adopted pursuant to Section 945 of the Act, the SEC adopted Rule 193, which requires issuers of registered ABS to perform a review of the underlying pool assets.

Details of Rule 193:

- (a) Applies Only to Registered Offerings. Rule 193 applies only to registered offerings.
- (b) Nature of Required Review. A review conducted under Rule 193 must, at a minimum, be designed and effected to provide reasonable assurance that the disclosure in the prospectus regarding the assets is accurate in all material respects. Rule 193 does not specify the particular type of review an issuer is required to perform and the review may vary based on numerous factors such as the nature of the assets being securitized and the degree of continuing involvement by the sponsor.

*Note: It is unclear to some industry participants how the “reasonable assurance” standard adopted by the SEC imposes additional responsibilities on issuers who are already accountable for misleading disclosure under existing federal securities laws.*

- (c) Persons Required to Perform the Review. The asset review is required to be performed by either:
  - (i) the ABS issuer, which for this purpose would be the depositor or the sponsor of the securitization; or
  - (ii) a third party engaged for purposes of performing the review; *provided, however,* that if an issuer engaged a third party to perform a review of assets and the issuer attributes the findings and conclusions of the review to such third party, then such third party must be named in the prospectus and consent to being treated as an expert in accordance with Rule 436 of the Securities Act. On the other hand, if an issuer obtains assistance from a third party but attributes to itself the findings and conclusions of the review, the third party would not be required to consent to being named as an expert.

- (d) Expanded Scope of ABS. Rule 193 relates to asset-backed securities as defined in new Section 3(a)(77)<sup>3</sup> of the Exchange Act, which is broader than the definition provided in Regulation AB and includes securities such as CDOs. Nevertheless, as adopted, Rule 193 still only applies to registered (publicly offered) ABS.
- (e) Disclosure. The SEC adopted Item 1111(a)(7) of Regulation AB, which requires disclosure regarding (i) the nature of an issuer's or third party's review of the assets under proposed Rule 193 and (ii) the findings and conclusions of such review.

## 2. Disclosure Regarding Exceptions to Underwriting Criteria

The SEC also adopted Item 1111(a)(8) of Regulation AB, which requires disclosure of the following information regarding any assets that deviate from disclosed underwriting criteria:

- how the assets in the pool deviate from the disclosed underwriting standards;
- data on the amount and characteristics of those assets;
- the identity of the entity that determined to include such assets in the pool, despite not having met the disclosed underwriting standards;
- factors that were used to determine to include such assets in the pool (such as compensating factors or a determination that the exception was not material); and
- if compensating factors were used, data on the amount of assets in the pool that met such compensating factors.

## 3. Compliance Date

Any registered offering of ABS commencing with an initial bona fide offer after December 31, 2011, will be required to comply with the Final Rule.

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<sup>3</sup> "Asset backed security (A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including— (i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if non of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company." See Section 3(a)(77) of the Securities Exchange Act of 1934, as amended by the Act.

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# Clients & Friends Memo

## Summary of Proposed Rulemaking Regarding Commodity Options & Agricultural Swaps

February 8, 2011

### Overview

The Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>1</sup> prohibits swaps in an agricultural commodity unless conducted pursuant to a rule or order under the Commodity Futures Trading Commission's ("CFTC" or "Commission") 4(c) exemptive authority. In the CFTC's Notice of Proposed Rulemaking regarding Commodity Options and Agricultural Swaps,<sup>2</sup> the Commission proposes to adopt new rules that would expressly require eligible parties that enter into swaps in an agricultural commodity to be subject to the same provisions of the CEA and the CFTC's regulations that apply to all other commodity swaps. In addition, all over-the-counter commodity option transactions, including options on physical commodities, would be subject to the same requirements that apply to commodity swaps.

### Revisions to the CFTC's Regulations

Under the Proposed Rule, the Commission would remove and then replace Part 35 of the existing regulations in its entirety. It would replace the existing eligible swap participant ("ESP") requirement with the same eligible contract participant ("ECP") requirement that applies to all swaps executed outside of a designated contract market ("DCM") under the Dodd-Frank Act. That is, a market participant will be unable to execute any agriculture swaps other than through a DCM (which will require initial and variable margin to be posted) unless such market participant is an ECP. In order to qualify as an ECP under the Dodd-Frank Act, a party that is a corporation, partnership, proprietorship, organization, or trust must have either total assets exceeding \$10,000,000, or a net worth exceeding \$1,000,000 if it is entering into the swap in connection with the conduct of its business or to manage a risk associated with an asset or liability of the party

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<sup>1</sup> Pub. L. No. 111-203 (2010) (to be codified as an amendment to the Commodity Exchange Act ("CEA") in 7 U.S.C. ch. 1) ("Dodd-Frank Act").

<sup>2</sup> 76 FR 6095 (Feb. 3, 2011) ("Proposed Rule").

(or one reasonably likely to be acquired) in the conduct of its business. Alternatively, this type of party can still qualify as an ECP if their guarantor or credit support provider for the swap meets the definitional requirements. For an individual to qualify as an ECP, the individual must have over \$10,000,000 in discretionary investments, or over \$5,000,000 in discretionary investments if the swap is being executed to manage a risk associated with an asset or liability of the individual (or one reasonably likely to be acquired). The Commission requests comment as to whether this requirement will adversely affect market participants.

The Commission also proposes several revisions to Part 32 of the CFTC's regulations. Specifically, the Proposed Rule would revise Rule 32.4 (trade option exemption), to require entities entering into commodity options to be ECPs. While non-ECPs could formerly execute options on non-enumerated agricultural commodities, provided the option was offered to a commercial producer or processor that was entering into the option for hedging purposes, under the proposed revisions to Rule 32.4, both parties will be required to be ECPs. The Commission requests comment as to whether this will significantly affect hedging opportunities available to currently active market participants.

The Commission further proposes to withdraw Rule 32.13 and the Agricultural Trade Option (ATO) exemption, which currently applies to options in enumerated agricultural commodities. The withdrawal of Rule 31.13 would remove the current \$10 million net worth requirement that applies to both parties to an option on enumerated agricultural commodities under the current Rule 32.13. Instead, under the Proposed Rule, parties with a net worth of less than \$10 million could enter into agricultural trade options as long as they qualify as an ECP.

The Proposed Rule also would withdraw Rule 32.12, commonly known as the "dealer options exemption." The Commission explains in the Proposed Rule that no participants have used the dealer option since "at least September 11, 2001, and likely for a decade before that."<sup>3</sup> The Commission requests comment as to whether there is any reason not to withdraw and replace Rule 32 in its entirety.

Finally, the CFTC proposes to make various conforming amendments to its rules. For example, the Commission proposes to amend Part 33 to remove references to options on physical commodities, which would instead be regulated as swaps. Under the Proposed Rule, only exchange-traded options on futures would remain subject to Part 33. The Commission does not believe that this change will have any practical effect on participants because anyone (including non-ECPs) could continue to trade physical commodity options on a DCM, while ECPs could trade over-the-counter physical commodity options subject to the same rules as other physical commodity swaps.

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<sup>3</sup> 76 FR at 6102.

In addition, Section 723(c)(3)(B) of the Dodd-Frank Act includes a “grandfather” clause, which provides that any rule, regulation or order regarding agricultural swaps that was issued pursuant to the Commission’s exemptive authority in CEA section 4(c), and was in effect on the date of enactment of the Dodd-Frank Act, will continue to be permitted under such terms and conditions as the CFTC may prescribe. Section 723(c)(3)(B)’s grandfather clause applies to agricultural swaps and calendar swaps entered pursuant to Part 35 of the Commission Regulations, but not to options entered pursuant to Part 32.

Although the CFTC otherwise is conforming its rules to apply the same framework to commodity options as to swaps, it proposes to apply the unlawful representation and anti-fraud rules (Rules 32.8 and 329) to agricultural options, even though they already will be subject to similar provisions applicable to swaps. This revision will give the CFTC’s Division of Enforcement another cause of action for the same violation.

### Summary

The Proposed Rules likely would become effective sixty days after the Commission issues final regulations, which is unlikely to occur before June or July 2011. The Proposed Rules could have a significant impact on active market participants executing swaps and options on agriculture products, especially if a market participant does not qualify as an ECP. While the full impact of the Proposed Rule cannot be ascertained until certain related rulemakings under the Dodd-Frank Act are promulgated by the CFTC, producers, processors and consumers of agriculture products who actively hedge their price exposure, as well as dealers, should keep abreast of the emerging regulations and consult with their advisors as to the impact such regulations could have on their business. Because the Commission is soliciting comments on the Proposed Rule through April 4, 2011, market participants may want to provide such comments to the CFTC either directly or through an industry association.

\* \* \* \*

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# Clients & Friends Memo

## Fed Issues Final Regulations on the Volcker Rule's Extension Periods

February 11, 2011

On February 9, 2011, the Board of Governors of the Federal Reserve System (the "**Federal Reserve Board**") issued final regulations implementing the various conformance and extension periods under the Dodd-Frank Act's "Volcker Rule."<sup>1</sup> These new regulations will be codified as new Subpart K of the Federal Reserve Board's Regulation Y.<sup>2</sup>

### Background

The Volcker Rule prohibits *banking entities* – generally, FDIC-insured depository institutions, their holding companies, and U.S. branches of foreign banks, and any of their respective affiliates – from (a) engaging in proprietary trading, (b) investing in or sponsoring a hedge fund or private equity fund, or (c) entering into certain transactions with a hedge fund or private equity fund advised, managed, or sponsored by the banking entity or its affiliate, subject to certain exceptions. The Volcker Rule does not impose such bars on nonbank financial companies deemed systemically significant and subject to Federal Reserve Board supervision, but does require the agencies to impose capital charges and quantitative limits on the proprietary trading and fund investing activities of such entities.

The Volcker Rule becomes effective on July 21, 2012 or one year after final implementing regulations are issued by the banking and securities agencies, whichever occurs first. These extension period regulations are not the final implementing regulations that trigger the effective date of the Volcker Rule; the agencies are expected to begin the rulemaking process on the implementing regulations later this year.<sup>3</sup> Rather, the recently issued regulations establish the period in which banking entities will be required to come into conformance once the Volcker Rule itself becomes effective.

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<sup>1</sup> The Volcker Rule was enacted as Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203, 124 Stat. 1376 (2010) (H.R. 4173).

<sup>2</sup> 12 CFR Part 225, Subpart K.

<sup>3</sup> For additional information concerning the Volcker Rule, please refer to Cadwalader's Clients & Friends Memo, *An Analysis of the Dodd-Frank Act's Volcker Rule* (October 15, 2010), [http://www.cadwalader.com/assets/client\\_friend/101510VolckerRuleAnalysis.pdf](http://www.cadwalader.com/assets/client_friend/101510VolckerRuleAnalysis.pdf).

### General Conformance Period

As set forth in the Volcker Rule itself, the regulations state that a banking entity must come into compliance with the Volcker Rule within two years after the Volcker Rule becomes effective. If an entity first becomes a banking entity *after* the effective date of the Volcker Rule – for example, if a foreign bank were to establish a U.S. branch and thereby become a *banking entity* – the regulations state that the banking entity must come into compliance within two years of the date it first became a banking entity – *i.e.*, the date it establishes a U.S. branch.<sup>4</sup>

The final regulations confirm that a similar two-year conformance period applies with respect to nonbank entities that are deemed systemically significant and therefore subjected to Federal Reserve Board supervision. These entities will have two years, beginning on the date they are deemed systemically significant, to come into compliance with the capital requirements and quantitative limits of the Volcker Rule with respect to any ongoing proprietary trading or fund investing activities within the scope of the Volcker Rule.<sup>5</sup>

### Discretionary Conformance Period Extensions

Although banking entities (and systemically significant nonbank entities) have two years to come into compliance with the Volcker Rule, the Volcker Rule allows the Federal Reserve Board to grant up to three one-year extensions on an individual entity basis. These one-year conformance period extensions commence at the end of the normal two-year conformance period. Thus, under the Volcker Rule, a banking entity may request that it be allowed to retain proprietary trading activities or fund investments after the end of the two-year conformance period. The final regulations reflect this discretionary authority, and stipulate that each extension period must be requested individually – a banking entity may not request all three extensions simultaneously – and the extension periods must run consecutively.<sup>6</sup>

The Supplementary Information accompanying the final regulations makes it clear that the extension periods are applicable to any activity that is restricted or prohibited by the Volcker Rule. Thus, extensions may be granted with respect to banking entities that advise, manage, or sponsor private equity funds or hedge funds and thus become subject to the transactional restriction, and also may be granted to nonbank entities that are deemed systemically significant and thus become subject to

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<sup>4</sup> See 12 CFR § 225.181(a)(2).

<sup>5</sup> 12 CFR § 225.182(a).

<sup>6</sup> 12 CFR § 225.181(c). In many respects, the three one-year conformance periods are substantially similar to the conformance period extensions allowed under the Bank Holding Company Act for new bank holding companies with any ongoing impermissible activities. See, *e.g.*, 12 USC § 1843(a); 12 CFR § 225.138.

the Volcker Rule's capital charges and quantitative restrictions on proprietary trading and fund investing activities.<sup>7</sup>

### Special Extension for Investments in Illiquid Funds

The Volcker Rule confers on the Federal Reserve Board the authority to grant a discretionary one-time five-year extension to a banking entity that is contractually obligated to maintain an investment in an *illiquid fund*. Much of the final rulemaking and its Supplementary Information is devoted to this aspect of the Volcker Rule.

Under the Volcker Rule, an *illiquid fund* is defined as a fund that, on May 1, 2010, was principally invested in illiquid assets, or was invested in, and contractually committed to principally invest in, illiquid assets. The Rule left undefined such critical terms as *illiquid assets*, *principally invested*, and *contractually committed*. The final regulations define these terms:

#### *Illiquid Assets*

In the final regulations, an *illiquid asset* is defined as any asset that is (i) not a *liquid asset*; (ii) an asset that cannot be sold by the fund to a person unaffiliated with the banking entity due to statutory or regulatory restrictions applicable to the fund; or (iii) an asset that cannot be sold by the fund for a period of three or more years to a person unaffiliated with the banking entity due to contractual restrictions.<sup>8</sup>

A *liquid asset* is in turn defined as:

- Cash or cash equivalents;
- Any asset that is traded on a recognized, established exchange, trading facility or other market on which there exists independent, bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for the asset almost instantaneously;
- Any asset for which there are bona fide, competitive bid and offer quotations in a recognized inter-dealer quotation system or similar system or for which multiple dealers furnish bona fide, competitive bid and offer quotations to other brokers and dealers on request;

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<sup>7</sup> See 12 CFR § 225.182(b).

<sup>8</sup> 12 CFR § 225.180(g).

- Any asset the price of which is quoted routinely in a widely disseminated publication that is readily available to the general public or through an electronic service that provides indicative data from real-time financial networks;
- Any asset with an initial term of one year or less and the payments on which at maturity may be settled, closed-out, or paid in cash or one or more other liquid assets described above; and
- Any other asset that the Federal Reserve Board determines, based on all the facts and circumstances, is a liquid asset.<sup>9</sup>

The final regulations and accompanying Supplementary Information indicate that whether an asset is illiquid is generally determined as of May 1, 2010. Thus, a fund that was principally invested in assets that were considered illiquid assets on May 1, 2010, but which assets have become liquid, will still be considered an illiquid fund for purposes of the Volcker Rule. However, the Federal Reserve Board will take into account the extent to which illiquid assets have become liquid assets when deciding whether to grant a five-year extension. Thus, an illiquid fund that now holds predominantly liquid assets may be less likely to obtain the special five-year extension. On the other hand, a fund that was *not* principally invested in illiquid assets (or was not contractually committed to invest in illiquid assets) on May 1, 2010 will not be entitled to the five-year extension at all, even if its assets have since become illiquid.

#### *Principally Invested*

The final regulations adopt the 75% standard of *principally invested* as announced in the proposed rulemaking. Thus, a fund is considered *principally invested* in illiquid assets if at least 75% of its assets are comprised of illiquid assets. The final regulations require that the determination be made based on the fund's most recent financial statements (prepared under U.S. GAAP) in the 90 days preceding May 1, 2010. The final regulations also allow a fund to include in its 75% calculation and treat as illiquid assets any assets, even if liquid, to the extent they are held by the fund as risk-mitigating hedges for its illiquid assets.<sup>10</sup>

#### *Contractually Committed*

The final regulations state that whether a fund is *contractually committed* to invest in illiquid assets may be determined based on either the fund's organizational documents or offering materials. Similarly, the regulations state that a fund is treated as if it has such a contractual commitment (and

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<sup>9</sup> 12 CFR § 225.180(h). The Supplementary Information accompanying the final regulations notes that the components of the definition of *liquid assets* was derived from other existing federal banking securities laws.

<sup>10</sup> 12 CFR § 225.180(i).

therefore is deemed principally invested in illiquid assets) if the fund markets or holds itself out to investors as intending to principally invest in illiquid assets, or has a documented investment policy of principally investing in such assets.<sup>11</sup> Once again, the relevant date for such a determination is as of May 1, 2010. Whether such offering materials, marketing materials, or investment policy in fact reflect investments in illiquid assets will be determined by the nature of the assets, and the materials do not need to specify that the assets are in fact illiquid. Thus, a written policy to invest in equity securities issued by early-stage nonpublic companies will be considered to be an investment policy to invest in illiquid assets, regardless whether those equity shares later become registered and therefore liquid.

### **Duration of the Special Five-Year Extension**

The final regulations allow the special five-year extension to run consecutively after the end of the one-year conformance period extensions (if any) granted by the Federal Reserve Board.<sup>12</sup> Thus, in theory the banking entity may seek three consecutive one-year conformance period extensions after the end of the initial two-year statutory conformance period, and then may seek a special extension, of up to five years, for any investment in an illiquid fund.

The Federal Reserve Board is not required to grant a five-year extension; it may grant a shorter extension, but in no case may it grant a longer extension. Regardless, the extension expires under the terms in the Federal Reserve's grant, or when the banking entity ceases to have a contractual obligation to invest in the illiquid fund, whichever occurs first.

### **Contractual Obligations**

As mentioned above, the Volcker Rule states that the special five-year extension terminates on the earlier of five years after it is granted or once the banking entity ceases to have a *contractual obligation* to invest in the illiquid fund. The Rule also requires that, to be eligible for the extension in the first instance, such a contractual obligation must have been in existence on May 1, 2010.

The final regulations require that any such *contractual obligation* be reflected in the written terms of the banking entity's contractual arrangements with the fund or with the nonaffiliated investors in the fund. If the banking entity is also the fund sponsor, the contractual obligation may be reflected in written representations made to nonaffiliated investors in the fund.<sup>13</sup>

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<sup>11</sup> *Id.*

<sup>12</sup> 12 CFR § 225.181(b)(2)(i).

<sup>13</sup> 12 CFR § 225.181(b)(3)(i).

The regulations also state that a contractual obligation will not be considered to exist if the banking entity has the ability to avoid or terminate the obligation, or if termination of the obligation requires third-party consent but the banking entity has not used its “reasonable best efforts” to obtain such consent.<sup>14</sup> Thus, if a banking entity has the legal right to redeem or sell its investment, the banking entity must do so before the end of the initial two-year conformance period and any one-year conformance periods granted by the Federal Reserve Board, regardless of economic consequence, and will not be entitled to the five-year extension period. Similarly, if a banking entity is able to terminate its investment with third-party consent but has not exercised its reasonable best efforts to obtain such third-party consent, the banking entity will not be eligible for any special five year extension.

The final regulations and Supplementary Information reiterate that the five-year extension period terminates *immediately* upon the elimination of any contractual commitment, and no grace period will be afforded. Thus, if a banking entity is granted a five-year special extension and, during the course of that extension the banking entity’s contractual obligation to maintain the investment is terminated, the banking entity must, under the terms of the final regulations, immediately dispose of its interest in the fund *on that date*.<sup>15</sup>

### **Extension Procedures**

The final regulations describe the procedures for requesting, and the criteria to be considered by the Federal Reserve Board in connection with, a request for either a one-year extension to the conformance period or the special five-year extension with respect to illiquid fund investments. The final rules require that any such request be filed at least 180 days in advance, and the Federal Reserve Board must act on the request within 90 days – thus giving the applicant at least 90 days to come into compliance if the request is denied.<sup>16</sup> However, in the Supplementary Information, the Federal Reserve Board noted that the 180-day requirement was merely the latest possible date that a request may be filed, and encouraged entities subject to the Volcker Rule to submit extension requests earlier if possible.

The factors to be considered by the Federal Reserve Board in determining whether to grant an extension include:

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<sup>14</sup> 12 CFR § 225.181(b)(3)(iii).

<sup>15</sup> 12 CFR § 225.181(b)(2).

<sup>16</sup> 12 CFR §§ 225.181(c), (d)(2), 225.182(c).

- (i) Whether the activity or investment--
  - (A) Involves or results in material conflicts of interest between the banking entity and its clients, customers or counterparties;
  - (B) Would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;
  - (C) Would pose a threat to the safety and soundness of the banking entity; or
  - (D) Would pose a threat to the financial stability of the United States;
- (ii) Market conditions;
- (iii) The nature of the activity or investment;
- (iv) The date that the banking entity's contractual obligation to make or retain an investment in the fund was incurred and when it expires;
- (v) The contractual terms governing the banking entity's interest in the fund;
- (vi) The degree of control held by the banking entity over investment decisions of the fund;
- (vii) The types of assets held by the fund, including whether any assets that were illiquid when first acquired by the fund have become liquid assets, such as, for example, because any statutory, regulatory, or contractual restrictions on the offer, sale, or transfer of such assets have expired;
- (viii) The date on which the fund is expected to wind up its activities and liquidate, or its investments may be redeemed or sold;
- (ix) The total exposure of the banking entity to the activity or investment and the risks that disposing of, or maintaining, the investment or activity may pose to the banking entity or the financial stability of the United States;
- (x) The cost to the banking entity of divesting or disposing of the activity or investment within the applicable period;

(xi) Whether the divestiture or conformance of the activity or investment would involve or result in a material conflict of interest between the banking entity and unaffiliated clients, customers or counterparties to which it owes a duty;

(xii) The banking entity's prior efforts to divest or conform the activity or investment(s), including, with respect to an illiquid fund, the extent to which the banking entity has made efforts to terminate or obtain a waiver of its contractual obligation to take or retain an equity, partnership, or other ownership interest in, or provide additional capital to, the illiquid fund; and

(xiii) Any other factor that the Federal Reserve Board believes appropriate.<sup>17</sup>

### Effective Date

The final regulations become effective on April 1, 2011. Thus, banking entities in theory could begin seeking extensions on that date. Given the ambiguities throughout the Volcker Rule, clients should, unless special circumstances indicate otherwise, postpone any filing of an extension request until the agencies issue final implementing regulations. However, clients should now be assessing the likelihood of obtaining extensions for their existing Volcker Rule activities and investments.

\* \* \* \*

We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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<sup>17</sup> 12 CFR §§ 225.181(d), 225.182(d).

# Clients & Friends Memo

## SEC Finalizes Rules Regarding Shareholder Approval of Executive Compensation and Golden Parachute Arrangements

March 1, 2011

On January 25, 2011, the Securities and Exchange Commission (the “SEC”) adopted final rules (the “Final Rules”) to implement the provisions of Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires publicly traded companies to provide for non-binding shareholder votes on executive compensation (“say-on-pay votes”), the frequency of say-on-pay votes (“say-when-on-pay votes”), and golden parachute packages of named executive officers (“say-on-golden-parachute votes”).<sup>1</sup> The Final Rules become effective on April 4, 2011 and are largely similar to proposed rules (the “Proposed Rules”) that the SEC issued on October 18, 2010, discussed [here](#).<sup>2</sup> This Clients & Friends Memo supplements our previous discussion of the Proposed Rules by summarizing some of the substantive differences between the Proposed and Final Rules.

Because say-on-pay votes are generally required for the upcoming proxy season, companies should review their executive compensation arrangements and Compensation Discussion and Analysis (“CD&A”) disclosures to identify any issues that might be seen as controversial and determine in consultation with their counsel and compensation advisors how best to comply with the mandated say-on-pay votes in their proxies, including determining whether an annual, biennial or triennial say-on-pay vote best fits with their overall executive compensation program, and whether the determined frequency will be recommended to shareholders in their proxies.

**Say-on-pay and say-when-on-pay voting.** Under both the Final and Proposed Rules, public companies must generally provide shareholders with say-on-pay and say-when-on-pay votes with respect to the first annual (or other) shareholder meeting occurring on or after January 21, 2011.

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- <sup>1</sup> Cadwalader prepared a summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these memoranda, please see [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).
- <sup>2</sup> See [http://www.cadwalader.com/assets/client\\_friend/112910SECProposesNewRulesReExecComp.pdf](http://www.cadwalader.com/assets/client_friend/112910SECProposesNewRulesReExecComp.pdf). A copy of the final rules can be found at <http://www.sec.gov/rules/final/2011/33-9178.pdf>. A copy of the Proposed Rules can be found at <http://www.sec.gov/rules/proposed/2010/33-9153.pdf>.

The following are some of the key substantive differences between the Proposed and Final Rules with respect to say-on-pay and say-when-on-pay voting:

- Companies with a public float of less than \$75 million do not have to comply with the say-on-pay and say-when-on-pay voting requirements until January 21, 2013. This exemption does not apply to the rules applicable to golden parachute packages.
- The Final Rules permit an issuer to exclude a shareholder proposal that would provide a say-on-pay vote or seek future say-on-pay votes, or relates to the frequency of say-on-pay votes, provided the issuer has adopted a policy on the frequency of say-on-pay votes that is consistent with the majority of votes cast in the most recent say-when-on-pay vote (without giving effect to abstentions). This “majority standard” adopted by the Final Rules is more stringent than the Proposed Rules’ “plurality standard” and, because a say-when-on-pay vote provides for three substantive choices (*i.e.*, a voting frequency of one, two or three years), it is possible that no choice will receive a majority of votes and that an issuer will not be able to exclude shareholder proposals relating to say-on-pay or say-when-on-pay votes.
- The Final Rules retain the requirement that an issuer disclose its decision regarding how frequently it will conduct say-on-pay advisory votes in light of the results of the say-when-on-pay vote, but effect this disclosure requirement through an amendment to Form 8-K instead of Forms 10-Q and 10-K. To comply with the disclosure requirement, an issuer must file an amendment to its prior Form 8-K under Item 5.07 that discloses the preliminary and final results of the say-when-on-pay vote. The amendment will be due no later than 150 calendar days after the date of the end of the shareholder meeting at which the say-when-on-pay vote occurred, but in no event later than 60 calendar days prior to the deadline for submitting shareholder proposals for the next annual meeting.
- Clarifying the requirement in the Proposed Rules that publicly traded companies provide for a non-binding say-on-pay vote at least once every three years, and a non-binding say-when-on-pay vote at least every six years, the Final Rules provide that these votes are only required with respect to an annual shareholder meeting, or a special meeting in lieu of the annual meeting, at which proxies are solicited for the election of directors, and must occur at least once every three or six calendar years (as appropriate) following the last say-on-pay or say-when-on-pay vote.

- Like the Proposed Rules, the Final Rules do not require issuers to use any specific language or form of resolution for say-on-pay votes, but do, however, provide a non-exclusive example of a satisfactory say-on-pay resolution.<sup>3</sup>
- The Final Rules clarify the Proposed Rules' general requirement that issuers address in their Compensation Discussion and Analysis ("CD&A") disclosures whether and, if so, how their compensation policies and decisions have taken into account the results of shareholder advisory votes on executive compensation. This mandatory topic relates only to an issuer's consideration of the most recent say-on-pay vote. The Final Rules do not add an analogous requirement for smaller reporting companies that are not required to include a CD&A.

**Disclosure of golden parachutes.** Consistent with the Proposed Rules, the Final Rules generally require disclosure of named executive officers' golden parachute arrangements in both tabular and narrative formats in proxy or consent solicitations in connection with an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets, beginning April 25, 2011. The following are some of the key substantive differences between the Proposed and Final Rules with respect to the disclosure of golden parachute arrangements:

- The Final Rules require that the disclosure separately identify amounts attributable to "single-trigger" arrangements (for example, amounts payable upon consummation of the transaction) and "double-trigger" arrangements (for example, amounts payable upon a qualifying termination of employment within a specified period of time following consummation of the transaction).
- The Final Rules provide that the tabular and narrative disclosure requirement applies only to compensation that is based on or otherwise relates to the subject transaction.
- The Final Rules permit issuers to include additional named executive officers and additional columns or rows to the tabular disclosure (e.g., to distinguish between cash severance and other cash compensation, or between "single-trigger" and "double-trigger" arrangements), so long as the disclosure is not misleading.
- Instead of measuring an issuer's stock price based on its closing price per share as of the latest practicable date, as the Proposed Rules required for a merger or

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<sup>3</sup> The example reads as follows: "RESOLVED, that the compensation paid to the company's named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis, compensation tables and narrative discussion, is hereby APPROVED." See Instruction to Rule 14a-21(a).

similar transaction, the Final Rules require the measurement to be based on the consideration per share to be paid with respect to the transaction, if this value is a fixed dollar amount, or otherwise on the average closing price per share over the first five business days following the first public announcement of the transaction.

- The Final Rules eliminate any requirement that a bidder in a third-party tender offer provide information in its Schedule TO about a target's golden parachute arrangements, which the Proposed Rules required if the bidder had knowledge of the arrangements. However, the Final Rules continue to require a bidder in a going-private transaction to disclose this information on its Schedule 13E-3.

\* \* \* \*

If you have any questions regarding this memorandum, please contact the individuals listed below or any other member of the [Cadwalader Tax Department](#).

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# Clients & Friends Memo

## CFTC, Prudential Regulators Propose Margin Rules for Non-Cleared Swaps

April 13, 2011

On April 12, 2011, the Commodity Futures Trading Commission (“**CFTC**”) voted 4-1 to issue proposed rules establishing minimum initial and variation margin requirements for non-cleared swaps entered into by CFTC-regulated swap dealers and major swap participants.<sup>1</sup> Later the same day, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, “**Prudential Regulators**”) jointly issued their own rules establishing margin requirements for swap dealers and major swap participants that are subject to their respective prudential regulation.<sup>2</sup>

The Dodd-Frank Act (Sections 731 and 764) requires the CFTC, SEC,<sup>3</sup> and Prudential Regulators to adopt rules imposing initial and variation margin for certain non-cleared swaps entered into by swap dealers (“**SDs**”) and major swap participants (“**MSPs**”). The CFTC and SEC have the responsibility to establish margin requirements for SDs and MSPs that are not primarily supervised by the Prudential Regulators.<sup>4</sup> Similarly, the Prudential Regulators have the responsibility to establish margin requirements for SDs and MSPs that are subject to their supervision, including domestic banks and thrifts, foreign banks, bank and savings and loan holding companies, Farm Credit Administration-chartered banks, and the government-sponsored enterprises. Although margin requirements for non-cleared swaps are potentially significant and highly anticipated, the

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- <sup>1</sup> Commissioner Scott O’Malia dissented, citing, among other things, a “lack of harmonization” in the proposed margin requirements applicable to financial companies and commercial end-users.
  - <sup>2</sup> The text of the CFTC’s proposal is not yet publicly available. This memorandum is principally based upon the CFTC’s “Fact Sheet” and “Q & A” regarding its proposed rules, statements at the CFTC’s meeting, and on the Prudential Regulators’ notice of proposed rulemaking that will appear in the Federal Register. Margin and Capital Requirements for Certain Swap Dealers and Major Swap Participants: Notice of Proposed Rulemaking to Implement Sections 731 and 764 of the Dodd-Frank Act (Apr. 12, 2011), available at <http://www.fdic.gov/news/board/Apr11no4.pdf>.
  - <sup>3</sup> The SEC has not published a proposed rule establishing margin requirements for non-cleared securities-based swaps.
  - <sup>4</sup> The CFTC has jurisdiction to impose capital and margin requirements on non-prudentially regulated SDs and MSPs. The SEC has jurisdiction to impose capital and margin requirements on securities-based swap dealers and major securities-based swap participants. For simplicity, we refer to both CFTC and SEC regulated-entities as SDs and MSPs, respectively.

proposed rules come close to the end of the scheduled year long rulemaking process for implementing Title VII of the Dodd-Frank Act. The delay reflects the challenge that regulators face when trying to implement Congress's goals of reducing systemic risk and promoting market integrity without inadvertently limiting access to important risk management products or compromising the competitiveness of the U.S. derivatives markets. Indeed, the CFTC is still attempting to finalize a proposed rule that would establish capital requirements for SDs and MSPs, and a related rule that would further define which agreements, contracts, and transactions constitute "swaps" under the Dodd-Frank Act. The CFTC noted that it currently expects to publish the rules proposing capital requirements and the definition of swap later in the month.

In its Q & A, the CFTC stated that it "consulted" with the Prudential Regulators in preparing its margin requirements, and that the SEC "participated" in these consultations. It is not clear whether the CFTC's choice of words indicates some difference in the relative relationships between the different agencies. Nevertheless, it is probably more important that the CFTC and the Prudential Regulators harmonize their requirements because banks will act as dealers in interest rates and currencies, both of which will also be regulated by the CFTC, whereas banks likely will not act as dealers in securities-based swaps regulated by the SEC.

While there are significant commonalities in the approaches taken by the CFTC and the Prudential Regulators, as described below, there are also significant differences, particularly with regards to the use of models and the treatment of commercial end-users.

### **Timing of the Proposed Margin Rules**

The comment period for the CFTC's proposed margin rule will run concurrently with the comment period for the proposed rule establishing capital requirements for SDs and MSPs that is expected to be published later this month (*i.e.*, comments to the CFTC's margin rule will be due on the same day as comments to the capital rule, 60 days after the rule establishing capital requirements for CFTC-regulated entities is published in the Federal Register).

The comment period for the Prudential Regulators' proposed capital and margin rules will close on June 24, 2011. As a preliminary indication of the large number and broad range of issues associated with the new margin requirements, the draft of the proposed rule distributed by the Prudential Regulators alone includes 92 numbered questions, many of which have several subcomponents.

## Products Covered

The margin rules issued by the CFTC and Prudential Regulators will apply only to non-cleared swaps entered into *after* the effective date of the regulations (*i.e.*, margin requirements will not be applied retroactively).<sup>5</sup> This should provide some degree of comfort to market participants, including structured products vehicles, that may have been unable to effectively renegotiate preexisting swaps to comply with the new margin requirements. In addition, the Prudential Regulators (but not the CFTC) would permit a registrant that uses a model to calculate its initial margin requirements on a portfolio basis to include only post-effective-date swaps in the relevant portfolio. With respect to variation margin, the Prudential Regulators have proposed requiring covered swap entities to comply with the margin requirements for *all* swaps governed by a master agreement, regardless of the date on which they were entered into, but have requested comment as to whether this requirement would raise practical difficulties for market participants. Similarly, the CFTC agreed to include a question to market participants in preamble to its proposed rule asking whether non-cleared swaps entered into before the effective date could be used to offset related positions.

## Categories of Non-Cleared Swap Transactions

The CFTC and Prudential Regulators have proposed different margin requirements depending whether the counterparty to a swap is an SD or MSP, a financial entity (*i.e.*, a “financial end-user”),<sup>6</sup> or a non-financial entity (*i.e.*, a “commercial end-user”).

SD/MSP to SD/MSP Swaps. In general, the requirements in the CFTC’s and Prudential Regulators’ rules are the same. Both parties would be required to pay and to collect initial and variation margin for each trade. Variation margin must be calculated and paid or collected at least once per business day.

SD/MSP to Financial Entity Swaps. In general, the requirements in the CFTC’s and Prudential Regulators’ rules are the same. SDs and MSPs would be required to collect (but not to pay) initial and variation margin for each trade.<sup>7</sup> Variation margin

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<sup>5</sup> Consistent with current industry practice, under the proposed rules cleared swaps will be subject to the rules of the applicable derivatives clearing corporation.

<sup>6</sup> The proposed rules define a “financial entity” or “financial end-user” in a manner that is consistent with the definition of “financial entity” in CEA Section 2(h)(7) (the end-user clearing exception).

<sup>7</sup> Presumably SDs and MSPs would not be prohibited from paying margin to a counterparty that is a financial entity pursuant to the terms of a bilaterally negotiated swap; however, the Fact Sheet provided by the CFTC ambiguously states that “for trades between SD/MSPs and financial entities, the rules would require the SD/MSP to collect, but not to pay, initial and variation margin for each trade . . .”).

must be calculated and paid or collected at least once per business day.<sup>8</sup> Under certain circumstances, margin requirements may be subject to minimum thresholds. For example, a low-risk financial end-user with a relatively small swap portfolio that uses swaps primarily to hedge its commercial risk (e.g., an insured depository institution) may qualify for initial and variation margin thresholds that would reduce the amount of margin that such a counterparty is required to post.

SD/MSP to Non-Financial Entity Swaps. The CFTC's proposed rule would require SDs and MSPs to enter into credit support arrangements with their non-financial counterparties, but *would not require* the SD or MSP to pay or to collect initial or variation margin.<sup>9</sup> Although the Prudential Regulators do not establish an explicit minimum threshold for initial or variation margin, their proposed rule *would require* SDs and MSPs to calculate a credit exposure limit for non-financial entities and collect (but not pay) initial and variation margin when the credit exposure exceeds the calculated limit.

Interestingly, at the CFTC open meeting, both Commissioners Sommers and O'Malia appeared to criticize the Prudential Regulators for not providing an exception from margin requirements for commercial end-users. For their part, the Prudential Regulators, in their release, raise the question as to whether the CFTC has statutory authority under Section 731 of the Dodd-Frank Act to except commercial end-users from posting margin, emphasizing the policy significance of protecting SDs against any swap credit risk created by commercial end-users.

### Calculation of Margin

The CFTC's proposed rule would require initial margin to be calculated in a manner that covers 99% of all 10-day price moves using a model that is approved by the CFTC and: (1) used by a clearinghouse for clearing swaps; (2) used by an entity subject to oversight by one of the Prudential Regulators; or (3) made available for licensing to any market participant by a vendor. If no model is available, SDs and MSPs must identify a comparable cleared swap and then use a multiplier to reflect the greater risk associated with the non-cleared product.

The Prudential Regulators' would permit SDs and MSPs to calculate their initial margin required by either: (1) using a standardized "lookup" table that specifies the minimum initial margin that must

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<sup>8</sup> The CFTC and Prudential Regulators have not indicated whether a failure to pay or collect variation margin would result in a default (either immediately or after a specified period of time) or in a capital charge to the swap dealer or major swap participant.

<sup>9</sup> Notwithstanding the proposed rule, a swap dealer or major swap participant and non-financial entity could negotiate margin requirements as part of a bilateral agreement.

be collected based on a percentage of a non-cleared swap's notional amount; or (2) using an internal model that is approved by the entity's primary regulator.<sup>10</sup>

### **Forms of Acceptable Margin**

In general, the CFTC's proposed rule would only recognize cash, Treasuries, and senior debt obligations of certain government-sponsored entities ("GSEs"); however, for non-cleared swaps between an SD or MSP and a non-financial entity, the CFTC's proposal would permit any form of collateral agreed to by the parties (e.g., physical natural gas in storage), provided that any non-traditional collateral must be revalued on a periodic basis.

In general, the Prudential Regulators' proposed rule would only recognize cash, Treasuries, and senior debt obligations of GSEs. Non-cash collateral would be subject to a mandatory haircut for purposes of determining their margin value. The Prudential Regulators have requested comment on expanding the types of eligible collateral, potentially to include asset-backed securities and foreign sovereign debt.

### **Segregation of Margin**

For non-cleared swaps between SDs and MSPs, the CFTC's proposed rule would require all collateral to be held by a third-party custodian. For all other non-cleared swaps, the SD or MSP would only be required to offer the counterparty the opportunity to have any margin held in such a segregated account.<sup>11</sup>

The Prudential Regulators' proposed rule would require all collateral to be held by an independent third-party custodian for non-cleared swaps between SDs and MSPs.

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<sup>10</sup> Interestingly, by contrast to the Prudential Regulators, the CFTC does not appear to have provided itself with the ability to approve models.

<sup>11</sup> The CFTC staff indicated that the custodian in this context could be an affiliate of the swap dealer or major swap participant.

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# Clients & Friends Memo

## The Dodd-Frank Act's Impact on Affiliate Transactions

April 21, 2011

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") contains several provisions that will tighten the restrictions that govern transactions between banks<sup>1</sup> and their affiliates – Sections 23A and 23B of the Federal Reserve Act<sup>2</sup> – beginning in July 2012. These new provisions will (i) **significantly increase the cost and burden** of certain types of transactions between a bank and its nonbank affiliates, in particular, derivatives, securities lending/borrowing, and repo transactions; (ii) **expand the scope of "affiliates"** subject to Sections 23A and 23B; and (iii) **increase the collateral burdens** applicable to extensions of credit. As a result, banks (as defined in footnote 1 below) **should review, and may be required to modify**, existing business arrangements with affiliates (as newly redefined) to comply with the new requirements.

### I. Background

Sections 23A and 23B of the Federal Reserve Act are prophylactic statutes that restrict certain types of transactions between a bank and its non-bank "affiliates." These restrictions apply without regard to whether the transactions are beneficial to the bank – or at least pose no greater risk than if the transactions were with third parties. As the Federal Reserve has stated, the objectives of Sections 23A and 23B are twofold: (i) preventing bank losses arising from transactions between a bank and the bank's affiliates, and (ii) precluding the bank from transferring to its nonbank affiliates the subsidy arising from the

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<sup>1</sup> Sections 23A and 23B apply by their own terms solely to "member banks" – national banks and those state banks that choose to become members of the Federal Reserve System – and their controlled subsidiaries. The Federal Deposit Insurance Act extends the application of Sections 23A and 23B to cover all FDIC-insured state banks, 12 U.S.C. § 1828(j), and the Home Owners' Loan Act extends Sections 23A and 23B to cover federal and state savings associations, 12 U.S.C. § 1468. Thus, Sections 23A and 23B now apply to all FDIC-insured depository institutions. For convenience, in this memo, the term "bank" will be used to refer to all of the foregoing. Sections 23A and 23B also apply to uninsured U.S. branches of foreign banks, but only with respect to transactions between the uninsured branch and an affiliate engaged directly in the U.S. in activities permitted solely to financial holding companies, namely, (i) merchant banking; (ii) insurance underwriting; (iii) securities underwriting, dealing, or market-making; or (iv) insurance company portfolio investing. See 12 C.F.R. § 223.61.

<sup>2</sup> 12 U.S.C. § 371c & 371c-1.

bank's access to the Federal Deposit Insurance safety net.<sup>3</sup> In that regard, the Federal Reserve has stated that it considers Section 23A “[a]mong the most important tools that U.S. bank regulators have to protect the safety and soundness of U.S. banks.”<sup>4</sup>

In short, Sections 23A and 23B are two of the most significant provisions of federal banking regulation and together have a significant impact on the structure of transactions between a bank and its affiliates, and, because of the attribution component of the sections (discussed below), the structure of three-party transactions involving a bank, an affiliate and a customer. That said, because of the broad and somewhat inflexible nature of their provisions, and because of the critical importance attached to them by the banking regulators, Sections 23A and 23B can also pose significant difficulty for banks even under current law.

## II. The Current Requirements of Section 23A and Section 23B.

### A. Section 23A's Four Principal Elements:

1. *Quantitative Limits.* A bank's **covered transactions** (i) with any single **affiliate** are limited to no more than 10% of the bank's capital stock and surplus, and (ii) with all affiliates (*i.e.*, a bank's Section 23A transactions in the aggregate) are limited to no more than 20% of the bank's capital stock and surplus.<sup>5</sup> **Covered transactions** include purchases of assets from an affiliate, loans or extensions of credit<sup>6</sup> to an affiliate, investments in securities issued by an affiliate, guarantees on

<sup>3</sup> See Final Regulation, Board of Governors of the Federal Reserve System, *Transactions Between Member Banks and Their Affiliates*, 67 Federal Register 76,560, 76,560 (December 12, 2002).

<sup>4</sup> Testimony of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System, Before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (March 5, 2008).

<sup>5</sup> 12 U.S.C. § 371c(a)(1).

<sup>6</sup> The phrase, **loan or extension of credit** is not defined by Section 23A. However, the Federal Reserve's implementing regulation, Regulation W, has a broad definition of **extension of credit**:

the making or renewal of a loan, the granting of a line of credit, or the extending of credit in any manner whatsoever, including on an intraday basis, to an affiliate. An extension of credit to an affiliate includes, without limitation:

(1) An advance to an affiliate by means of an overdraft, cash item, or otherwise;

(2) A sale of Federal funds to an affiliate;

(3) A lease that is the functional equivalent of an extension of credit to an affiliate;

(4) An acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other debt securities, of an affiliate;

behalf of an affiliate, and certain other transactions that expose the bank to an affiliate's credit or investment risk (such as a bank extending credit to a third party collateralized by securities issued by an affiliate).<sup>7</sup> A bank's **affiliates** include any company that controls the bank, any company under common control with the bank, and certain investment funds that are advised by the bank or an affiliate of the bank.<sup>8</sup>

2. *Qualitative Limits.* A bank generally cannot purchase **low-quality assets** from an affiliate.<sup>9</sup>

3. *Collateral Requirements.* A bank's "extensions of credit" to affiliates and guarantees on behalf of affiliates must be appropriately secured by a statutorily defined value of collateral, ranging from 100% to 130% of the initial amount of the extension of credit depending on the nature of the collateral. Certain forms of collateral, such as low-quality assets or securities issued by an affiliate, are not eligible as collateral for extensions of credit to affiliates.

4. *Safe & Sound Terms.* All covered transactions between a bank and its affiliates must be on terms and conditions that are consistent with safe and sound banking practices.<sup>10</sup>

Section 23A also has an **attribution rule**, which treats a transaction between a bank and a third party as a covered transaction if the proceeds of the transaction are used for the benefit of, or are transferred to, an affiliate of the bank. For example, a bank's loan to a third party to acquire assets or securities from a bank's affiliated broker-dealer is treated as if it were a Section 23A covered transaction.

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(5) Any increase in the amount of, extension of the maturity of, or adjustment to the interest rate term or other material term of, an extension of credit to an affiliate; and

(6) Any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent).

12 C.F.R. § 223.2(o).

<sup>7</sup> 12 U.S.C. § 371c(b)(7).

<sup>8</sup> 12 U.S.C. § 371c(b)(1).

<sup>9</sup> 12 U.S.C. 371c(a)(3). A *low-quality asset* includes assets that are classified or treated as "substandard," "doubtful," "loss," or "other loans especially mentioned"; assets in nonaccrual status; any asset in which principal or interest are more than 30 days past due; or any asset the terms of which have been renegotiated or compromised due to the obligor's deteriorating financial condition. 12 U.S.C. § 371c(b)(10).

<sup>10</sup> 12 U.S.C. § 371c(a)(4).

Section 23A, by its terms, does provide for a few exceptions, most significantly for: (i) transactions between sister banks, (ii) a bank's extension of credit to an affiliate that is fully collateralized by cash or U.S. Treasuries, (iii) a bank's purchase of assets from an affiliate if the assets have a readily identifiable and publicly available market quotation, (iv) a bank's giving of credit for items in the process of collection, and (v) a bank's repurchase of loans sold to an affiliate with recourse.<sup>11</sup> The Federal Reserve Board is authorized to create further exemptions by order or by rule, and the Federal Reserve Board's regulation implementing Sections 23A and 23B – Regulation W – creates additional exemptions for certain types of transactions.<sup>12</sup> In addition, the Federal Reserve Board also from time to time has issued orders granting limited exemptions to individual banks.

In summary, Section 23A effectively discourages banks from entering into covered transactions with their affiliates. The **quantitative limit** caps the total amount of covered transactions that may be outstanding at any one time,<sup>13</sup> and banks therefore use their 23A capacity quite sparingly. The **qualitative limits** effectively bar transactions involving certain types of assets altogether. The **collateral requirement** artificially increases the cost of covered transactions by requiring, at a minimum, 100% collateral (in some cases Section 23A requires up to 130% collateral – in effect imposing *above market* conditions on extensions of credit to an affiliate).

## B. Section 23B.

Section 23B is intended to protect a bank by requiring that transactions between the bank and its affiliates occur on market terms, *i.e.*, on terms and under circumstances that are substantially the same, or at least as favorable to the bank as those prevailing at the time for comparable transactions with unaffiliated companies.<sup>14</sup> Section 23B applies this restriction to any **covered transaction** with an affiliate as well as certain other transactions, such as (i) any sale of assets by the bank to an affiliate; (ii) any payment of money or furnishing of services by the bank to an affiliate; and (iii) any transaction by the bank with a third party if an

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<sup>11</sup> See 12 U.S.C. § 371c(d).

<sup>12</sup> See, e.g., 12 C.F.R. §§ 223.41, 223.42.

<sup>13</sup> Covered transactions count against the quantitative limits as long as they remain on the books of the bank, whether in the form of the outstanding balance of a loan or extension of credit, a contingent obligation (such as a guarantee), the unamortized value of an asset purchased from an affiliate, or the greater of the purchase price or carrying value of affiliate securities in which the bank is invested.

<sup>14</sup> 12 U.S.C. § 371c-1(a)(1).

affiliate has a financial interest in the third party or if an affiliate is a participant in the transaction.<sup>15</sup> Like Section 23A, Section 23B has its own attribution rule, and thus Section 23B applies to a bank's transactions with a third party that benefit an affiliate or transactions in which the proceeds of which are transferred to an affiliate.<sup>16</sup>

### III. The Changes Made by the Dodd-Frank Act.

The Dodd-Frank Act amends Sections 23A and 23B effective one year after the "transfer date" (*i.e.*, effective July 21, 2012), as explained below.

#### A. Nonregistered Funds will be Treated as Affiliates

Section 23A currently defines an **affiliate** in terms of "control," whether through ownership of voting shares, by having the ability to appoint a majority of the directors or trustees, or by exercising a controlling influence over the management or policies of the entity.<sup>17</sup> In that respect, Section 23A uses an approach very similar to that used in the Bank Holding Company Act. In addition, irrespective of whether voting "control" exists, Section 23A currently defines an **affiliate** to include:

any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the ... bank or any subsidiary or affiliate of the ... bank; or

any investment company with respect to which a ... bank or any affiliate thereof is an investment adviser as defined in [the Investment Company Act of 1940].<sup>18</sup>

In addition, by regulation the Federal Reserve has determined that any "investment fund" (whether or not registered under the '40 Act) is also an **affiliate** for purposes of Section 23A if (i) the bank (or one of its affiliates) advises the fund **and** (ii) the

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<sup>15</sup> 12 U.S.C. § 371c-1(a)(2).

<sup>16</sup> 12 U.S.C. § 371c-1(a)(3).

<sup>17</sup> 12 U.S.C. § 371c(b)(3).

<sup>18</sup> 12 U.S.C. § 371c(b)(1)(D).

bank (or one of its affiliates) holds 5% or more of the voting securities or equity capital of the fund.<sup>19</sup>

The Dodd-Frank Act repeals both of the above statutory provisions, effective July 2012, and in its place, inserts the following:

any investment fund with respect to which a ... bank or an affiliate thereof is an investment adviser.<sup>20</sup>

The new term *investment fund* (which will be used in lieu of the term investment company) is not defined by the Dodd-Frank Act,<sup>21</sup> but presumably was intended to include a broader category of funds than '40 Act registered investment companies and REITS to the extent they are advised by a bank or any of its affiliates.<sup>22</sup> The effect of the Dodd-Frank amendment is to treat *any* fund (for example, hedge funds, private equity funds, or offshore funds) advised by the bank (or by one of its affiliates) as an affiliate for Section 23A purposes, regardless whether the fund is a '40 Act fund or whether the fund is sponsored by the bank (or one of its affiliates), and regardless whether the bank or its affiliates hold 5% or more of the fund's voting shares or equity capital. The amendment thus discourages a bank from engaging in fund-related covered transactions – loans to, investments in, or asset purchases – with a broad range of funds that are simply advised by the bank or its affiliate, and makes it more difficult for banks to provide implicit support to funds advised by the bank or its affiliates.<sup>23</sup>

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<sup>19</sup> 12 C.F.R. § 223.2(a)(6).

<sup>20</sup> Dodd-Frank Act § 608 (amending 12 U.S.C. § 371c(b)(1)(D)).

<sup>21</sup> While the term *investment fund* is currently used in Regulation W, the term is not defined there, either. In the Supplementary Information accompanying the final rule, the Federal Reserve indicated that the term *investment fund* was intended to encompass funds that are exempt from registration under the '40 Act, either due to the 3(c)(1), 3(c)(7), or 3(a)(1) exemptions, or due to the fact that the fund is located offshore. See Final Regulation, Board of Governors of the Federal Reserve System, *Transactions Between Member Banks and Their Affiliates*, 67 FEDERAL REGISTER 76,560, 76,562 (December 12, 2002).

<sup>22</sup> Likewise, the term *investment adviser* is not defined by the Dodd-Frank Act, but clearly was intended to encompass persons other than registered investment advisers. Presumably the term was intended to cover the providing of investment advice on a regular or routine basis and not merely the one-off provision of advice. However, it should be noted that, in amending Section 23A, Congress removed the prior language that required the advice be provided "on a contractual basis."

<sup>23</sup> A separate provision of the Dodd-Frank Act, Section 619 (known as the Volcker Rule) restricts the ability of a bank or its affiliates to invest in or sponsor a private equity fund or hedge fund, subject to certain exceptions, and also prohibits a bank or its affiliates from entering into a transaction with an advised, managed, or sponsored fund if the transaction otherwise would constitute a *covered transaction* under Section 23A (again, subject to certain exceptions). Thus, the Volcker Rule establishes further restrictions on the relationship between banks (and their affiliates) and private equity or hedge funds. For

## B. Derivative Transactions as “Loans or Extensions of Credit”

Currently, derivative transactions – other than credit derivatives in which the bank provides credit protection to the affiliate – are not considered to be a “loan or extension of credit” for purposes of Section 23A. When the Federal Reserve promulgated Regulation W in 2001, the Federal Reserve specifically chose not to subject derivatives to Section 23A, reasoning that banks and their affiliates typically engage in noncredit derivatives transactions for risk management and hedging purposes, and therefore one of the rationales for Section 23A – prohibiting a bank from transferring the benefits of the FDIC insurance subsidy – was not implicated.<sup>24</sup> Rather than subject derivatives to Regulation W, the Federal Reserve instead required that a bank engaging in non-credit derivative transactions with an affiliate must have policies and procedures to monitor and control the bank’s credit exposure to affiliates in derivative transactions (including by imposing appropriate credit limits, mark-to-market requirements, and collateral requirements). In addition, the Federal Reserve required that such transactions comply with the arm’s length requirements of Section 23B.<sup>25</sup> Thus, subject to the

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further information concerning the Volcker Rule, please refer to Cadwalader’s Clients & Friends Memos, *An Analysis of the Dodd-Frank Act’s Volcker Rule* (October 15, 2010), [http://www.cadwalader.com/assets/client\\_friend/101510VolckerRuleAnalysis.pdf](http://www.cadwalader.com/assets/client_friend/101510VolckerRuleAnalysis.pdf), and *Fed Issues Final Regulations on the Volcker Rule’s Extension Periods* (February 11, 2011), [http://www.cadwalader.com/assets/client\\_friend/021111FedIssuesFinalRegsVolckerRule.pdf](http://www.cadwalader.com/assets/client_friend/021111FedIssuesFinalRegsVolckerRule.pdf).

<sup>24</sup> In 2001, the Board recognized that noncredit derivatives transactions are largely entered into for risk management or hedging reasons:

Derivative transactions between a bank and its affiliates generally arise either from the risk management needs of the bank or the affiliate. Transactions arising from the bank’s needs typically arise when a bank enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract or is unable to hedge the risk directly because the bank is not authorized to hold the hedging asset. In order to manage the market risk, the bank may have an affiliate acquire the hedging asset. The bank would then do a “bridging” derivative transaction between itself and the affiliate maintaining the hedge.

Other derivative transactions between a bank and its affiliate are affiliate-driven. A bank’s affiliate may enter into an interest-rate or foreign-exchange derivative with the bank in order to accomplish the asset-liability management goals of the affiliate. For example, a BHC may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The BHC may then enter into a fixed-to-floating interest-rate swap with its subsidiary bank to reduce the holding company’s interest-rate risk.

Banks and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. Banks and their affiliates often choose to use each other as their derivative counterparties, however, in order to maximize the profits of and manage risks within the consolidated financial group.

See Final Regulation, Board of Governors of the Federal Reserve System, *Transactions Between Member Banks and Their Affiliates*, 67 FEDERAL REGISTER 76,560, 76,587 (December 12, 2002).

<sup>25</sup> See 12 C.F.R. § 223.33.

foregoing, under existing law banks are free to engage in non-credit derivative transactions with their affiliates without being subject to Section 23A's quantitative limits or collateral requirements.

Section 608 of the Dodd-Frank Act reverses the Federal Reserve's position. Beginning in July 2012, all **derivative transactions** will be subject to Section 23A to the extent that they cause the bank to have **credit exposure** to the affiliate. The definition of the term **derivative transaction** is not reflected in Section 23A, but instead is incorporated by reference from the Dodd-Frank Act's amendments to the national bank lending limit statute. There, **derivative transaction** is defined as including:

any transaction that is a contract, agreement, swap, warrant, note, or option, that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest, or other rates, indices, or other assets.<sup>26</sup>

While not required by the Dodd-Frank Act, the Federal Reserve will likely engage in rulemaking to further define what constitutes a **derivative transaction** for purposes of Section 23A.

**Credit exposure** is not defined in the Dodd-Frank Act, but the term instead was left for the Federal Reserve to define through the rulemaking process.<sup>27</sup> Nor does the Dodd-Frank Act stipulate how often a derivative transaction would need to be re-valued to determine its utilization of capacity under the quantitative limits and the amount of collateral require, but again this was apparently left to the Federal Reserve to decide in rulemaking. These decisions will in good part determine the impact of Dodd-Frank Section 608. If **credit exposure** is defined narrowly – for

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<sup>26</sup> Dodd-Frank Act § 610 (adding 12 U.S.C. § 84(b)(3)). The definition of **derivative transaction** is less detailed than the definition of **swap** and **security-based swap** in Title VII and in some respects may be broader than a Title VII swap. For example, **derivative transaction** includes an option on a security, which under Title VII is not a swap, and arguably includes various linked debt securities, also not considered swaps under Title VII. Bear in mind, however, that the Title VII definition of swap is extremely broad and includes many transactions not ordinarily regarded as swaps. While the CFTC is to issue a regulation that will further interpret the term **swap** as used in Title VII the CFTC's definition of **swap** is not specifically incorporated by reference into 12 U.S.C. § 84 and it is unclear to what extent the OCC will rely on the CFTC's rulemaking when construing the scope of the national bank lending limits.

<sup>27</sup> However, in the Federal Reserve's 2001 proposed rulemaking under Regulation W, the Federal Reserve explored the concept of **credit exposure** when considering a number of alternatives for valuing a derivative transaction if Section 23A were to apply. See Notice of Proposed Rulemaking, Board of Governors of the Federal Reserve System, *Transactions Between Banks and Their Affiliates*, 66 FEDERAL REGISTER 24,186, 24,196-97 (May 11, 2001).

example, including only the non-intraday exposure between the bank and its counterparty after taking into account any margin and netting arrangements – the impact of Section 608 may be limited. On the other hand, if a broad definition of **credit exposure** is adopted – for example, disregarding any netting or applying the Section 23A 100% - 130% collateral standards to the total potential exposure rather than just the actual net exposure – the Section 23A amendment would have a significant negative impact on a bank's transactions with its affiliates.

Unlike other aspects of the Dodd-Frank Act that were intended to prohibit certain activities or at least drive the activities out of the bank – such as the Volcker Rule and the Lincoln Amendment<sup>28</sup> – Section 608 does not have an exemption for transactions where a bank is in good faith seeking to hedge the risk of its activities. Thus, while the Volcker Rule permits a banking entity to retain hedging-related private equity investments, and the Lincoln Amendment allows a bank to retain swaps dealing activities if necessary to hedge existing risk, no such exemption was created in Section 608. Section 608 would impose the 23A requirements to an affiliate derivative transaction even if the transaction is a *bona fide* hedge designed to reduce bank risk. By subjecting the derivatives transactions to the collateral requirements and quantitative limits of Section 23A, the Dodd-Frank Act in fact discourages a bank from entering into hedging transactions with its own affiliates. In this regard, Section 608 seems at odds with the overall purposes of the Dodd-Frank Act to reduce systemic risk to the financial services industry; Section 608 will inadvertently encourage banks to enter into hedging transactions with other nonaffiliated entities, thereby increasing the intertwined relationships and systemic risks among banks.

### C. Securities Lending & Borrowing Transactions as “Loans or Extensions of Credit”

Section 608 also states that securities lending and securities borrowing transactions between a bank and its affiliate must be treated as a “loan or

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<sup>28</sup> The Lincoln Amendment (also known as the “swaps pushout rule”) bars banks from acting as a swap or security-based swap dealer except in certain circumstances – one of which is “hedging and other similar risk mitigating activities.” See Dodd-Frank Act § 716. For further information concerning the Lincoln Amendment, please refer to Cadwalader's Clients & Friends Memo, *The Lincoln Amendment: Banks, Swap Dealers, National Treatment, and the Future of the Amendment* (December 14, 2010), [http://www.cadwalader.com/assets/client\\_friend/121410FutureoftheLincolnAmendment.pdf](http://www.cadwalader.com/assets/client_friend/121410FutureoftheLincolnAmendment.pdf).

The Volcker Rule likewise contains an exemption from its prohibition on private equity fund investments for “risk mitigating hedging activities.” See Dodd-Frank Act § 619. For further information concerning the Volcker Rule, please refer to Cadwalader's Clients & Friends Memo, *An Analysis of the Dodd-Frank Act's Volcker Rule* (October 15, 2010), [http://www.cadwalader.com/assets/client\\_friend/101510VolckerRuleAnalysis.pdf](http://www.cadwalader.com/assets/client_friend/101510VolckerRuleAnalysis.pdf).

extension of credit” to the extent that **credit exposure** is created. This does not seem to be a material change in existing practices; while Section 23A did not specifically enumerate a securities lending transaction or a securities borrowing transaction as a form of covered transaction, the Federal Reserve construes them to be the equivalent of a loan and subjects them to Section 23A.<sup>29</sup>

It is interesting to note, however, that Section 608 stipulates that these transactions are deemed to loans or extensions of credit only to the extent **credit exposure** is created, rather than subjecting such transactions to Section 23A in their entirety. Thus, depending on how the term **credit exposure** is defined, Section 608 may result in a partial *relaxation* of existing law in a manner that is consistent with the market’s understanding of the term “credit exposure.” For example, if **credit exposure** is defined to include only the noncollateralized portion of the securities lending or borrowing obligation, then only a portion of the transaction is subject to Section 23A and only that portion would count against the quantitative limits.

#### D. Repo Transactions as “Loans or Extensions of Credit”

Section 608 of the Dodd-Frank Act provides that affiliate repurchase transactions – transactions in which the bank agrees to purchase certain assets from an affiliate on the condition that the affiliate repurchase those assets at a later date – must be treated as a “loan or extension of credit” for purposes of Section 23A. Currently, for purposes of Section 23A repo transactions generally are viewed as two separate transactions – an asset purchase followed by an asset sale – with only one leg of the transaction – the asset purchase – being treated as a covered transaction.<sup>30</sup> Inasmuch as this leg is treated as an asset purchase, the transaction is subject to the quantitative limits and qualitative limits (*i.e.*, the low-quality asset restriction), but the transaction is not subject to the collateral requirements. The Dodd-Frank Act collapses the two legs of the transaction and treats the transaction in its entirety as an extension of credit by the bank to its

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<sup>29</sup> See, e.g., Letter to Patrick S. Antrim, Assistant General Counsel, Bank of America Corporation (January 23, 2007) (securities lending transactions); Letter to John H. Huffstutler, Associate General Counsel, Bank of America Corporation (securities borrowing transaction).

<sup>30</sup> The one exception is, the Federal Reserve has on occasion treated repo transactions involving U.S. Treasuries or other marketable securities as **extensions of credit** for purposes of Section 23A. See, e.g., Amendments to Restrictions in the Board’s Section 20 Orders, Board of Governors of the Federal Reserve System, *Bank Holding Companies and Change in Bank Control (Regulation Y)*, 62 FEDERAL REGISTER 45,295 (August 27, 1997) (discussing now-rescinded Section 20 Firewall 1(b), which treated securities repo transactions as Section 23A “extensions of credit” subject to the collateralization requirements).

affiliate. Thus, the repo transaction will be subject to the Section 23A collateral requirements.<sup>31</sup> By the same token, in reclassifying a repo transaction as an **extension of credit** rather than as a **purchase of assets** under Section 23A, Congress in effect lifted the prohibition against repo transactions involving low-quality assets.<sup>32</sup>

Section 608 does not contain the qualifier, “to the extent that the transaction causes the ... bank ... to have **credit exposure** to the affiliate.” By comparison, this qualifier appears in both the newly added securities borrowing/lending provision and in the newly added derivatives provision. Thus, it appears that Congress may have intended the entire amount of the repurchase transaction to be subjected to the quantitative limits and collateral requirements, regardless of the amount of actual **credit exposure** (as that term is eventually defined by the Federal Reserve).<sup>33</sup>

#### E. Debt Obligations of an Affiliate Subject to Section 23A

Existing law provides that, in connection with a bank’s loan or extension of credit to a third party (*i.e.*, to a non-affiliate), the acceptance of **securities** issued by the bank’s affiliate as collateral results in a “covered transaction.”<sup>34</sup> In promulgating Regulation W in 2002, the Federal Reserve stated that it looks primarily to federal securities laws to determine what constitutes a **security** for purposes of Section 23A. Thus, in promulgating Regulation W the Federal Reserve concluded that, for these purposes, **securities** includes both equity and debt securities, bonds, debentures, commercial paper, or notes.<sup>35</sup>

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<sup>31</sup> The Dodd-Frank Act does not treat reverse repo transactions as if they are “loans or extensions of credit” for purposes of Section 23A. This makes sense; arguably, a reverse repo is the functional equivalent of a loan to the bank and should not be treated as if it is a Section 23A “loan or extension of credit.” However, the aspect of the reverse repo transaction involving the bank’s purchase of assets from a nonbank affiliate would continue to be treated as a “purchase” for Section 23A purposes.

<sup>32</sup> However, low-quality assets are not considered to be acceptable collateral for Section 23A’s collateral requirements. See 12 U.S.C. § 371c(c)(3). Thus, any low-quality asset that is the subject of the repo transaction could not serve as collateral, and the transaction would need to be separately collateralized.

<sup>33</sup> This curious result is especially true with respect to repurchase transactions involving securities, which are functionally quite similar to a securities borrowing transaction. While the securities borrowing transaction is subject to Section 23A only to the extent **credit exposure** is created, no such limitation applies to securities repo transactions.

<sup>34</sup> 12 U.S.C. § 371c(b)(7)(D).

<sup>35</sup> See Final Regulation, Board of Governors of the Federal Reserve System, *Transactions Between Member Banks and Their Affiliates*, 67 FEDERAL REGISTER 76,560, 76,572 (December 12, 2002). While commercial paper is in many instances not considered a **security** under federal securities laws, the Federal Reserve reasoned that it was sufficiently similar to

Dodd-Frank amends Section 23A to provide that acceptance as collateral of **debt obligations** of an affiliate also results in a covered transaction for purposes of Section 23A. The intent was to make it clear that the acceptance-of-collateral provision is not limited to collateral that otherwise would constitute a **security** under federal securities laws. Thus, in making a loan to a third party, a bank's acceptance of *any* debt obligation of an affiliate – such as a loan or receivable – as collateral for the loan results in a covered transaction, effective July 21, 2012.

Likewise, Section 23A currently bars certain types of assets from serving as collateral for a bank's loan or extension of credit to an affiliate. In particular, under the terms of the statute, "securities issued by an affiliate" are ineligible. The Dodd-Frank Act amends this prohibition to make **debt obligations of an affiliate** equally ineligible as collateral for a covered transaction, effective July 21, 2012.<sup>36</sup>

#### F. Collateral Maintenance Requirement is Ongoing

Currently, Section 23A requires that collateral be posted in connection with a loan or extension of credit to an affiliate, in an amount ranging from 100% to 130%, with the exact percentage depending on the nature of the collateral posted. The amount of collateral posted is determined "at the time of the transaction," based on the transaction's "initial value" and the value of the collateral at the time of the transaction. If any portion of the posted collateral later amortizes or is retired, the amortized or retired collateral is required to be replaced with other collateral sufficient to maintain the appropriate percentage. However, if the collateral otherwise diminishes in value, additional collateral is *not* required to be posted to maintain the appropriate percentage.<sup>37</sup> For example, if an extension of credit to an affiliate is to be collateralized by publicly traded equity securities, the appropriate collateral percentage is 130% as of the time of the transaction, but if the equity securities later deteriorate in value, no additional collateral is required to maintain the 130% ratio.

Section 608 substantially changes these existing collateral practices, and requires maintenance of the required percentage "at all times" rather than merely "at the time of the transaction." Thus, banks will be required to add additional collateral if

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"debentures" and "notes" and therefore specifically included commercial paper in Regulation W's concept of "securities."  
*Id.*

<sup>36</sup> Section 23A precludes a low-quality asset from serving as collateral for such a covered transactions. 12 U.S.C. § 371c(c)(3). Intangible assets (such as pledged mortgage servicing rights) are also ineligible as collateral.

<sup>37</sup> 12 C.F.R. § 223.14(e).

the posted collateral deteriorates in value below the required threshold. It is unclear whether the obligation to post additional collateral will be triggered upon a change in valuation required for GAAP purposes, or whether the bank will otherwise be required to mark-to-market the posted collateral (regardless of GAAP requirements) and, if so, how often.

#### G. Repeal of Quantitative Limit Exemptions for Financial Subsidiaries

Under current law, a *financial subsidiary* – a subsidiary of a national bank that engages in “financial in nature” activities not otherwise permissible for a national bank, such as certain insurance or securities activities<sup>38</sup> – is considered an *affiliate* for purposes of Section 23A. However, transactions between the national bank and its financial subsidiary are exempt from the 10% individual quantitative limit, although covered transactions with the financial subsidiary (including the national bank’s investment in the financial subsidiary, other than retained earnings) are counted towards the 20% aggregate quantitative limit.

Section 609 of the Dodd-Frank Act withdraws the exemption from the 10% individual quantitative limit in its entirety. In addition, Section 609 repeals the provision that excludes retained earnings from the 20% aggregate quantitative limit. The effect of these changes is to restrict the amount of a national bank’s investment in or other covered transaction with its financial subsidiaries. However, Section 609 states that these changes apply solely to covered transactions entered into after the effective date of the amendment (*i.e.*, after July 21, 2012). Thus, covered transactions (including investments) entered into prior to July 21, 2012 with a financial subsidiary should not be subject to the 10% limit, and retained earnings accrued in a financial subsidiary prior to July 21, 2012 should not count towards the 20% limit.

#### H. Change in Federal Reserve Exemptive Authority

Section 608 significantly changes the Federal Reserve’s exemptive authority. Under current law, the Federal Reserve has the authority to grant exemptions, by both rule and order, from the provisions of Section 23A. Pursuant to that authority, the Federal Reserve has granted exemptions for certain types of transactions (such as intraday extensions of credit) by regulation,<sup>39</sup> and has granted exemptions

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<sup>38</sup> See, e.g., 12 U.S.C. § 24a; 12 C.F.R. 223.3(p).

<sup>39</sup> See, e.g., 12 C.F.R. §§ 223.41, 223.42.

on a case-by-case basis to banks by order.<sup>40</sup> In granting exemptions by order, the Federal Reserve's practice has been to consult with the primary Federal banking agency for the bank that is the subject of the request.

Section 608 shifts to the primary Federal banking agency the authority to grant exemptions by order. Thus, with respect to national banks and federal savings banks, the authority to grant Section 23A exemptions by order is shifted to the OCC; with respect to state nonmember banks and state savings associations, the authority to grant Section 23A exemptions by order is shifted to the FDIC. In all cases, the primary Federal banking agency must conclude that the exemption "is in the public interest and ... consistent with the purposes of" Section 23A (with respect to state banks – whether member or not – the determination must be made jointly by both the Federal Reserve and the FDIC). In all instances, the FDIC is conferred a 60-day period in which it can object to the exemption order (and thus block the grant of the exemption) if the FDIC determines "that the exemption presents an unacceptable risk to the Deposit Insurance Fund."

Under the Dodd-Frank Act, the Federal Reserve retains the authority to grant exemptions by regulation. However, the FDIC is once again conferred a 60-day period in which it can object to the regulation if it determines "that the exemption presents an unacceptable risk to the Deposit Insurance Fund."

## I. Netting Regulations

Section 608 of the Dodd-Frank Act states that the Federal Reserve may issue regulations or interpretations addressing whether a netting agreement between a bank and its affiliate may be taken into account in determining the amount of covered transactions between a bank and its affiliates, and whether a covered transaction is appropriately collateralized. Currently, Section 23A does not formally recognize netting agreements, and the quantitative limits and collateral requirements on their face apply without taking into account the existence of any such netting arrangements that might effectively reduce the bank's exposure to the affiliate.

Section 608 requires that any such netting regulation or interpretation must be issued "jointly with the appropriate Federal banking agency for such ... bank,

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<sup>40</sup> The Federal Reserve typically publishes on its website its Section 23A exemptive orders as legal interpretations of the Federal Reserve Act. See <http://www.federalreserve.gov/boarddocs/legalint/>.

subsidiary, or affiliate.” As Section 23A applies to OCC, FDIC, and Federal Reserve -regulated banks and thrifts, this provision will require across-the-board joint agency rulemaking. If adopted, this provision could significantly reduce the amount of collateral required for loans or extensions of credit with affiliates (especially derivatives) and somewhat ease the pressure on the quantitative limits as well.

#### J. FDIC Consent Required for Section 23B Exemptions

Currently, the Federal Reserve has authority to grant exemptions or exclusions from Section 23B by regulation.<sup>41</sup> Section 608 amends Section 23B to require that any such exemption or exclusion be “in the public interest and ... consistent with the purposes of” Section 23B, and further confers on the FDIC a 60-day period in which it can object to the regulation if the FDIC determines “that the exemption presents an unacceptable risk to the Deposit Insurance Fund.”

#### IV. Next Steps

Dodd-Frank’s amendments to Sections 23A and 23B will have a significant impact on transactions between banks and their affiliates. Anticipated Federal Reserve rulemaking, such as establishing the definitions of *credit exposure* and *derivative transaction*, whether to recognize netting arrangements, and determining how the appropriate amount of collateral should be maintained “at all times,” will heavily influence the impact.

The impact of these changes will be felt most heavily with respect to a bank holding company’s derivative programs and fund advisory relationships. Bank holding companies that advise funds will need to be cognizant that transactions directly with those funds (or, under the attribution rule, with third parties but the proceeds of which are transferred to those funds) will be subject to Section 23A’s quantitative limits, and if in the form of an extension of credit, the onerous collateral requirements as well. Bank holding companies will need to re-evaluate the structure of their derivative programs, too. Bank holding companies in which a bank enters into back-to-back derivatives transaction with a single nonbank affiliate will need to be cognizant that this structure may place a strain on the bank’s 10% individual quantitative limit. In any case, the application of the 20% aggregate quantitative limit, coupled with the imposition of collateral requirements – with no exemption for *bona fide* hedging transactions – may lead some banks to enter into hedging

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<sup>41</sup> 12 U.S.C. § 371c-1(e).

transactions with third parties rather than with affiliates, simply in order to preserve the bank's 23A quantitative limit capacity.

Undoubtedly the Federal Reserve will issue proposed amendments to Regulation W to reflect the changes required by the Dodd-Frank Act, and to add new definitions (such as the critical term, *credit exposure*), although no timeline for issuing the proposed amendments has been announced.

In the meantime, banks should be preparing *now* for the application of expanded Sections 23A and 23B:

- Banks should identify any new "affiliates" created by the expanded definition. In particular, banks should identify funds advised by the bank or any affiliate and determine to what extent the bank has existing, or is expected to enter into, covered transactions with (or for the benefit of) those funds, and should assess the quantitative and collateral implications of these transactions as well.
- Banks should identify all derivative transactions, repos, and securities lending / borrowing transactions with affiliates. Banks should determine the individual and aggregate quantitative limit and collateral impacts of these transactions, especially with respect to the amount of exposure not covered by any existing netting or margin.
- Banks should identify all transactions with third parties in which the bank has accepted debt obligations of an affiliate as collateral. These transactions should be re-evaluated in light of the quantitative limits and collateral requirements.
- Banks that rely on covered transaction collateral that is not routinely marked-to-market should consider replacing that collateral with marked-to-market collateral.

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# Clients & Friends Memo

## The Dodd-Frank Whistleblower Provisions:

### Considerations for Effectively Preparing for and Responding to Whistleblowers

May 26, 2011

As part of the Dodd-Frank Act (“**Dodd-Frank**” or the “**Act**”), Congress created powerful incentives to encourage persons to report (i) potential violations of the federal securities laws to the Securities and Exchange Commission (“**SEC**”)<sup>1</sup> and (ii) potential violations of the Commodity Exchange Act (the “**CEA**”) to the Commodity Futures Trading Commission (the “**CFTC**”).<sup>2</sup> While the Sarbanes-Oxley Act (“**SOX**”) encouraged up-the-ladder reporting by employees and allowed for self-policing and self-reporting by companies of potential violations, the Dodd-Frank Act’s whistleblower provisions will incentivize external reporting to the regulators that may hamper a company’s ability to self-police and self-report. The SEC’s rules to implement those provisions of the Act within the SEC’s authority, approved yesterday on May 25, 2011,<sup>3</sup> raise serious challenges for public corporations, broker-dealers, investment advisers, hedge funds, credit rating agencies, and other companies that are subject to the federal securities laws.

Companies may expect an increase in the number of complaints that circumvent internal reporting mechanisms and instead go directly, or through plaintiffs’ lawyers, to the government. Indeed, “[t]he Commission estimates that it will receive approximately 30,000 tips, complaints and referrals submissions each year” pursuant to the Dodd-Frank whistleblower provisions.<sup>4</sup> Put bluntly, there is now a material risk that individuals will disdain internal reporting in favor of a potential bounty from the government. Accordingly, affected companies are faced with increased regulatory and law enforcement scrutiny and a threat of more and more rapid derivative and private securities class

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<sup>1</sup> Dodd Frank Act, § 922, *et seq.*

<sup>2</sup> Dodd-Frank Act § 748 *et seq.* Although the CFTC’s proposed rules have not been finalized, these proposed rules tracked the SEC’s originally proposed rules. Companies that have exposure to both securities and commodities regulations should be aware of the overlap of, and potential interaction between, the SEC and CFTC whistleblower rules. This article is not intended as an analysis of the CFTC whistleblower rules.

<sup>3</sup> “Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934,” SEC Release No. 34-64545 (May 25, 2011) (“SEC Rules Release”). See <http://sec.gov/rules/final/2011/34-64545.pdf>.

<sup>4</sup> SEC Rules Release at 209.

actions as plaintiffs' firms offer enticing promises to whistleblowers. Tellingly, typing in the phrase "whistleblower" into an internet search engine results in a number of law firms trying to recruit corporate employees to profit by becoming whistleblowers. An examination of these profit-oriented sites shows that they are in the business of selling to employees the notion of making money by becoming whistleblowers.

Without a critical evaluation and modification of internal policies, procedures, and training, a company may lose the benefit of itself conducting a considered examination of the validity of claims, addressing and correcting any problems, and, where appropriate, self-reporting the conduct to the appropriate governmental authorities.

With these new rules, there is little doubt that whistleblowers who elect to go to the government, rather than attempt to prevent or correct problems internally, will cause companies considerable expense, even where their allegations are unfounded or relate to immaterial violations. That said, the manner in which a company responds to a whistleblower will ultimately have a tremendous impact on the company's legal and financial exposure. Although a company is prohibited from retaliating against a whistleblower, companies can and should take steps to encourage internal reporting, prevent the unauthorized flow of information to non-parties, and reduce the likelihood that other employees and non-parties become external whistleblowers. When a complaint is received, companies now must decide even more promptly whether to investigate, self-report, and cooperate with the government. Obtaining "credit" from the government for cooperating becomes more challenging, albeit not impossible, when there is a whistleblower.

This memorandum describes the mechanics of the whistleblower rules and discusses some of the proactive steps companies should consider to encourage individuals to use internal reporting systems before, or instead of, contacting the SEC. It also highlights some of the issues companies should consider in order to reduce potential financial and legal liability once whistleblowers have gone to the government.

### **Dodd-Frank Whistleblower Provisions Explained**

Numerous websites, including those sponsored by plaintiffs' lawyers, are designed to entice employees to become whistleblowers and to turn against their companies in the hope of big bounties. When faced with such ubiquitous marketing, there is no doubt that employees may misunderstand exactly what is required under the Dodd-Frank whistleblower provisions and related SEC rules. Educating employees concerning a company's established compliance programs as well as on the SEC whistleblower provisions may be the best way to encourage employees to report any problems internally and allow a company to self-correct any real problems.

The Dodd-Frank Act adds Section 21F to the Securities Exchange Act of 1934. Section 21F requires the SEC to award eligible whistleblowers a bounty of 10 to 30% of the monetary sanctions recovered in eligible SEC or related actions stemming from the whistleblower's information. The Dodd-Frank whistleblower provisions were immediately effective as of June 22, 2010, and arguably cover misconduct reported on or after that date, even if the conduct itself occurred prior to the passage of Dodd-Frank. Even though the provisions became effective on adoption of Dodd-Frank, Congress dictated that the SEC pass rules regulating how those provisions would be implemented in practice. Those rules, proposed on November 3, 2010,<sup>5</sup> were finalized yesterday, May 25, 2011.

The SEC rules state that eligible individuals who voluntarily provide the SEC "original information" (as defined in the rules) about any violation of the federal securities laws, that leads to a successful SEC enforcement action of \$1 million or more, are entitled to a sizeable percentage of the aggregate recovery by the government in that or any related action. Importantly, the SEC rules do not require an employee-whistleblower to report complaints internally first or at all. However, the rules are intended to provide certain incentives for individuals to utilize internal compliance resources. As explained below, however, the whistleblower rules still pose a significant threat to the efficacy of internal compliance programs by incentivizing individuals, including even those employees with compliance responsibilities, to bypass internal compliance measures.

***Who Can Be A Whistleblower?*** Except for legal entities and the other exclusions discussed below, almost any individual may be eligible to receive a whistleblower bounty. Employees, former employees, vendors, agents, contractors, clients, customers, and competitors are all potential sources of tips and complaints that could justify a whistleblower award. Perhaps somewhat remarkably, even individuals involved in securities violations may be eligible whistleblowers under Dodd-Frank.

***Exclusions.*** With some significant exceptions, the following categories of individuals are generally excluded from obtaining a whistleblower award under Dodd-Frank.

- Officers, directors, trustees, or partners of an entity, who are informed of allegations of misconduct.<sup>6</sup>
- Individuals with compliance or audit responsibilities at an entity, who receive information about potential violations.

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<sup>5</sup> "Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934," SEC Release No. 34-63237 (Nov. 3, 2010).

<sup>6</sup> Officers, directors, trustees, and partners still may be eligible whistleblowers relating to possible violations that the individual observes or discovers themselves.

- Attorneys cannot be whistleblowers on their own behalf in connection with information they obtained in the course of their representation of a client. This prohibition applies both to in-house lawyers and outside counsel representing a company.<sup>7</sup>
- Accountants are ineligible for awards when providing information about a client or its directors or officers if obtained in the context of providing outside auditing services to that company.
- Foreign government officials.
- Individuals with a pre-existing legal obligation to report information about potential violations to the SEC or to other authorities (e.g., government contracting officers).

**Significant Exceptions to the Excluded Persons.** Notwithstanding these limitations, officers, directors, trustees, partners, and individuals responsible for, or involved in, internal compliance or audit at an entity, may take advantage of potentially broad exceptions and be eligible as whistleblowers. First, these individuals may report directly to the SEC as whistleblowers to the extent they have a “reasonable basis to believe that disclosure of the information to the Commission is necessary to prevent . . . conduct that is likely to cause *substantial injury* to the financial interest or property of the entity or investors.”<sup>8</sup> Second, these individuals may report directly to the SEC 120 days after the individual has reported the information internally to appropriate internal resources (such as, for example, a supervisor, the chief legal officer, or the audit committee).<sup>9</sup> These exceptions alone threaten to swallow the rule.

**Culpable Individuals Not Excluded.** The SEC rules do *not* exclude individuals who may be responsible or complicit in a violation from receiving a whistleblower award unless and until they are convicted of a crime related to the information reported.<sup>10</sup> The SEC, however, will consider the conduct of a whistleblower in determining the amount of any eligible award, and will subtract the amount of a fine paid by the whistleblower, or attributable to the whistleblower’s conduct, in assessing whether the \$1 million recovery threshold has been reached.

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<sup>7</sup> Other laws and regulations may impose distinct obligations on individuals relating to the reporting of potential violations. For example, SOX Section 307 requires, in most cases, attorneys appearing and practicing before the SEC to report credible evidence of potential violations of the securities laws “up the chain” within a company.

<sup>8</sup> SEC Rule 21F-4(b)(4)(v)(A).

<sup>9</sup> SEC Rule 21F-4(b)(4)(v)(C). Where an officer, director, partner, trustee, or compliance or audit personnel have received information under circumstances indicating that appropriate internal resources are already aware of the information, the 120 days begins running immediately, without any further internal reporting by the individual. Those same otherwise excluded individuals also may report directly to the SEC and be eligible as an SEC whistleblower if they “have a reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct.” *Id.* at 21-F-4(b)(4)(v)(B).

<sup>10</sup> Thus, an individual that enters into a non-prosecution or deferred prosecution agreement with the Department of Justice or another criminal authority would not be precluded from receiving a whistleblower award.

**“Original Information” Must Be Derived from “Independent Knowledge.”** Under the SEC rules, “original information” is information that is (1) not already known to the SEC, (2) derived from an individual’s independent knowledge or analysis, and (3) not exclusively derived from an allegation in a judicial or administrative hearing, or similar action. “Independent knowledge,” meanwhile, is defined as information that is not obtained from public sources,<sup>11</sup> although a whistleblower need not have direct, first-hand knowledge of potential violations. Independent knowledge can include information from experience, observation, or even communications with other employees, clients, vendors or non-parties.

**Submission Must Be Voluntary.** An individual is eligible for a whistleblower award if he or she provides information to the SEC prior to the SEC (or any other enumerated regulator)<sup>12</sup> making any formal or informal request, inquiry or demand directly to the whistleblower for that information.<sup>13</sup>

**Information Must “Lead to” a Successful Enforcement Action.** The SEC has made clear that it will not award a whistleblower bounty for every tip and complaint. Rather, a bounty only will be awarded to a whistleblower who provides information that “leads to” a successful SEC enforcement action. The SEC rules contemplate that only information of high quality, reliability, and specificity will merit an award. The SEC will look to both the significance of the information provided in opening an investigation as well as the role the information plays in the success of a related enforcement action.

With respect to situations where the SEC is not already looking into the precise conduct raised by the potential whistleblower, information will be considered to have led to successful enforcement when it is “sufficiently specific, credible, and timely to cause the staff to commence an examination, open an investigation, reopen an investigation that the Commission had closed, or to inquire concerning different conduct as part of a current examination or investigation, and the Commission brings a successful judicial or administrative action based in whole or in part on the conduct identified in [the] original information.”<sup>14</sup> A whistleblower award should be rare in connection with

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<sup>11</sup> According to the comments to the SEC rules release, “publicly available sources may include both sources that are widely disseminated (such as corporate press releases and filings, media reports, and information on the internet), and sources that, though not widely disseminated, are generally available to the public (such as court filings and documents obtained through Freedom of Information Act requests).”

<sup>12</sup> Information provided subsequent to a request from “[the SEC], Congress, any other federal, state, or local authority, any self-regulatory organization, or the Public Company Accounting Oversight Board,” would not be deemed voluntary.

<sup>13</sup> The commentary to the SEC rules notes that “individuals who wait to make their submission until after a request is directed to their employer will not face an easy path to an award. We expect to scrutinize all of the attendant circumstances carefully in determining whether such submissions ‘significantly contributed’ to a successful enforcement action under Rule 21F-4(c)(2) in view of the previous request to the employer on the same or related subject matter.” SEC Rules Release at 31 n. 73.

<sup>14</sup> SEC Rule 21F-4(c)(1).

conduct that is already under investigation. In those situations, only information that has “significantly contributed” to the success of an SEC enforcement action, will be considered eligible to merit a whistleblower award.

***Internal Reporting Still Permitted But Not Required.*** In an attempt to recognize the importance of a company’s internal compliance function, the SEC rules are intended to provide some incentive to whistleblowers to first report the possible violation through internal company channels. First, the SEC rules provide that an internal whistleblower may be eligible for an award in those circumstances where the company reports to the SEC information received from the whistleblower, or the results of an investigation initiated in response to the whistleblower’s information. In those circumstances, all the information reported by the company will be deemed attributable to the internal whistleblower. Second, the rules grant a 120-day grace period to an internal whistleblower. An individual would be deemed to have reported directly to the SEC at the same time they have reported internally, so long as he or she voluntarily reports original, independent information to the SEC within 120 days of having first reported the information internally to the company. Finally, when considering the amount of an award to grant a whistleblower, the SEC will consider whether and to what extent an individual made use of (or alternatively, interfered with) internal compliance procedures.

***Recovery and Rewards.*** Dodd-Frank and the SEC rules provide that where the SEC recovers at least \$1 million, a reward to eligible whistleblowers must be between 10 and 30% of the aggregate monetary sanctions obtained by the SEC and other U.S. governmental entities in any related actions. The calculation of the monetary sanctions includes penalties, civil and criminal fines, and disgorgement, in addition to interest. The SEC retains broad discretion to determine the precise amount awarded to an eligible whistleblower, vetted through a new Claims Review Staff.<sup>15</sup> The SEC will consider the following factors in determining the amount of an award: the significance of the information provided; the degree of assistance provided; the SEC’s “programmatic interest”; and various other factors, including, as observed above, whether the whistleblower made use of (or alternatively impeded) a company’s internal compliance function, whether the individual put himself or herself in danger, whether the whistleblower encouraged others to assist the SEC, and the culpability of the whistleblower.

***Reward and Anonymity Is Not Guaranteed.*** Although the whistleblower provisions are designed specifically to incentivize individuals to come forward, there are important substantive and procedural steps that the SEC requires before issuing an award. In addition to the eligibility requirements described above, potential whistleblowers must: (i) submit information, under the

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<sup>15</sup> As noted below, the SEC rules provide a purported whistleblower with the right to appeal the denial of an award, but no right to appeal the amount of an award that is within the statutory range.

penalty of perjury, on a designated federal form; (ii) agree to provide testimony if requested; (iii) enter into a confidentiality agreement with the government if requested; and/or (iv) provide other assistance and cooperation with the Commission's investigation or related actions. As a result, whistleblowers may be faced with years of ongoing cooperation obligations, including the time, difficulty and out-of-pocket expense associated with such cooperation. And, at the end of the process, if the SEC has not recovered over \$1 million from the alleged violation, or if the SEC determines that the individual is ineligible, the whistleblower will not receive any bounty.

Even assuming there is an eligible recovery from a final judgment, a whistleblower also must file a claim for award, which is reviewed and evaluated by the SEC staff. If history guides, the time from initiation of investigation to the SEC's recovery of a monetary sanction could run anywhere from two to eight years, and a whistleblower's bounty will be paid only after the SEC actually collects eligible funds.<sup>16</sup> Moreover, although initial whistleblower reports can be filed anonymously via an attorney, a whistleblower must identify himself or herself to the SEC prior to collecting any reward.

Potential whistleblowers will have no control over the scope or length of an SEC investigation they instigate through a whistleblower complaint. Once a formal order of investigation is opened by the SEC, the SEC Enforcement staff may decide to investigate whether the whistleblower had a role in the alleged violation or should have done more to prevent any wrongdoing, and could pursue any potential violations, even those involving the whistleblower.<sup>17</sup>

***Expanded Protection for Whistleblowers.*** The Dodd-Frank Act enhances existing protections for employees who report possible violations of the securities laws either internally or to the SEC or other federal authorities. As a result, companies must have strict anti-retaliation policies and procedures and must be prepared to clearly document those practices in order to limit exposure to employment-related claims that could add further liability beyond the reported offense.

Dodd-Frank makes it unlawful for any employer to "discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and

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<sup>16</sup> An individual has a right to appeal an SEC decision as to whether he or she is an eligible whistleblower. However, there is no right to appeal the SEC's determination of the amount of a whistleblower award that is within the statutory range of 10-30% of the aggregate monetary recovery. Nor is there any obvious right for a whistleblower to challenge the amount of an SEC (or other regulatory) settlement, even though the amount of any settlement will dictate their eligibility to receive an award and the amount of any such reward. Nevertheless, it is not far-fetched to imagine instances where an aggressive whistleblower (or a whistleblower with aggressive legal counsel) could seek to intervene as an interested party during the federal court review of an SEC settlement of a federal court action.

<sup>17</sup> An individual's status as a whistleblower will not provide amnesty from SEC charges or criminal prosecution. SEC Rule 21F-15. For this reason, a whistleblower that has potential legal exposure also may seek to enter into a cooperation agreement with the SEC (and other authorities), to best ensure leniency. SEC cooperation agreements are relatively new (first announced in January 2010), and it remains to be seen how the SEC's new cooperation agreements and the new whistleblower provisions will interact.

conditions of employment because of any lawful act done by the whistleblower.”<sup>18</sup> Protected conduct includes (1) providing information under the whistleblower provisions, (2) participating in an investigation or action of the SEC relating to information provided under the provisions, or (3) otherwise making disclosure required or protected under any law or regulation within the SEC’s purview. Employee-whistleblowers under Dodd-Frank can sue their employers civilly for up to six years after any alleged retaliatory conduct, and can recover up to twice their back pay with interest. They need not seek administrative relief first, unlike whistleblower protections under the Sarbanes-Oxley Act (“SOX”). In addition, the SEC has indicated that it has “enforcement authority” against employers who violate the Dodd-Frank whistleblower protections.<sup>19</sup>

Dodd-Frank also extends protections under the pre-existing SOX whistleblower protections that have been in place since 2003. Pursuant to SOX Section 806, employee-whistleblowers may continue to file discrimination claims if they face adverse employment actions on the basis of providing information regarding potential violations of the federal mail, wire, bank or securities fraud statutes (or for assisting in related investigations), either internally within a company, or externally to a federal law enforcement or regulatory agency. Dodd-Frank expands those protections in four significant respects.

*First*, Dodd-Frank extends the time period for employee-whistleblowers to file SOX discrimination claims with OSHA from 90 days to 180 days. *Second*, the Act expressly provides for jury trials for discrimination claims brought under SOX. *Third*, the Act prohibits the use of predispute arbitration agreements for SOX discrimination claims. *Fourth* and finally, the Act expands SOX coverage to include not only employees of issuers, but also to all employees (including those abroad) of subsidiaries of publicly traded companies whose financial information is included in the consolidated financial statements of the publicly traded company and financial service employees and employees of nationally recognized statistical rating organizations.

### **Proactively Reassessing Compliance Controls, Training, and Response Plans**

The new whistleblower provisions create a host of concerns even for careful companies. Entities with exposure to federal securities laws should consider a critical assessment of their company’s existing compliance regime and response plans as a step in preparing for the new world of Dodd-Frank whistleblowers.

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<sup>18</sup> Dodd-Frank Act, § 922(h)(1)(A).

<sup>19</sup> SEC Rules Release at 18. A judge in the Southern District of New York already has interpreted the Dodd-Frank whistleblower protections. In *Egan v. TradingScreen*, 10 Civ. 8202 (LBS) (S.D.N.Y. May 4, 2011), the district court ruled that an employee must do more than report a complaint internally at a privately held company to state a retaliation claim under Dodd-Frank’s SEC whistleblower protections.

***Encouraging Internal Reporting Procedures.*** Even without a whistleblower bounty, entities should not expect internal reporting procedures to be used unless the company has established a clear tone of compliance, published unambiguous policies and procedures, and trained adequately employees regarding those internal rules. The internal rules must be clear and easy for employees to understand, and enforcement of the rules must be consistent. Companies should consider implementing an overall risk system that integrates compliance, legal, internal audit, and external audit to create a risk-based approach to preventing, detecting, and responding promptly to potential violations. As part of such a system, user-friendly internal reporting mechanisms are essential to encourage employees, agents, and others to bring any potential wrongdoing to the attention of the company.

Moreover, an effective compliance program, which delineates clear guidelines for the detection and reporting of corporate misconduct, is critically important to how Department of Justice prosecutors evaluate an organization's compliance controls. The Principles of Federal Prosecution for Organizations, which govern how prosecutors investigate and penalize corporations, emphasize the existence of a meaningful compliance program in determining the just resolution of corporate investigation.<sup>20</sup> The principles instruct prosecutors to consider the comprehensiveness of the compliance program and to specifically evaluate whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct. The critical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives. Accordingly, companies should consider steps to encourage internal reporting, while alerting employees to the reality of the SEC's whistleblower bounty program. For example, companies should consider:

- *Hotlines.* Anonymous hotlines for employees, contractors, vendors and clients to report potential securities law violations, and a process that prioritizes such tips and complaints based on risk factors.
- *Audit.* An independent internal audit function with designees in the business lines, and an audit committee with active oversight and involvement in the audit function.
- *Prioritization.* Processes and procedures that ensure that internal complaints are prioritized and evaluated quickly and thoroughly, and that results and trends from complaints are integrated into the company's assessment of its compliance risks and financial reporting controls.
- *Internal Reporting Requirements.* Employing or strengthening internal rules that require employees to report any suspected wrongdoing to legal or compliance personnel, and that

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<sup>20</sup> See U.S. Attorney's Manual available at <http://www.justice.gov/opa/documents/corp-charging-guidelines.pdf>.

expressly prohibit employees from sharing information with certain non-government entities, such as the media.

- *Internal Reporting Incentives.* Whether to provide rewards or other incentives – either financial or otherwise – for reporting potential violations internally. For example, prompt reporting of potential violations could form the basis of positive employment evaluations or promotion considerations.
  - Such a program, however, may raise its own problems of fair and effective administration.
  - In addition, companies should consider how internal incentives may affect employees' views of their existing obligations to prevent, detect, and report potential violations.
- *Training.* Establishing training programs that credibly reiterate an institutional commitment to integrity and fair dealing and clearly set out internal complaint procedures.
  - Effective training programs may incorporate a discussion of the SEC's whistleblower provision, including the burdens individuals face when they become whistleblowers and the ramifications for reporting false information.
  - Training should highlight for employees their obligation to report suspected wrongdoing to appropriate channels within the company, and, where applicable, remind relevant employees of their periodic certification and sub-certification responsibilities, and of potential adverse employment consequences of non-compliance.<sup>21</sup>
  - Employees also should understand that the company will not restrict their ability to report matters directly to the SEC. On the other hand, employees should be reminded of their confidentiality obligations to the company and the ramifications of disclosing information to non-parties with whom they lack an attorney-client relationship.
  - Companies should explain to employees that they will not forgo their opportunity to receive a bounty from the SEC if they report the allegations first to the company, and in fact, stand to receive a greater award if they utilize internal reporting channels.<sup>22</sup>

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<sup>21</sup> Although Dodd-Frank prohibits a company from stopping an employee from reporting to the SEC, nothing prohibits a company from establishing and enforcing its own internal reporting requirements. Indeed, the Securities and Exchange Act's internal control provisions arguably require public companies to rigorously enforce employees' duties to report suspected wrongdoing within the company. Securities Exchange Act of 1934, § 13(b)(2)(B) (requiring issuers to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that transactions and assets are recorded appropriately).

<sup>22</sup> As discussed above, an employee who makes use of internal compliance reporting mechanisms may be eligible for an increased award in the SEC's discretion, and, to the extent the company reports to the SEC the whistleblower's information or the results of an investigation initiated based on that information, may receive an award as if they reported the information directly to the SEC.

- *Exit Interviews.* Establishing a comprehensive exit-interview process designed to identify both potential substantive issues and potential disgruntled employees, before a former employee becomes a future whistleblower.

***Responding to Internal Complaints.*** The best way to truly encourage internal complaint reporting is to foster trust in the internal system. This is best accomplished by effectively responding in a timely fashion to any credible tips or complaints. Employees who believe that the company is unresponsive to complaints are more likely to go outside when they perceive problems. Moreover, because of the incentives for both whistleblowers and companies to be the first to report a violation to the SEC, the whistleblower provisions greatly increase the importance for a company to quickly, yet sufficiently, assess complaints in order to be in a position to self-report a violation to the SEC.<sup>23</sup>

A key element in the successful defense or mitigation of any federal investigation is the company's ability to stay ahead of the investigation. A company's ability to reduce the breadth, depth, and length of governmental investigations by proactively self-investigating potential violations, remedying problems, and ultimately receiving credit for cooperation, can provide substantial benefit to a company, including reducing fines and penalties, preventing debarment, and avoiding some or all civil and criminal charges. But a company must act promptly to receive cooperation credit after a whistleblower's tip or complaint has been received.

Under the SEC's *Seaboard 21(a) Report*, the SEC adopted a policy of crediting companies for "self-report[ing]" violations. The SEC release relating to the whistleblower provisions makes clear that the SEC's cooperation policy is not altered by the whistleblower rules:

[W]hen considering whether and to what extent to grant leniency to entities for cooperating in our investigations and related enforcement actions, the promptness with which entities voluntarily self-report their misconduct to the public, to regulatory agencies, and to self-regulatory organizations is an important factor. At the same time, it is important to note that this rule is not intended to, and does not, create any new or special duties of disclosure on entities to report violations or possible violations of law to the Commission or to other authorities.<sup>24</sup>

Even well-prepared companies may find it difficult to conduct a thorough review of an internal complaint in a timeframe that permits the company to get to the SEC before a whistleblower does. Companies may decide to self-report certain allegations received through internal reporting channels before the company has had an opportunity to fully investigate if the allegation is serious

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<sup>23</sup> Entities subject to FINRA regulations may have regulatory obligations to report violations pursuant to FINRA Rule 4530.

<sup>24</sup> SEC Rules Release at 76 (internal footnotes omitted). See also, *infra* discussing a company's response to a known SEC whistleblower.

and has some indicia of credibility. However, the SEC appears to acknowledge these potential issues and invites companies to conduct internal investigations and self-report findings, in lieu of merely responding to an SEC-driven investigation.

Nor do we intend to suggest that an internal investigation should in all cases be completed before an entity elects to self-report violations, or that 120 days is intended as an implicit “deadline” for such an investigation. Companies frequently elect to contact the staff in the early stages of an internal investigation in order to self-report violations that have been identified. Depending on the facts and circumstances of the particular case, and in the exercise of its discretion, the staff may receive such information and agree to await further results of the internal investigation before deciding its own investigative course. This rule is not intended to alter this practice in the future.<sup>25</sup>

Companies, particularly large and multi-national companies, should consider reassessing their response plans related to internal complaints. Companies should be able to identify quickly serious complaints, make appropriate internal reports and assessments, investigate, and determine whether and when to self-report to the authorities. In order to do so, companies should consider the following factors, among others:

- The initial indicia of credibility associated with the complaint, including where applicable, the source of the complaint, the persons alleged to have been involved in the violation, the nature of the violation, and the likelihood that a violation may have occurred.
- The reasonable prospect that the whistleblower will (or has already) contacted the authorities.
- The initial assessment of the size and relative importance of the alleged violation (*i.e.*, materiality, including but not limited to SAB 99 criteria).
- Whether the violation is ongoing and/or relates to a current period.
- The possible legal ramifications if the allegations prove to be credible.

Companies also should consider identifying, in advance, a pool of potential outside counsel who could later be selected on short notice to conduct investigations with the speed and thoroughness required, so that critical time is not wasted vetting external counsel candidates after a significant complaint is received.

***Self-Reporting When Dealing with a Whistleblower.*** The consideration of whether and when to self-report an actual or potential violation will not be new for corporations with U.S. legal exposure.

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<sup>25</sup> SEC Rules Release at 77.

The whistleblower rules add a new dynamic in those decisions. Where it is clear that the internal whistleblower intends to report allegations to the SEC, a company should carefully consider whether to make a pre-emptive report to the SEC of the existence of a complaint, even where the company believes the complaint is untrue, immaterial, or otherwise defensible. A company's reporting of those allegations to the SEC first, or at least reporting them voluntarily, and explaining why those allegations are unfounded or unimportant, may avoid or truncate what otherwise could be a long and expensive government investigation. Self-reporting to the SEC may avoid or delay the institution of an SEC investigation.

There may be times that a whistleblower complaint to the SEC reveals such potentially serious misconduct that companies also must consider reporting the whistleblower complaint to the Department of Justice as well. This is necessary because the Department of Justice has its own criteria for rewarding cooperation and mitigating penalties for companies whose compliance policies comport with the principles enunciated in Chapter 8 of the United States Sentencing Guidelines. If a company is aware of a complaint regarding potential criminal misconduct, it must self-report in the face of a potential whistleblower complaint in order to obtain leniency from the Department of Justice in any potential criminal action the Department may bring. In particular, in order for a company to obtain the most leniency in a criminal prosecution, the Sentencing Guidelines and related commentary provides that a company must have, "(A) prior to an imminent threat of disclosure or government investigation; and (B) within a reasonably prompt time after becoming aware of the offense, reported the offense to appropriate governmental authorities, fully cooperated in the investigation, and clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct."<sup>26</sup>

***Reducing the Likelihood that an Employee Notifies the SEC after a Company Receives an Internal Complaint.*** Once a complaint is received internally, a company will have a particularly keen interest in minimizing the chance that a whistleblower will also report that information to the SEC. By doing so, a company will remain better positioned to control the scope and length of the investigation, remediate, and, where necessary, self-report misconduct to receive cooperation credit. Companies can take several steps to reduce the likelihood that an internal whistleblower will turn also to the SEC.

*First*, if their identity is known, the company should consider providing comfort to the whistleblower that the company is taking adequate steps to respond. A swift, objective investigation conducted by outside legal counsel will demonstrate to the whistleblower that the company is serious and responsible. While the company should not usually involve a whistleblower in the actual internal investigation, the company should consider providing procedural updates to the whistleblower,

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<sup>26</sup> See U.S. Sentencing Guidelines, 8C2.5(g).

including face-to-face meetings with in-house and/or external legal counsel, in order to address any concerns with the investigation. In some instances, the company may want to share limited substantive information with the whistleblower and may want to inform the whistleblower, where applicable and as appropriate,<sup>27</sup> that the conduct has been reported to the SEC in order to dissuade the employee from going separately to the SEC.

*Second*, the company should take immediate remedial actions where necessary. Where there are legitimate problems, the company should act immediately to rectify them, including, where local law permits, suspending potential wrongdoers during the pendency of an investigation and ultimately disciplining responsible parties.<sup>28</sup> Remediation is an important step towards earning cooperation credit from the government and fulfilling officers' and directors' fiduciary duties, in addition to reducing the likelihood that the whistleblower will go directly to the SEC.

*Finally*, by the same token, where the company concludes that there has been no violation, or that any breaches are immaterial, the company should consider explaining its findings to the whistleblower. While it is not always possible or advisable to inform an individual employee of the specific results or conclusions of an internal investigation, where appropriate the whistleblower should be provided with information sufficient to convince him or her of the thoroughness of the company's response and the reasonableness of the company's ultimate decisions.

***Responding Once a Whistleblower Has Gone to the SEC.*** Even despite best practices, some companies can expect that they will have an employee, former employee, vendor, client, or customer who will become an SEC whistleblower. When a company learns that an individual has gone to the SEC to report potential wrongdoing, the company must take appropriate steps to reduce subsequent liability by aggressively investigating the substantive issues and affirmatively interacting with the SEC.

Companies should recognize the process by which the SEC evaluates whistleblower complaints. The SEC's Whistleblower Office, in conjunction with the Office of Market Intelligence in the Division of Enforcement, is responsible for prioritizing tips and complaints. The SEC's priority system looks to the seriousness of the allegation, the quality of the information, the level of persons involved in the alleged wrongdoing (e.g., CFO), and whether harm to investors is ongoing or expected. From there, the Division of Enforcement will determine, on a case-by-case basis, whether and to what extent to devote resources to further investigative steps. This is not unlike

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<sup>27</sup> External and in-house legal counsel should remain cognizant of applicable local ethics rules that may restrict direct contact with whistleblowers who have legal representation.

<sup>28</sup> Multi-national companies may face substantial hurdles in effectively disciplining employees in light of local labor laws, but those hurdles should not impede the ability of the company to draw credible conclusions about individuals based on its internal review and taking appropriate and justified employment actions permitted by law.

what companies themselves must do, and it will pose the same time and resources constraints for the SEC.

In the year prior to the whistleblower regulations, the SEC's Division of Enforcement, which has 1,100 employees, received hundreds of thousands of tips and complaints. The number of complaints is expected to rise with the advent of Dodd-Frank; the Commission estimates it will receive at least 30,000 tips and complaints annually under the Dodd-Frank whistleblower provisions alone. Given this volume, the SEC's own budgetary restrictions, and the necessary lag between the receipt and investigation of those tips and complaints, the SEC may find it challenging to investigate all the tips and complaints from whistleblowers. Consequently, the SEC has made clear that, under appropriate circumstances, the Enforcement staff will allow (and in some instances may prefer) companies to conduct their own internal investigations of whistleblower complaints received by the SEC using outside counsel, prior to instituting or pursuing an SEC investigation.

[W]e expect that in appropriate cases . . . our staff will, upon receiving a whistleblower complaint, contact a company, describe the nature of the allegations, and give the company an opportunity to investigate the matter and report back. The company's actions in these circumstances will be considered in accordance with [the *Seaboard 21(a) Report*] and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions. This has been the approach of the Enforcement staff in the past, and the Commission expects that it will continue in the future. Thus, in this respect, we do not expect our receipt of whistleblower complaints to minimize the importance of effective company processes for addressing allegations of wrongful conduct.<sup>29</sup>

Companies have found that the opportunity to conduct a proactive internal investigation with experienced outside counsel is preferred over merely reacting to an SEC investigation. Companies that do so have a better chance to contain the breadth and length of the investigation, reduce intrusion on employees and interference with day-to-day business, and resolve potential issues more favorably with the regulator by receiving credit for cooperation.

***Handling an SEC Whistleblower.*** Once a company is aware of an SEC whistleblower, the company not only needs to handle the substance of the complaint itself, as described above, but also needs to evaluate how to deal with the individual source of the complaint.

*First*, in light of the enhanced protections and private rights of action available to employees under Dodd-Frank and SOX Section 806, companies should consider proactively reassessing their

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<sup>29</sup> SEC Rules Release at 92.

employment policies and procedures, rather than attempting to adapt only after a whistleblower has appeared. To limit exposure to future employment-related claims, companies must have well-defined policies and procedures that appropriately protect individuals from whistleblower discrimination, and must train employees to follow them.

*Second*, where the identity of the whistleblower is unknown, the company in consultation with outside counsel should carefully consider legitimate, non-discriminatory ways to quickly identify the source of the complaint. Understanding the source is an important part of evaluating the veracity of the complaint and appropriately focusing resources on how to investigate allegations. Moreover, identifying the source of the complaint gives the company the opportunity to protect itself from future employment claims. The company can ensure that a current employee identified as a whistleblower is treated appropriately, rather than risk the chance of an otherwise normal and justifiable employment action being misperceived or alleged as discriminatory. Identifying the source of a complaint also can be invaluable in successfully limiting and defending against exposure of the underlying allegations. Even before the Dodd-Frank whistleblower rules, experienced practitioners in both government and private practice realized that some whistleblowers may have less than altruistic objectives and less than perfect information. Understanding those limitations may provide tremendous assistance to a company in its dealings with regulators by permitting complaints from such individuals to be placed in the correct context.

Nevertheless, companies must be careful not to allow the appropriate identification of a whistleblower to become, or be perceived as, a witch hunt designed to pressure the individual who made the complaint or to have a chilling effect over potential future whistleblowers or cooperators. Mere allegations of such pressure could be devastating to a company's credibility before a regulator, and in the worst cases could give rise to stand-alone claims and criminal charges of obstruction of justice. The risks and rewards regarding the steps taken to identify a whistleblower must be weighed carefully and such steps must be executed with discretion and skill.

*Finally*, in those instances where an individual is identified as a whistleblower, the company should reevaluate whether and to what extent to share information about the company's internal investigative steps or conclusions with that individual.<sup>30</sup> In those circumstances, there will no longer be a need to mitigate the risk of an individual reporting directly to the SEC, but there still may be compelling reasons to ensure a whistleblower believes the company is responding appropriately. Companies may find that establishing and maintaining an open line of communication with the whistleblower provides the best opportunity to limit future additional complaints from the same individual, become aware of what information the whistleblower is continuing to share with

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<sup>30</sup> As noted above, local ethics rules may restrict company counsel's direct access to whistleblowers who are represented by counsel.

regulators or others, and enhance and positively project the company's commitment to compliance. With that said, companies must assume that a whistleblower will continue to act as a direct conduit of information to the SEC and perhaps to plaintiffs' attorneys.

On the other hand, companies also may want to carefully consider whether to discipline a current employee who failed to adequately report potential fraud internally, despite having gone to the SEC directly. Companies should protect the integrity of their own internal compliance regime and internal control over financial reporting, by expecting employees to do their job to detect, prevent, and report potential fraud or other violations. Companies are not required to ignore a whistleblower's own transgressions of internal policies and procedures. As with steps taken to identify whistleblowers, however, disciplining a known whistleblower is likely to result in severe criticism, and may garner claims of discrimination or obstruction. Those potential results should be weighed carefully in consultation with experienced counsel.

***Interplay of Whistleblower Reporting to SEC and Impact on Criminal Cases.*** The regulations published today do not address directly the consequences of a whistleblower reporting to the SEC in a case that warrants criminal, rather than only civil or administrative, enforcement. While the rules under Dodd-Frank may require significant proactive cooperation, including testimony, before a bounty is paid, it is not clear whether the whistleblower is similarly obligated to cooperate in a criminal prosecution with the Department of Justice. Moreover, while the rules contemplate the payment of a bounty in the case of "related actions" such as an investigation conducted by the Attorney General or his designees, it is usually anathema to federal prosecutors to rely on cooperating witnesses with a huge financial stake in the outcome of a case – particularly those who might have participated in the misconduct. It thus remains to be seen whether the Department of Justice will rely on the SEC's paid whistleblowers to the extent contemplated by Dodd-Frank, and consequently whether there will be a large number of million dollar plus recoveries in these types of cases.

## **Conclusion**

The Dodd-Frank whistleblower provisions have the potential to alter the landscape of internal compliance for issuers, financial institutions, and other organizations with exposure to the federal securities laws. Companies can reduce their liability by taking proactive steps now to reevaluate their policies, procedures, and controls relating to internal reporting and whistleblowers. When whistleblowers emerge, companies must act promptly to investigate the allegations and determine the appropriate response.

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# Clients & Friends Memo

## Joint Agencies' Proposed Rules Governing Incentive-Based Compensation at Covered Financial Institutions

June 1, 2011

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**")<sup>1</sup> requires seven Federal agencies (the "**Agencies**") to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions.<sup>2</sup> On April 14, 2011, the government published proposed rules governing such incentive-based compensation arrangements at covered financial institutions (the "**Proposed Rules**").<sup>3</sup>

The Proposed Rules are broad in scope and generally cover incentive-based compensation arrangements for any executive officer, employee, director or principal shareholder of a covered financial institution. As required by the Act, the Proposed Rules prohibit incentive-based payment arrangements at a covered financial institution that encourage inappropriate risks by a financial institution by providing excessive compensation or that could lead to material financial loss, and require a covered financial institution to disclose to its appropriate Federal regulator the structure of its incentive-based compensation arrangements in sufficient detail to determine whether the structure provides "excessive compensation, fees, or benefits" or "could lead to material financial loss" to the institution. A covered financial institution need not report the actual compensation of particular individuals as part of this requirement. The Proposed Rules also require a "larger covered financial institution" (which is generally defined as a covered financial institution with assets of \$50 billion or more) to defer a portion of incentive-based compensation paid to its executive officers and subjects the compensation of any persons (other than executive officers) who have the ability to expose the institution to possible losses that are substantial in relation to the institution's size,

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<sup>1</sup> Cadwalader has prepared a summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these memoranda, please see [Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php).

<sup>2</sup> Section 956 of the Act. The seven Agencies are: Office of the Comptroller of the Currency ("**OCC**"); Board of Governors of the Federal Reserve ("**Board**"); Federal Deposit Insurance Corporation ("**FDIC**"), Office of Thrift Supervision ("**OTS**"), National Credit Union Administration ("**NCUA**"); Securities and Exchange Commission ("**SEC**"); and the Federal Housing Finance Agency ("**FHFA**").

<sup>3</sup> A copy of the Proposed Rules can be found at <http://www.fdic.gov/news/news/press/2011/pr11061a.pdf>.

capital or overall risk tolerance to additional limitations and board approval. The board or a committee of the board at such institutions must approve the incentive-based compensation arrangements for such individuals and maintain documentation of such approval. The Agencies propose to make the terms of the Proposed Rules, if adopted, effective six months after publication of the final rules in the Federal Register.

Financial institutions subject to the Proposed Rules should review their compensation arrangements in consultation with their counsel and compensation advisors in order to adequately prepare for compliance with the mandates and restrictions set forth in the Proposed Rules once they are finalized. As part of their preparation, financial institutions will need to determine whether any of their incentive arrangements would be covered by the Proposed Rules and how to design and implement an internal framework to ensure compliance with the Proposed Rules.

### Highlights

#### *“Covered Financial Institutions”*

The Act defines the term “covered financial institution” to include any of the following types of institutions that have \$1 billion or more in assets: (A) a depository institution or depository institution holding company; (B) a broker-dealer; (C) a credit union; (D) an investment adviser; (E) the Federal National Mortgage Association (Fannie Mae); (F) the Federal Home Loan Mortgage Corporation (Freddie Mac); and (G) any other financial institution that the appropriate Federal regulators, jointly, by rule, determine should be treated as a covered financial institution for these purposes.

Under the Proposed Rules, a “covered financial institution” includes:

- in the case of the OCC, a national bank and Federal branch and agency of a foreign bank;
- in the case of the Board, a state member bank, a bank holding company, a state-licensed uninsured branch or agency of a foreign bank and the U.S. operations of a foreign bank with more than \$1 billion of U.S. assets that is treated as a “bank holding company”;
- in the case of the FDIC, a state nonmember bank and an insured U.S. branch of a foreign bank;
- in the case of the OTS, a savings association and a savings and loan holding company;
- in the case of the NCUA, an insured credit union or a credit union eligible to make application to become an insured credit union;
- in the case of the SEC, a broker-dealer and an investment adviser;

- in the case of the FHFA, Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Home Loan Bank System's Office of Finance.

#### *Mandates and Requirements*

The following is a summary of the mandates and requirements set forth in the Proposed Rules:

- *Prohibition of Excessive Compensation*. The Proposed Rules prohibit incentive-based compensation arrangements that encourage executive officers, employees, directors or principal shareholders<sup>4</sup> ("**Covered Persons**") to expose a covered financial institution to inappropriate risks by providing the Covered Person with excessive compensation.
  - No categories of employees are specifically excluded from the definition of Covered Persons.
  - The Proposed Rules define the term "incentive-based compensation" broadly as "any variable compensation that serves as an incentive for performance" and includes all direct and indirect payments, fees or benefits, cash and non-cash, awarded to, granted to, or earned by or for the benefit of a Covered Person in exchange for services rendered to the covered financial institution regardless of the form of the compensation. Compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (such as salary) would not be considered "incentive-based compensation." In addition, a compensation arrangement that provides rewards solely for activities or behaviors that do not involve risk-taking (for example, payments solely for achieving or maintaining a professional certification or higher level of educational achievement) would not be considered incentive-based compensation.
  - Consistent with the mandate of section 956 of the Act, the Agencies propose using standards comparable to those under section 39 of the Federal Deposit Insurance Act of 1950 (which defines excessive compensation as amounts unreasonable or disproportionate to the services rendered) to determine whether incentive-based compensation is excessive. Under the Proposed Rules, incentive-based compensation for a Covered Person would be considered excessive when amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality and scope of services performed by the Covered Person. In making such a determination, the Agencies will consider:

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<sup>4</sup> The Proposed Rules generally define the term "principal shareholder" as an individual that directly or indirectly, or acting in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution.

- the combined value of all cash and non-cash benefits provided to the Covered Person;
  - the compensation history of the Covered Person and other individuals with comparable expertise at the covered financial institution;
  - the financial condition of the covered financial institution;
  - comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the institution's operations and assets;
  - for post-employment benefits, the projected total cost and benefit to the covered financial institution;
  - any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and
  - any other factors the relevant Agency determines to be relevant.
- Prohibition of Inappropriate Risk-taking. The Proposed Rules prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangements that may encourage inappropriate risks by the institution. This prohibition applies to those incentive-based compensation arrangements for Covered Persons, individually or in the aggregate, whose activities may expose the covered financial institution to material financial loss.
    - The Proposed Rules identify the following Covered Persons as those that may expose a covered financial institution to material financial loss:
      - executive officers and other Covered Persons who are responsible for oversight of the covered financial institution's firm-wide activities or material business lines;
      - other individual Covered Persons, including non-executive employees, whose activities may expose the covered financial institution to material loss (e.g., traders with large position limits relative to the covered financial institution's overall risk tolerance); and
      - groups of Covered Persons who are subject to the same or similar incentive-based compensation arrangements and who, in the aggregate, could expose the covered financial institution to material financial loss, even if no individual Covered Person in the group could expose the covered financial institution to material financial loss (e.g., loan officers who, as a group, originate loans that account for a material amount of the covered financial institution's credit risk).

- The Agencies propose to adopt standards that are consistent with the key principles established for incentive compensation in the Interagency Guidance on Sound Incentive Compensation Policies<sup>5</sup> for determining whether an incentive-based compensation program may encourage inappropriate risk-taking by the covered financial institution. An incentive-based compensation arrangement would not comply with these standards unless it:
  - balances risks and rewards (by using deferred payments, risk adjustments, diminished sensitivity to short-term performance, or longer performance periods);
  - is compatible with “effective controls and risk management”; and
  - is supported by “strong corporate governance.”
- Enhanced Regulation of “Larger Covered Financial Institutions.” The Proposed Rules provide for enhanced regulation of “larger covered financial institutions,” which generally includes all covered financial institutions with assets of \$50 billion or more.<sup>6</sup> The following is a summary of the enhanced regulations mandated by the Proposed Rules for such institutions.
  - Deferral of Incentive-Based Compensation. The Proposed Rules require the deferral of a portion of incentive-based compensation for executive officers at larger covered financial institutions. At these institutions, at least 50 percent of the incentive-based compensation of an “executive officer”<sup>7</sup> would have to be deferred over a period of at least three years; deferred amounts paid would be adjusted for actual losses of the institution or other measures or aspects of performance that are realized or become better known during the deferral period. The Proposed Rules provide for some flexibility in how a required deferral is administered by permitting the release or vesting of deferred amounts in equal pro rata increments for each year of the deferral period (but in no event may the release or vesting of amounts be faster than a pro rata equal-annual increments distribution). For example, an institution required to apply a three-year deferral to a \$150,000 deferral amount could release a maximum of \$50,000

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<sup>5</sup> Guidance on Sound Incentive Compensation Policies, 75 FR 36395 (June 25, 2010), adopted by the Federal banking agencies (*i.e.*, the OCC, Board, FDIC and OTS).

<sup>6</sup> The Proposed Rules define the term “larger covered financial institution” as follows: for the Federal banking agencies and the SEC, those covered financial institutions with total consolidated assets of \$50 billion or more; for the NCUA, all credit unions with total consolidated assets of \$10 billion or more; for the FHFA, all Federal Home Loan Banks with total consolidated assets of \$1 billion or more.

<sup>7</sup> The Proposed Rules define the term “executive officer” as a person who holds the title or performs the function (regardless of title, salary or compensation) of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer or head of a major business line.

each year or could withhold the entire sum for the entire period and distribute it as a lump-sum at the conclusion of the three-year period. Alternatively, the institution could choose a distribution schedule that is less rapid than a pro-rata equal-annual-increments schedule, such as no release after the first year, releasing a maximum of \$100,000 the second year, and then \$50,000 for the third year.

- Identification of Covered Persons. The Proposed Rules require the board of directors or a committee of the board at a larger covered financial institution to identify those Covered Persons (other than executive officers) who have the ability to expose the larger covered financial institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance. The Proposed Rules note that these Covered Persons may include traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution.
- Approval of Incentive-Based Compensation Arrangements. The board or a committee of the board at larger covered financial institutions must approve incentive-based compensation arrangements for Covered Persons identified as described above, and maintain documentation of such approval. Under the Proposed Rules, the board (or a committee of the board) at such institutions may not approve such incentive-based compensation arrangements unless it determines that the arrangement, including the method of paying compensation under the arrangement, effectively balances the financial rewards to the Covered Person and the range and time horizon of risks associated with the Covered Person's activities, employing appropriate methods for ensuring risk sensitivity.
- Maintenance of Policies and Procedures. The Proposed Rules require a covered financial institution to maintain policies and procedures to ensure compliance with the requirements and prohibitions of the Proposed Rules, appropriate to their size, complexity and use of incentive-based compensation to ensure compliance with the requirements and prohibitions of the Proposed Rules. At a minimum, such policies and procedures must:
  - be consistent with the reporting requirements and prohibitions set forth in the Proposed Rules;
  - ensure that risk-management, risk-oversight and internal control personnel have an appropriate role in the covered financial institution's processes for designing incentive-based compensation arrangements and for assessing their effectiveness in restraining inappropriate risk-taking;
  - provide for the monitoring by a group or person independent of the Covered Person, where practicable in light of the covered financial institution's size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk

- outcomes to determine whether incentive-based compensation payments for Covered Persons, or groups of Covered Persons, are reduced to reflect adverse risk outcome or high levels of risk taken;
- provide for the covered financial institution's board of directors (or committee thereof) to receive data and analysis from management and other sources sufficient to allow the board (or committee) to assess whether the overall design and performance of the covered financial institution's incentive-based compensation arrangements are consistent with the Proposed Rules;
  - ensure that documentation of the covered financial institution's processes for establishing, implementing, modifying and monitoring incentive-based compensation arrangements is maintained that is sufficient to enable the applicable regulator to determine the covered financial institution's compliance with the Proposed Rules;
  - in the case of larger covered financial institutions, where deferral is used in connection with an incentive-based compensation arrangement, provide for deferral of incentive-based compensation awards in amounts and for periods of time appropriate to the duties and responsibilities of the covered financial institution's Covered Persons, the risks associated with those duties and responsibilities, and the size and complexity of the covered financial institution and provide that the deferral amounts paid are adjusted to reflect actual losses or other measures or aspects of performance that are realized or become better known during the deferral period; and
  - subject any incentive-based compensation arrangement to a corporate governance framework that provides for ongoing oversight by the board of directors (or a committee thereof), including the approval by the board of directors (or committee) of incentive-based compensation to executive officers.
- Annual Reports. As mandated by section 956(a)(1) of the Act, the Proposed Rules require covered financial institutions to provide certain information concerning incentive-based compensation arrangements for Covered Persons to Federal regulators annually (a "Report").
    - A Report must contain:
      - a clear narrative description of the incentive-based compensation arrangements applicable to Covered Persons and specifying the types of Covered Persons to which they apply;
      - a succinct description of the covered financial institution's policies and procedures governing such arrangements;

- for larger covered financial institutions, a succinct description of any specific incentive compensation policies and procedures for the institution's executive officers, and other Covered Persons who the board, or a committee thereof determines individually have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital or overall risk tolerance;
  - any material changes to such arrangements and policies and procedures made since the covered financial institution's last report was submitted; and
  - specific reasons why the covered financial institution believes the structure of its incentive-based compensation plans does not encourage inappropriate risks by the institution by providing Covered Persons with excessive compensation or incentive-based compensation that could lead to material financial loss to the covered financial institution.
- A covered financial institution's annual Report will be due within 90 days of the end of each applicable fiscal year.
  - The Proposed Rules provide that the Agencies generally will maintain the confidentiality of the information submitted in Reports, and the information will be nonpublic, to the extent permitted by law.
  - The volume and detail of the information provided in Reports should be commensurate with the size and complexity of the institution, as well as the scope of its incentive-based compensation arrangements.
- Anti-Evasion. The Proposed Rules prohibit a covered financial institution from evading the restrictions of the rule by doing any act or thing indirectly, or through or by any other person, that would be unlawful for the institution to do directly under the Proposed Rules.

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If you have any questions regarding this memorandum, please contact the individuals listed below or any other member of the [Cadwalader Tax Department](#).

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# Clients & Friends Memo

## Two Dodd-Frank Problems: the Effective Date and the Definitions *Contingency Planning in the Absence of a Regulatory Structure*

June 13, 2011

[Watch Steven Lofchie's June 9 Interview on Bloomberg Law](#) in which he discusses the uncertainty created by provisions of the Dodd-Frank Act as they relate to the regulation of swaps.

This memorandum first explains the July 16, 2011 problem that will arise because the Dodd-Frank derivatives legislation (Title VII of the statute) goes into effect without either a ready regulatory plan or an operating market structure. The effective date problem is made worse because of drafting problems in Dodd-Frank, including the flawed definition of the single most important term in all of the statute: “swap.”

The effective date problems will not be resolved on July 16, 2011. July 16, 2012 will bring another set of problems due to a deadline that cannot be achieved and should not be targeted.

The final part of the memorandum recommends that all market participants, in fact, all participants in the economy, contingency plan as to how to conduct their business in the absence of a workable regulatory structure. At best, we will be operating, from July 16, under a law that is far from being implemented, if it can be implemented at all, on the basis of likely-incomplete regulatory exemptions the effectiveness of which depends on statutory language that is itself uncertain.<sup>1</sup>

### I. July 16, 2011

On July 16, 2011, Section 731(a) of Dodd-Frank makes it illegal for an entity to act as a swaps dealer unless registered with the Commodity Futures Trading Commission (the “**CFTC**”). On July 16, 2011, Section 764(a) of Dodd-Frank similarly makes it illegal to act as a security-based swaps dealer unless registered with the Securities and Exchange Commission (the “**SEC**”). There is currently no means to register available with either the CFTC or the SEC (the “**Commissions**”),

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<sup>1</sup> The SEC has recently issued its first proposed effective date exemption – but it is limited to security-based swaps issued by certain clearing agencies. Hopefully more and broader exemptions will quickly follow.

nor is there any body of rules that would apply to a dealer that could register, nor even a set of proposed rules that is near-ready.<sup>2</sup>

On July 16, 2011, Section 723 of Dodd-Frank makes it illegal for a person or entity that does not qualify as an “eligible contract participant” (“ECP”) to enter into a swap, other than one executed on an exchange that trades swaps. Section 763 of Dodd-Frank contains a somewhat parallel provision, making it illegal for anyone to execute a security-based swap for any non-ECP other than on an exchange that trades security-based swaps. There are no such swap exchanges, nor will there be by July 16, and therefore the exceptions to the prohibitions will be unavailable on July 16.

On July 16, 2011, Sections 731 and 761 of Dodd-Frank require that any swap dealer that acts as an “advisor” to a “Special Entity” (essentially a municipality, pension plan or endowment) shall have a duty to act in the “best interests” of the Special Entity. The term “advisor” is not defined, but it is generally feared that the regulators will expand the term beyond its plain English meaning. Further, it is not that clear how a swap dealer, which trades with a Special Entity and is also deemed to be an advisor to the Special Entity, can act in the Special Entity’s best interest – since the two parties are on *opposite sides* of a trade, and therefore any price that the swap dealer charges above zero may not be in the Special Entity’s “best interest.” In short, as of July 16, 2011, there will be legal uncertainty in any swap dealer communicating with Special Entities with which it trades lest it be deemed an advisor.

When Congress adopted Dodd-Frank with an effective date of July 16, it also as of that date terminated significant parts of the Commodity Futures Modernization Act (the “CFMA”), which provided the legal framework under which the swaps market had previously operated, and which had given legal certainty to the enforceability of swaps contracts. Likewise, Dodd-Frank, as of the same date, terminates provisions of the Commodity Exchange Act (the “CEA”) that had protected swaps from legal attack under state law by either state regulators or private litigants.<sup>3</sup>

#### **A. The Mechanics of Effectiveness of Dodd-Frank**

Section 754 of Dodd-Frank provides that the provisions of Title VII (essentially the derivatives portion of Dodd-Frank) become effective (i) in the case of provisions that do not require rulemaking,

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<sup>2</sup> The CFTC has published a significant number of rule proposals, while the SEC has published fewer. However, the gap between the CFTC and the SEC output is narrower than it appears because a material number of the CFTC’s rule proposals require, at least in my view, substantial revision.

<sup>3</sup> See Dodd-Frank Act, Title VII, Section 723(a)(1)(2) (repealing CEA Section 2(g), the statutory exclusion for swap transactions enacted by the CFMA and CEA Section 12(e)(2)(B), as amended by the Dodd-Frank Act (deleting reference to Section 2(g) from the provision preempting application of state laws on gaming and on bucket shops).

July 16, 2011<sup>4</sup> and (ii) in the case of provisions that do require rulemaking, not less than sixty days after the rulemaking becomes effective.

Neither Section 731 nor Section 764 (which make it illegal to act as an unregistered swaps dealer) require by their terms a rulemaking – they are simply prohibitions.<sup>5</sup> Similarly, neither Section 723 nor Section 763 (which make it illegal to enter into swaps with a non-ECP) require a rulemaking – they, too, are simply prohibitions. Section 721 of Dodd-Frank (the definition of a “swap”), likewise, does not require a rulemaking. Thus, these provisions become immediately effective. Likewise, the provisions of Dodd-Frank that eliminate the CFMA and the protection from attack under state law also become effective on July 16.

#### **B. The Statutory Definition of the Term “Swap” and How That Worsens the Effective Date Problem**

The Dodd-Frank definition of “swap” (Section 721) sets out a number of types of contracts that are either “included within” or “excluded from” the scope of that term. The broadest (and thus most problematic) of the “included within” prongs is to the effect that the term “swap” includes any contract that has any purchase, sale, *payment, or delivery [obligation or amount]*<sup>6</sup> that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event with a potential financial, economic, or commercial consequence.

This inclusive prong of the definition is too broad: it can include by its literal terms, as the Commissions have recognized, transactions such as the following (assuming that there is some element of payment or delivery contingency to the contract):<sup>7</sup>

- agreements to acquire or lease personal property
- agreements to obtain a mortgage
- agreements to provide personal services
- agreements to assign rights, such as intellectual property rights

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<sup>4</sup> Under the words of the statute, Dodd-Frank is to become effective 360 days after its adoption. As Dodd-Frank was adopted on July 21, 2010, the 360-day delay between adoption and effectiveness sets the effective date as July 16, 2011.

<sup>5</sup> Hopefully, the Commissions will adopt the view that these prohibitions implicitly do require a rulemaking; *i.e.*, a registration procedure, and thus they are ineffective until at least sixty days after a registration procedure is available. Be aware, however, that not all of the provisions of Dodd-Frank that apply to swaps dealers are limited to those that are registered, or even to those that are required to be registered (although some of this too may be loose drafting).

<sup>6</sup> Emphasis supplied. (Not an exact quote. I added the words “obligation or amount” added for clarity.)

<sup>7</sup> See 76 Fed. Reg. 29818 (May 23, 2011) (the “Swap Definition Release”).

- agreements to purchase home heating oil (if the contract has a cap in it)
- agreements that have any interest rate cap or lock
- consumer loans with variable rates of interest
- mortgage loans with various rates of interest
- retirement benefit arrangements
- sales arrangements
- merger agreements
- warehouse lending agreements
- any loan with a variable rate of interest made by a nonbank
- leases
- service contracts
- certain employment agreements
- insurance contracts<sup>8</sup>

In short, the literal words of Dodd-Frank seem to define as “swaps” a substantial portion of all contracts entered into in the United States. Whether this is  $\frac{1}{4}$  or  $\frac{1}{2}$  or  $\frac{3}{4}$  by value of contracts, I cannot say. But it is large enough to be meaningful to the general U.S. (and global) economy, not just on Wall Street.

The problem of this broad definition is compounded by the fact that any of these contracts is illegal, as of July 16, 2011, if (i) entered into by a non-ECP or (ii) by an unregistered swaps dealer. We have also noted that there are likely to be additional risks, even if not outright illegality, attached to swaps with so-called “Special Entities.”<sup>9</sup>

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<sup>8</sup> One of the really interesting questions as to the grant of power to the Commissions arises with respect to the definition of the term “insurance.” Historically, the U.S. federal government has deferred to the individual states as to the regulation of insurance. See generally the *McCarran-Ferguson Act*, 15 U.S.C. Section 1011-1015. However, given the broad definition of the term “swap,” the Commissions are effectively delegated the power to define what constitutes insurance (i.e., what is not a “swap”) within the meaning of McCarran-Ferguson. The types of state-regulated insurance contracts that will be permitted by the Commissions are described at pages 29821-27 of the Swaps Definition Release. But see also page 29822 (the Commissions express concern that the offering of state-regulated insurance contracts could be used as a means “to evade the [ir] regulatory regime” under Dodd-Frank, such that the Commissions will prescribe what fits within the definition of the term insurance).

<sup>9</sup> I also note that the term “swap” is not the only defined term in Dodd-Frank with which there are serious problems-although it is obviously significant that the single most important defined term in the entire statute cannot possibly mean what it says.

## C. Some Limited Solutions to the Effective Date and Definitional Problems

### 1. The Rulemaking Solution to the Swap Definition Problem?

In order to address the problem of the breadth of the definition of the term “swap,” the Commissions have proposed in the Swap Definition Release to exclude by rule many of the contracts listed above from the definition of the term “swap,” *albeit subject to conditions*. For example, under the Commissions’ proposed rule, a capped agreement to purchase home heating oil would not be a swap *provided* it were entered into by a “natural person . . . primarily for personal, family or household purposes. . . .”

This leaves open the question of whether a home heating oil contract could be a “swap” if entered into for other purposes (for example, to purchase gas for a rental unit owned by a natural person as a business) or if the heating contract were entered into through a personal trust. The Commissions’ response to this question and numerous other uncertainties, in the Swap Definition Release, is that “the Commissions invite . . . [anyone having definitional questions] to seek an interpretation” – but this seems likely to be a slow process given the volume of questions that could arise and the required procedures for answering them.<sup>10</sup>

In the Swap Definition Release, the Commissions do not attempt to tie their proposed limitation of the definition of the term “swap” to the actual statutory language of Dodd-Frank or to its legislative history (of which there is not much substantive; most of the legislative history is just earlier versions of the final bill, and these versions do not provide guidance as to the intended meaning of the term “swap”). Rather, the Commissions merely state that they “do not believe that Congress intended to include” these types of transactions within the “swap” definition.

This somewhat loose tie between (i) the statutory definition in Section 721 of the term “swap,” on the one hand, and (ii) the Swap Definition Release, on the other, emphasizes an important, and somewhat overlooked, legal question as to whether the Commissions even have the authority, which is assumed by the Swap Definition Release, to limit the scope of the term swap. Section 721(c) of Dodd-Frank provides that the CFTC can *include* transactions within the

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For example, the term “Special Entity” is defined (at Section 731) to include “endowments,” but the term endowment is not itself defined.

<sup>10</sup> In the Swap Definition Release (at 29864), the Commissions caution that “*any* [emphasis supplied] interpretation of, or guidance by,” either of the Commissions, with respect to the derivatives legislation, is only effective if the two Commissions “*issue joint regulations*” [emphasis supplied] “*after consultation*” [emphasis supplied] with the Federal Reserve Board.

As a practical matter, it could seldom be less than six months, and one would think realistically a longer time, to obtain a joint rulemaking from two major federal agencies, after consultation with a third. This leaves open the question of whether it would even be possible to obtain the attention of the agencies, given the backlog of Dodd-Frank rulemaking, never mind other duties of the Commissions.

definition of the term “swap” to the extent that such transactions have been structured to *evade* Dodd-Frank. This would seem to imply that the Commissions can *expand the definition* of swap even further (not that such expansion is needed), but do not have legal authority to shrink it. That the Commissions do not have authority to limit the scope of the swap definition is further evidenced by Section 772 of Dodd-Frank, which amends Section 36 of the Exchange Act to limit the SEC’s authority to provide any exemptions with respect to the definition of the term “swap.”<sup>11</sup> That the Commissions do not have the authority to limit the scope of the term “swap” might also be argued by comparing the authority that the Commissions are given with respect to other defined terms. For example, the CFTC is given authority to “include within, or exclude from” the term commodity pool operator. But this authority is not provided to the Commissions acting either alone or jointly with respect to swaps, which would seem to imply that the authority to limit the definition was not intended.

Section 712(d) of Dodd-Frank does give the Commissions, subject to various procedural and consultation requirements, various kinds of regulatory authority to adopt rules with respect to the definitions, including to “**further define**” the term swap. It is certainly not clear that this gives the Commissions plenary authority to limit the definition of the term swap, so as to effectively provide exemptions, as this seems inconsistent with the plain words of Sections 721 and 772. That said, the Commissions, as a practical matter, *must ignore this problem of their authority*. That is, in order to have any hope of making the statute workable, they must effectively expand their exemptive authority under Section 712(d) (and ignore the limitations on their authority under Sections 721 and 772), which is exactly what they do in the Swap Definition Release. Although I agree that they had no choice but to proceed in this way, it would be better if the Swaps Definition Release stood on firmer legal ground.<sup>12</sup>

Assuming the Commissions have authority to limit the statutory definition of the term “swap,” even if the Commissions’ proposed rule were to be adopted yesterday, given a 60-day waiting period, the proposed rule would not be effective before July 16. This delay in limiting of the definition of the term “swap” may create more uncertainty.

## 2. The “Common Sense” Solution to the Swap Definition Problem?

One possible “solution” to the legal uncertainty problem created by the Dodd-Frank definition of “swap” is to pretend that it does not exist; in other words, to pretend that we all know “by common

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<sup>11</sup> Section 721 of Dodd-Frank appears to similarly expressly limit the power of the CFTC to provide exemptions with respect to the definition of the term “swap”. We say “appears” because the key verbs were actually omitted from the relevant provision of Section 721, leaving only a very long and garbled sentence fragment.

<sup>12</sup> Ultimately, the best argument for the Commissions’ expansive definitional authority is probably just common sense: the definition of the term “swap” can’t possibly be read at its literal meaning.

sense” what a “swap” is, and that it does not really matter what the words of Dodd-Frank say or whether the Commissions have adopted a rule to limit the statutory definition, or whether the Commissions even have the authority to adopt such a rule.

There are at least two problems with this approach.

*The Common-Sense Problem.* First, there is a point at which our respective understandings of “common sense” must diverge. For example, I would have said that, as a matter of common sense, Congress could not have intended either to regulate the sale of loan participations between banks as swaps or to treat the purchase of a capped contract on home heating oil as a swap. However, the Commissions seem to disagree, at least as to those contracts that do not meet the conditions imposed in the Swap Definition Release. And of course, there will be other instances where my common sense tells me that I am in a gray area, and I may not want to take the chance of entering into an illegal transaction.

*The Law School Exam Problem; Also the Private Litigant Problem.* The second problem is in the places where there is risk in spite of our common sense agreement. For example, suppose that a bank offers a floating-rate home mortgage to a young couple with children. We all may agree that – by common sense – a floating rate home mortgage is not a “swap.” Suppose, for purposes of our law school exam example, the home mortgage is affordable given the couple’s current income and current interest rates. Now, a lawyer for the bank is called upon to give a legal opinion that the floating rate mortgage is valid and binding; e.g., the mortgage is not a “swap” within the meaning of Dodd-Frank, notwithstanding that the payments required on the mortgage will vary with events of economic consequences; i.e., changes in interest rates.

What is the correct answer to the law school exam question: should the lawyer (i) opine that the mortgage is valid and binding, based on common sense, or (ii) express no view as to the treatment of the mortgage as a swap under Dodd-Frank?

Suppose that the bank goes ahead and makes the loan, perhaps based on the flat opinion of the lawyer. After three years, one of the couple is unemployed and interest rates have risen, so that the couple is unable to make the now-higher payments on the floating rate mortgage. The bank tries to foreclose on the loan. The lawyer for the couple asserts that the floating rate mortgage cannot be enforced because, under the literal language of Dodd-Frank, the mortgage is an illegal swap.

What does the judge do? Does the judge enforce the foreclosure of the bank, notwithstanding the literal language of Dodd-Frank? If the judge rules in favor of the couple, can the bank sue the lawyer for malpractice?

These law school exam questions are intended to demonstrate that the effective date and definitional problems of Dodd-Frank cannot be solved entirely by assuming the common sense and restraint of federal regulators. One must also be concerned with the independent actions of private litigants, as well as the actions of state government authorities.

### 3. The “Announcement” Solution to the Problem

CFTC Chairman Gensler was recently quoted in the newspapers as saying that July 16 “would not be an event at all for market participants.”<sup>13</sup> He went on to say, “We will have “announceables.” There will be documents on our website. . . before July 16.”

While Chairman Gensler’s statement is obviously good news, it also raises legal questions. That is, on the one hand, Dodd-Frank is a statute, adopted by Congress, which, by its literal terms, seems to regulate a good portion of all the transactions in the entire U.S. economy as of July 16. On the other hand, a regulator, in fact a single regulator, is able to promise to make the statute “not . . . an event.” Further, even if the Chairman was speaking for the CFTC or for all of the relevant regulatory organizations, there must be a limit as to what the regulators can do without Congress.<sup>14</sup>

#### D. Further Trouble on the Horizon

The problems with the implementation of Dodd-Frank are not simply July 16, 2011 problems. Suppose that the regulators will be, by July 16, 2011, halfway to their required task of building a new regulatory system. This means that, all during the coming year, as the regulators are adopting

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<sup>13</sup> Jamila Trindle, *Regulators to Give More Guidance on Dodd-Frank Law before July Deadline*, Reuters (June 2, 2011), available at <http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=201106021601dowjonesdjonline000637&title=regulators-to-give-more-guidance-on-Dodd-Frank-law-before-july-deadline>.

Another story quoted Chairman Gensler as saying, “We have ample latitude within the statute to address any July 16 issues as I know about them.” Jonathan Spicer, *CFTC aims for certainty over July 16 rule deadline*, Reuters (June 2, 2011), available at <http://www.reuters.com/article/2011/06/02/financial-regulation-cftc-idUSN0228261220110602>.

It is not entirely clear from which parts of Dodd-Frank the latitude to which Chairman Gensler refers arises. It is likewise not clear what to make of the statement that issues could be solved if he would “know about them.” That is, without a public proposal of the required exemptive rules, there is not an opportunity to give input as to whether in fact all issues are resolved.

<sup>14</sup> It appears that the Chairman has been joined by at least one other CFTC Commissioner in expressing confidence that the fundamental questions relating to the statutory deadline can, in effect, be voided by administrative action. See Huw Jones, *Traders to get “safe harbors” on some rules*, Reuters (June 7, 2011), available at <http://www.reuters.com/article/2011/06/07/us-cftc-omalina-idUSTRE7563CL20110607> (quoting CFTC Commissioner Scott O’Malia as stating that the CFTC is “working on a document and a proposal right now that creates certain safe harbors for self executing rules, to delay them until the new rules are in place. . . [and that] [w]e are going to provide some temporary safe harbor until the underlying rule or definition is provided. . . So all of this will hopefully be clear in a week or two.”).

new rules, swap dealers (who are primarily banks) will be attempting to build systems and procedures to comply with the new rules (which will be challenging to accomplish).

On July 16, 2012, Section 716 of Dodd-Frank (more commonly known as the Lincoln Amendment) goes into effect. Under this provision of Dodd-Frank, U.S. branches of non-U.S. banks can generally no longer act as swaps dealers. Thus, all of these branches that have spent the year attempting to build a system to come into compliance with Dodd-Frank will now have to move their swap dealer business to a different legal entity. Even assuming that the regulatory system is by then completed, this will prove a material operational strain on these non-U.S. banks.

As a practical matter, the problem gets worse. Section 716 materially discriminates against U.S. branches of non-U.S. banks as compared to U.S. banks. That is, U.S. banks in the United States are provided exemptions not available to non-U.S. banks in the United States. This discrimination has *no policy basis whatever*; it was a mistake that was supposed to be corrected in a post-Dodd-Frank amendment, but never was.<sup>15</sup> Can this prohibition against non-U.S. banks can go into effect without non-U.S. governments considering actions to level the playing field, either by imposing similar disadvantages on U.S. banks operating abroad or acting against other U.S. corporations?

There will be more deadlines to come. In the two-year period after July 16, 2012, portions of the Lincoln Amendment will gradually come into effect even against U.S. banks. These banks too will then have the practical problem of meeting the deadline for moving their swaps dealer business to another legal entity.

## II. Why Dodd-Frank Could Never Have Been Ready: Just Too Big

Various legal observers have published “fun facts” about Dodd-Frank; e.g., as to the number of rules that Dodd-Frank requires to be implemented, the number of studies to be made and, lately, as to the number of deadlines missed by the regulators. Although these numbers seem to illustrate

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<sup>15</sup> In light of the various inconsistencies in the treatment of U.S. branches of U.S. banks and U.S. branches of non-U.S. banks by the Lincoln Amendment, after the Conference Committee voted out the bill, but before full Senate approval, on July 15, 2010, Senator Lincoln made a statement on the floor of the Senate, stating that it was not the intent of the Senate to exclude U.S. branches of foreign banks from the exemptions and safe harbors provided to U.S. banks, and that they should be treated under the Lincoln Amendment in the same fashion as U.S. branches of U.S. banks. At the same time, Senator Dodd indicated that this would likely be addressed on a technical corrections bill. ***No such technical corrections bill has ever been introduced in the Senate.*** Thus, in the absence of a correction, U.S. branches of foreign banks would effectively be barred from serving as swap dealers from July 16, 2012. For additional information, please refer to Cadwalader's Clients & Friends Memo, *The Lincoln Amendment: Banks, Swap Dealers, National Treatment, and the Future of the Amendment* (December 14, 2010), [http://www.cadwalader.com/assets/client\\_friend/121410FutureoftheLincolnAmendment.pdf](http://www.cadwalader.com/assets/client_friend/121410FutureoftheLincolnAmendment.pdf).

the problem, they in fact diminish the scope of the task, as if we were counting hiking Mount Everest as taking one of 453 bumps in the road.

#### **A. Too Many Rules**

By way of example, let's take the need for the regulators to establish rules for the regulation of swaps exchanges. Let's suppose that there is a need for five CFTC and five SEC rules under Dodd-Frank relating to the establishment of such exchanges. At one point, the CFTC was estimating that there might be 50 such exchanges under its authority alone. To keep the numbers simple, suppose that there might be 100 such exchanges, 50 under the authority of the CFTC and 50 under the authority of the SEC. Each such exchange will need its own set of rules: let's say 100 rules per exchange. This brings us from our original ten rules that must be written to 10,010 (although the 10,000 need not be written by the SEC and the CFTC).

But this again diminishes the problem by reducing it to mere numbers.

#### **B. Too Much Infrastructure**

None of these swap exchanges exist. How are the communications and operations systems for all these exchanges to be built within a reasonable timeframe, so that links between them and the dealers and the customers can be created? And that is to say nothing of the other operating structures assumed by Dodd-Frank: clearing corporations, swaps data repositories, major swap participants.

The problem of scaling Mount Everest is not just that we have gone from 453 to 10,010 bumps in the road. At least Mount Everest is already standing; all we have to do is walk over the bump. Dodd-Frank requires construction.

#### **C. Too Much Legal Staffing**

I do not know how much staff the regulators thought they would need to implement Dodd-Frank, but whatever was estimated, it was likely too small. If we would have 100 newly created exchanges, along with clearing corporations, swap data repositories, newly regulated dealers, swap participants, additional regulated investment funds, and many dually- and triply-registered entities,<sup>16</sup> along with staffs to regulate all of the newly regulated entities, that is a lot of lawyers.

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<sup>16</sup> Many institutions that previously had a single federal regulator will now have either two or three. For example, many banks will now be directly regulated not only by the banking regulators, but also by the CFTC and the SEC. Many investment funds that might previously have been subject only to the SEC will now be subject to the CFTC as well.

The more rules that must be drafted and reviewed and complied with, the more the private sector will also need more staffing. In short, the private sector will need far more legal staffing at the same time that the government's needs will also be expanding, making it difficult for both sides to hire enough people.

While we have said that there is not enough staffing, it is important to recognize that this is not just a matter of numbers. It simply does not work to hire 100 or 1000 lawyers at the Commissions if they do not have relevant experience. This is not simply a matter of producing 453 rules. All of the rules must work together. The SEC/CFTC/Banking Dodd-Frank rules must all work together; **and** all of the Dodd-Frank rules must work with the existing bodies of securities, commodities and banking law, as well as with relevant sections of the Bankruptcy Code. Further, one must (or at least ought) take account of international law. One thousand lawyers without experience cannot complete this task in a year.<sup>17</sup>

And as far behind as the regulators may be in the rulemaking process, the volume of proposed rules, even though far from sufficient to meet the statutory task, has been overwhelming to private industry. No amount of additional government hiring to speed the process will make it less overwhelming to the private sector. And of course all these staffing problems are without the problems of actually implementing any compliance – all those problems yet loom.

#### **D. Too Much Technology Staffing**

Similarly, I have been told that there are not enough technology people in the United States (in fact in the world) to implement Dodd-Frank. I have no idea whether this is true. At a minimum, it points out the issue that the resources to implement Dodd-Frank are not just legal staffing resources.

#### **E. Too Tough Ain't Tough Enough**

The problems of size and staffing have been compounded by both the legislators' and the regulators' approach to making laws and rules applicable to derivatives. Essentially, **every requirement** that is applicable to participants in the securities or futures markets is made applicable to the swaps markets, but also made **stricter**. This is the wrong approach for a number of reasons. But, as I am simply focusing on raw size, this is the key point: the body of laws (and the related rules and infrastructure) applicable to broker-dealers under the Securities Exchange Act has had nearly 80 years to develop; the body of laws (and the related rules and infrastructure) applicable to

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<sup>17</sup> Imagine that one were to hire 1,000 artists and give each of them a square piece of blank cardboard, instruct each of them to go off by him- or herself, and work very hard for a year, and, at the end of the year, they should collectively come back with a jigsaw puzzle that, when fit together, will look like the Mona Lisa. It would not work. At best, they would come back with *Dora Maar Au Chat*. [http://en.wikipedia.org/wiki/Dora\\_Maar\\_au\\_Chat](http://en.wikipedia.org/wiki/Dora_Maar_au_Chat). This problem of co-ordination cannot be solved by hiring 10x more lawyers.

listed futures, approximately 90 years. The notion that one could take these two bodies of law and reconstruct them (but in a stricter fashion) in a single year was too optimistic.

### III. Where Are We Now

As the July 16 effective date of Dodd-Frank approaches, there are three possible viewpoints one can take as to the statute.

1. **Optimistic.** It is essentially a good law, but it cannot be ready for July 16.
2. **Resigned.** It is a well-meaning law, but it has very serious drafting problems that will create major problems whenever it is implemented and, in any case, it cannot be ready by July 16.
3. **Critical.** It is a law that was hastily drafted in response to a crisis even before the cause of that crisis had been carefully considered; the problems with the statute are becoming more obvious to observers as we have had time to analyze the words more carefully; the law would, if implemented, leave the financial regulatory system worse off than when it started; and, in any case, the statute cannot be ready for July 16.

There is no point in hiding that I am of the third viewpoint and was so even before Dodd-Frank had been proposed.<sup>18</sup> But that should not distract from the fact that, even for those who may be Dodd-Frank supporters, the July 16 date is not workable. This means that, on July 16, we do not move from the old financial regulatory structure (CFMA) to the new financial regulatory structure (Dodd-Frank). The old dies, but the new is not ready to be born. We are moving away from a regulatory framework – but not moving from one regulatory framework to another, but rather moving from one regulatory framework to nothing is ready.

### IV. Where Do Market Participants Go from Here: Dealing with Contingencies

We are in a very unusual situation as to our market “regulations.” In short, we do not have “regulations” – as the term is ordinarily used – meaning that we cannot look to the words of either a statute or any related rules for firm guidance as to conduct.

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<sup>18</sup> See, e.g., *Meet the New Regulators: Same as the Old Regulators* (Jan. 27, 2009). This is an article I wrote approximately a year and a half before Dodd-Frank was adopted, explaining why the direction of financial “reform” was misguided. [http://www.cadwalader.com/assets/client\\_friend/012209\\_Future\\_of\\_Financial\\_Regulation.pdf](http://www.cadwalader.com/assets/client_friend/012209_Future_of_Financial_Regulation.pdf).

See also, more specifically, *Some Concerns with the Derivatives Legislation* (May 3, 2010), explaining that Dodd-Frank can not work as drafted, and what might be done to rescue the statute. [http://www.cadwalader.com/assets/client\\_friend/050310\\_DerivativesLegislation.pdf](http://www.cadwalader.com/assets/client_friend/050310_DerivativesLegislation.pdf).

The statute has drafting problems where, among other things, even the single most important definition in the statute (“swap”) cannot mean what it says. Even without those definitional problems, the statute does not really “work,” at least in the sense that the statute requires certain things (including both rules and a market structure) that do not now exist.

The regulations to implement that statute are far from completed, and many of the proposals arguably also do not “work,” in the sense that they would be difficult or even impossible to accomplish. On the somewhat positive side, the regulators are aware of at least some of the statutory problems and, in some cases, seem to be drafting definitions and other regulatory provisions that are not tied to the statutory language. But of course the absence of a relationship between the statutory language and the regulatory provisions raises its own problems as to what “law” is in effect and as to the basis on which the regulations may be claimed to rest.

Even if the proposed regulations were in place, there would be a further difficulty in actual compliance by the persons regulated by the law. That is, such compliance probably cannot “work” in the sense that the proposed legal and regulatory requirements – building a whole new compliance structure within a year, and then, in the case of non-U.S. banks, moving the entire structure out of the bank branch at the end of year, or, with some delay, in the case of U.S. banks – probably can not be done. Thus, market participants are left to the discretion of the regulators to adopt broad exemptions – which we must hope are effective by midnight on July 15.

If, as Chairman Gensler says, July 16 is a non-event, then it may be that there is nothing to do. However, it is hard to feel confident of that without more express guidance that is grounded in statutory authority. In the absence of certainty, market participants (meaning essentially everyone) must adopt a contingency plan to transact in markets that will not be governed by clear law, but, at best, by regulatory pronouncements, and, at worst, by private litigants. Below are some of the measures that it may be prudent to take.

#### **A. Market Participants Generally**

If one is of a pessimistic nature (and I suppose all lawyers are to some extent, and I am certainly demonstrating that I am), there may be some value to entering into contracts before July 16. From that date onwards, there will be some level of uncertainty as to the application of Dodd-Frank, as we await further regulatory exemptive action, the breadth and basis of which are uncertain.

#### **B. Non-ECPs and “Special Entities”**

For persons (such as small businesses) that do not qualify as “eligible contract participants,” any transaction that is a “swap” (under an uncertain definition) may be unavailable to them as of that date. They should try to enter into whatever “swaps” are relevant to their business before July 16 so as to avoid the possible market disruptions.

The same advice applies to “Special Entities.” Because of the various “protections” afforded these entities, the swaps markets may either not be available to them as of such date or their access may be more limited.

### **C. U.S. “Corporates” and All Other Legal Entities**

Such persons should consider which products the company trades or enters into that might be within the broad definition of “swap” contained in Dodd-Frank. Discuss with potential counterparties what are the counterparty’s plans for trading on July 16.

Also firms should consider which transactions require a legal opinion to close. Firms should consider whether they will be able/willing to close without a legal opinion or with an opinion that has a Dodd-Frank carve-out.

### **D. Firms with Global Operations**

Consider the possibility of shifting trading operations offshore so as to minimize potential legal uncertainty, at least in the immediate aftermath of the effective date.

### **E. Firms Potentially Subject to Dealer Registration**

Assume, for this purpose, that the Commissions allow “notice registration” (meaning that a firm can be registered by sending an email to the CFTC and the SEC) without any significant rules that apply to swaps dealers, and that there continues to be material uncertainty as to the definition of the term “swap” and the definition of the term “swaps dealer.” For firms that are not certain whether they fit within the definition of swaps dealer, there is an argument that it is prudent to register on the theory that (i) there will not be a body of existing regulations and (ii) if the firm fails to register, it is acting illegally.

Corporate groups that will register should select the legal entity or entities that they will want to register as swaps dealers. They should also identify the provisions of Dodd-Frank that will apply without further rulemaking; *e.g.*, the requirement to appoint a Chief Compliance Officer, the prohibitions on trading swaps with non-ECPs, and the collateral-related notice requirements.

We note that one risk in taking such an approach is that the firm may not be able to withdraw from registration if the final regulations are too burdensome. A potential (very partial) solution to this problem might be that the firm include in its swap transactions a right to either terminate or to assign the transactions (although such rights will be resisted by some counterparties).

**F. Non-U.S. Firms with Non-U.S. Regulators**

Non-U.S. financial institutions may be advised to reach out to their home country regulators and request that these home country regulators seek guidance from U.S. regulators as to how Dodd-Frank will be applied to non-U.S. institutions. For example, non-U.S. regulators may wish to seek assurance from their U.S. counterparts that non-U.S. financial institutions may freely withdraw from registration as swaps dealers if the regulations prove too burdensome.

It would also be prudent to take up the discrimination problem in the Lincoln Amendment.

**G. SEC-Registered Broker-Dealers That Act as Securities-Based Swaps Brokers**

On July 16, brokerage activities with respect to security-based swaps become subject not only to many of the securities laws, but also to many of the FINRA rules. There has not been a concerted regulator/industry plan to consider which FINRA rules would be relevant to swaps. That said, firms should consider which SEC/FINRA rules create litigation risk because they could give rise to private rights of action, as opposed to “mere” regulatory risk. For example, firms should be mindful of the requirement to send trade confirmations consistent with Rule 10b-10. Firms should also review their general supervisory and communications programs.

\* \* \*

Please call your Cadwalader attorney if you would like to discuss contingency planning with respect to the effective date of Dodd-Frank. The table at the end of this memorandum provides a list of, and contact information for, some of the Cadwalader attorneys who are involved with specific legal issues raised by Dodd-Frank.

\* \* \*

I am also posting a version of this memorandum on the website for the Center for Financial Stability, a nonpartisan organization. See [www.centerforfinancialstability.org](http://www.centerforfinancialstability.org). If you would like to respond to the questions in Appendix A, please email them to my address at [slofchie@the-cfs.org](mailto:slofchie@the-cfs.org) and we will try to post them on the site either in summary form or anonymously as you indicate.

\* \* \*

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## Appendix A

Leaving aside the question of whether Title VII of Dodd-Frank is good or bad,

1. What would be a reasonable length of time to adopt implementing rules, given the need to seek comment and to coordinate between regulators?
2. How much and what type of legal staffing would the regulators require?
3. How would one form estimates of the above?
4. How much time would industry require to implement the rules?
5. How much staffing and what type would be required?
6. How would one form estimates of the above?

You may email your response to [slofchie@the-cfs.org](mailto:slofchie@the-cfs.org).

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<sup>1</sup> Cadwalader also makes available to subscribers an on-line library (the “**Cadwalader Cabinet**”) that includes, among other things, substantial materials in regard to Dodd-Frank. Contact: Steven Lofchie (+1 212 504 6700) / steven.lofchie@cwt.com.

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# Clients & Friends Memo

## **Living Wills: A User's Guide To Dodd-Frank's Bequest to Banks**

**June 13, 2011**

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. While many of its provisions have received greater publicity — such as the Orderly Liquidation Authority of Title II and the swap provisions of Title VII — the so-called “living will” provisions of Dodd-Frank are now receiving more focused attention. Section 165(d) of Dodd-Frank requires “systemically significant” financial institutions to periodically report to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Company and the Financial Stability Oversight Counsel a plan for the rapid and orderly resolution of their business in the event of material financial distress.

The FDIC and the Federal Reserve recently proposed joint rules governing the implementation of this “living will” requirement. The proposed rules would require systemically significant financial institutions to file and update their resolution plans periodically and file related quarterly credit exposure reports. As discussed below, the proposed rules provide extensive detail concerning the content of these filings. The comment period for the proposed rules ends on June 10, 2011, with the final rule expected no later than January 2012.

The proposed rules are intended to (a) reduce the possibility of the failure of organizations that were previously considered “too big to fail,” and (b) minimize the impact of the failure of such an organization on the broader economy. In proposing the rules, FDIC Chairman Sheila C. Bair stated:

The ability to plan in advance for the orderly resolution of a systemic entity is key to ending Too Big To Fail. Viable resolution plans will require systemic institutions to conduct a strategic analysis on how they could be resolved under the Bankruptcy Code as well as evaluate significant credit exposures and other key information across the entities and their affiliates. These plans will be instructive to institutions as a way for them to better understand how their business lines interact and how to mitigate the effects of failure risk. The plans also will help inform the FDIC on how to lessen the systemic ripple effects in the event one of these companies must be resolved under the new Orderly Liquidation Authority.

The living will requirement imposes significant informational and oversight burdens on large financial institutions. We expect these institutions to devote enormous resources to the process of preparing living wills over the next year and to update quarterly and annually. Given the burden imposed by the proposed rules, systemically significant institutions that have not already done so may find it prudent to begin the process of preparing their living will without delay.

It remains unclear how the living wills will be of use. Although the living wills may help institutions prevent another situation similar to the systemic failure of 2008, the significant undertaking required by the proposed rules may prove for naught when crisis actually arises. Predicting the cause of a future massive disruption is, of course, difficult. Thus, any preparation may not address the ultimate issues that arise.

The proposed rules leave some other important questions unanswered. For example, the proposed rules require the financial institutions to draft their plan under the Bankruptcy Code, as opposed to the Orderly Liquidation Authority under Title II of Dodd-Frank.<sup>1</sup> It is unclear how the living will requirement and Orderly Liquidation Authority interact.

### **Who Must Comply With the Rules?**

The proposed rules apply to “Covered Companies,” defined to include:

- any non-bank financial company supervised by the Federal Reserve;
- any bank holding company that had \$50 billion or more in total consolidated assets; and
- any foreign bank or company that is a bank holding company or is treated as a bank holding company under the International Banking Act of 1978 and that had \$50 billion or more in total consolidated assets.

The proposed rules require that the resolution plan of a domestic Covered Company include information with respect to the subsidiaries and operations that are domiciled in the U.S. as well as foreign subsidiaries, offices, and operations. For a foreign Covered Company, the resolution plan must include information with respect to its domestic subsidiaries, branches, agencies, critical operations and core businesses.

The FDIC estimates that the rules will apply to approximately 124 organizations.

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<sup>1</sup> The Orderly Liquidation Authority is a new federal receivership process created under Title II of Dodd-Frank. Under the Orderly Liquidation Authority, the FDIC may seize control of a financial company whose imminent collapse is determined by the Secretary of the Treasury to threaten the stability of the U.S. financial system.

**What Do Covered Companies Have to Do?**

The proposed rules impose ongoing obligations on a Covered Company to prepare and update its living will. Note that the board of directors of a Covered Company is required to approve each resolution plan prior to filing. In particular:

- Each Covered Company must file its initial resolution plan with the FDIC and the Federal Reserve within 180 days of the effective date of the final rule.
- Each Covered Company then must submit an annual updated resolution plan no later than 90 days after the end of each calendar year.
- Each Covered Company must file an updated resolution plan no later than 45 days after any event, occurrence, or change in conditions or circumstances which results in, or could reasonably be foreseen to have, a material effect on its currently filed resolution plan. Material events include, among other things, a significant acquisition or sale by the Covered Company or the loss of a material servicing subsidiary or servicing contract.

The initial submissions likely will not end the process. Following submission of a resolution plan, the FDIC and the Federal Reserve have 60 days to determine and acknowledge whether the resolution plan satisfies the minimum informational requirements of the proposed rules. If the FDIC and the Federal Reserve determine that the resolution plan is informationally incomplete, they will inform the Covered Company in writing of what additional information is required. The Covered Company would then be required to submit a modified resolution plan satisfying these requests.

After acceptance of the submission by the FDIC and the Federal Reserve, the agencies will review the resolution plan for compliance with the proposed rules. If, following this review, the FDIC and the Federal Reserve determine jointly that the resolution plan would not facilitate an orderly resolution of the Covered Company, then the FDIC and the Federal Reserve will notify the Covered Company of the plan's failure. Within 90 days of receiving notice of the insufficiency of its plan, a Covered Company must submit a revised resolution plan that addresses these deficiencies. The revised resolution plan would be required to address: (1) the revisions made by the Covered Company to address the deficiencies identified by the FDIC and the Federal Reserve; (2) any changes to the Covered Company's business operations and corporate structure that the Covered Company proposes to facilitate implementation of the revised resolution plan; and (3) why the Covered Company believes the revised resolution plan is credible and would result in an orderly resolution of the Covered Company under the Bankruptcy Code.

### **What Are the Key Aspects of the Resolution Plan?**

In general, each resolution plan must include: (1) an executive summary; (2) strategic analysis of the plan for resolution; (3) a description of the corporate governance structure for resolution planning; (4) a summary of overall organization structure; (5) detail on management information systems; (6) a review of interconnections and interdependencies; and (7) supervisory and regulatory information.

The resolution plan of a domestic Covered Company shall include the information below with respect to its subsidiaries and operations that are domiciled in the United States as well as any foreign subsidiaries, offices, and operations. The resolution plan of a foreign Covered Company must include the information described below (other than the provisions regarding interconnections and interdependencies) only with respect to its U.S.-based subsidiaries, branches and agencies, and critical operations and core business lines. These entities must also include a detailed explanation of how resolution planning for its subsidiaries, branches and agencies, and critical operations and core business lines is integrated into the foreign-based Covered Company's overall resolution and other contingency planning process.

#### **INITIAL LIVING WILL CHECKLIST:**

- I. Executive Summary.** The proposed rules require a summary of:
- Key elements of the strategic plan for rapid and orderly resolution in the event of failure of the Covered Company.
  - Material changes from most recently filed plans, including actions taken to improve the effectiveness of the resolution plan.
- II. Strategic Analysis of the Resolution Plan's Components.** This section provides the meat of the company's plan for orderly resolution. Each Covered Company must:
- Describe its plan for a rapid and orderly resolution, including:
    - Setting forth key assumptions and supporting analysis underlying the plan, including any assumptions made concerning the economic or financial conditions that would be present at the time the Covered Company sought to implement the plan.

- Detailing how reorganization or liquidation of the Covered Company could be accomplished in a manner that mitigates substantially the risk that the failure of the Covered Company would have a serious adverse effect on financial stability in the United States.
  - Identifying specific actions to be taken by the Covered Company to facilitate resolution.
  - Describing funding, liquidity, support functions, and other resources, including capital resources, and “mapping” them to the Covered Company’s material entities, core business lines and critical operations.
  - Detailing its strategy for maintaining and funding critical operations and core business lines during financial distress. This should also be “mapped” to the critical operations and core business lines.
  - Demonstrating how resources would be utilized to facilitate an orderly resolution.
  - Detailing its strategy in the event of a failure or discontinuation of a material entity, core business line, or critical operation, and the actions that will be taken by the Covered Company to mitigate adverse effects a failure will have on the financial stability of the company and the United States.
  - Detailing its strategy for ensuring that any insured depository institution subsidiary will be protected adequately from risks arising from the activities of any non-bank subsidiaries of the Covered Company.
- Identify the time period needed to implement the plan.
  - Describe any potential material weaknesses to execution of the Covered Company’s plan and detail actions and steps necessary to mitigate those weaknesses.
  - Provide a detailed description of the processes the Covered Company employs for:
    - Determining the current market values and marketability of the core assets.
    - Assessing the feasibility of the Covered Company’s plans.
    - Assessing the impact of any dispositions and restructurings on the value and operations of the Covered Company.
  - Demonstrate how core assets and critical operations could be resolved and transferred to potential acquirers.
  - Demonstrate how critical elements of the business operations could survive during material financial distress or the failure of key entities within the Covered Company.

- III. Description of Corporate Governance Structure for Resolution Planning.** This section details how the company prepared its resolution plan and requires the Covered Company to:
- Describe how resolution planning is integrated into the corporate governance structure.
  - Describe the Covered Company's procedures and internal controls governing preparation and approval of the resolution plan.
  - Identify the senior management official primarily responsible for overseeing the development and implementation of the plan.
  - Describe the nature, extent, and frequency of reporting to senior executive officers and the board of directors on development of the plan.
  - Describe the Covered Company's processes to collect and report the data underlying the plan.
  - Describe the nature of any planning to assess the viability of or to improve the resolution plan.
  - Identify and describe the relevant risk measures used by the Covered Company to report credit risk exposures both internally and to the appropriate Federal regulator.
- IV. Information Regarding Overall Organizational Structure and Related Information.** This section includes details on the company's organizational structure, finances, liabilities and assets and requires the Covered Company to:
- Provide a detailed description of the Covered Company's organizational structure, including:
    - An organizational chart of all material legal entities.
    - A "mapping" of the Covered Company's critical operations and core business lines.
  - Provide an unconsolidated balance sheet for the Covered Company and a consolidating schedule for all entities that are subject to consolidation.
  - Include a description of the material components of its assets, liabilities, critical operations, and core business lines.
  - Identify and describe the processes used by the Covered Company to determine to whom the Covered Company has pledged collateral, and identify the person or entity that holds such collateral, the jurisdiction in which the collateral is located and in which the security interest in the collateral is enforceable.

- Describe any material off-balance sheet exposures (including guarantees and contractual obligations).
- Describe booking of trading and derivative activities.
- Identify material hedges and hedging strategies of the Covered Company.
- Describe the process undertaken by the Covered Company to establish exposure limits.
- Identify major counterparties of the Covered Company and describe the interconnections, interdependencies, and relationships with those major counterparties.
- Analyze whether the failure of each major counterparty would likely have an adverse impact on the Covered Company.
- Identify each system on which the Covered Company conducts a material number or value amount of trades.
- Identify each payment, clearing, or settlement system of which the Covered Company, directly or indirectly, is a member and on which the Covered Company conducts material transactions and “map” membership in each system to the Covered Company’s material entities, critical operations and core business lines.
- If it has foreign operations, identify the extent of the risks related to its foreign operations and its strategy for addressing these risks.
- Evaluate the continued ability to maintain core business lines and critical operations in foreign jurisdictions during material financial distress and identify practical steps to address weaknesses or vulnerabilities.

**V. Information Regarding Management Information Systems.** This section includes details on the Covered Company’s relevant information management systems. Critical Companies must:

- Provide detailed inventory and description of key management information systems and applications supporting its core business lines and critical operations, including systems and applications for risk management, accounting, and financial and regulatory reporting.
- Identify the legal owner of all key management information systems.
- Identify the scope, content and frequency of the key internal reports used to monitor the financial health, risks, and operation of the Covered Company.
- Describe the process for the appropriate supervisory or regulatory agencies to access the management information systems and applications.

**VI. Description of Interconnections and Interdependencies.** This section sets forth the Covered Company's critical relationships. The Critical Company must:

- Identify interconnections and interdependencies within the Covered Company that, if disrupted, would materially affect the funding or operations of the Covered Company. Interconnections and interdependencies may include:
  - Common or shared personnel, facilities, or systems;
  - Capital, funding, or liquidity arrangements;
  - Existing or contingent credit exposures;
  - Cross-guarantee arrangements, cross-collateral arrangements, cross-default provisions, and cross-affiliate netting agreements;
  - Risk transfers; and
  - Service level agreements.
- Identify steps to ensure that service level agreements for key services survive insolvency.

**VII. Supervisory and Regulatory Information.** The Covered Company must detail:

- Its supervisory authorities and regulators and contact information for those authorities and regulators.

**VIII. Miscellaneous.** Additionally, the Covered Company must:

- Identify a senior management official responsible for serving as a point of contact.
- Include contact information for the material entities, critical operations, and core business lines of the Covered Company.
- Describe processes and systems to collect, maintain, and report data underlying the plan and identify any deficiencies in these processes and systems.
- Discuss plans to remedy the deficiencies.
- Demonstrate ability to produce promptly the data underlying the key aspects of the resolution plan.

**What Must Each Updated Resolution Plan Include?**

The Executive Summary of each updated resolution plan (updated annually or as a result of a material event) must contain the following:

- A description of all material changes from the Covered Company's most recently filed resolution plan.
- A description of any action taken by the Covered Company to improve the resolution plan's effectiveness or mitigate any material weaknesses or impediments to effective and timely execution of the resolution plan.

Any update may incorporate by reference informational elements from the previously submitted resolution plan, provided that:

- The resolution plan clearly indicates (1) the informational elements being incorporated by reference; and (2) which of the Covered Company's previously-submitted resolution plans originally contained the information being incorporated by reference.
- The Covered Company certifies that the information it is incorporating by reference remains accurate.

Any update filed as a result of a material event should (1) describe the material effects that the material event may have on the Covered Company's resolution plan; and (2) detail any actions that the Covered Company has taken or will take to address such material effects.

**What Are the Key Aspects of the Credit Exposure Reports?**

Each Covered Company is also required to submit a Credit Exposure Report to the Federal Reserve and the FDIC no later than 30 days after the end of each calendar quarter. The credit exposure reports should contain the following information:

- The aggregate credit exposure associated with (a) all extensions of credit, including loans, leases, and funded lines of credit by, (b) all committed but undrawn lines of credit by, and (c) all deposits and money placements by:
  - The Covered Company and its subsidiaries to each other significant company<sup>2</sup> and its subsidiaries; and

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<sup>2</sup> The term "significant company" is defined to include all other Covered Companies and any other non-bank financial company that had \$50 billion or more in total consolidated assets as of the end of its most recently completed fiscal year.

- Each other significant company and its subsidiaries to the Covered Company and its subsidiaries.
- The aggregate credit exposure associated with all repurchase agreements, reverse repurchase agreements, securities borrowing transactions and securities lending transactions (each on both a gross and net basis) between the Covered Company and its subsidiaries and each significant company and its subsidiaries.
- The aggregate credit exposure associated with all guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit) issued by:
  - The Covered Company and its subsidiaries on behalf of each significant company and its subsidiaries; and
  - Issued by each significant company and its subsidiaries on behalf of the Covered Company and its subsidiaries.
- The aggregate credit exposure associated with all purchases of or investments in securities issued by each significant company or its subsidiaries by the Covered Company and its subsidiaries.
- The aggregate credit exposure associated with all counterparty credit exposure in connection with a derivative transaction between the Covered Company and its subsidiaries and each significant company and its subsidiaries.
- A description of the systems and processes that the Covered Company used to:
  - Collect and aggregate the data underlying the Credit Exposure Report; and
  - Produce and file the Credit Exposure Report.
- The credit exposure associated with intra-day credit extended by the Covered Company to each significant company and its subsidiaries during the prior quarter.
- Any other transaction that results in credit exposure between a Covered Company and its subsidiaries and each significant company and its subsidiaries that the Federal Reserve, by order or regulation, determines to be appropriate.

### **Critical Considerations for Covered Companies**

The proposed rules require large financial institutions to take several important steps. Most notably, the proposed rules require Covered Companies to undertake significant and burdensome reviews to prepare the initial and updated reports. We expect the plans to require costly efforts both internally and by external lawyers and financial advisors. Given the size and scope of the likely

obligations, Covered Companies should not delay in beginning preparation of the information and materials necessary for the living will.

Other issues for consideration:

- *Triggers.* The living will is designed to permit orderly liquidation at a time of great financial distress. However, as even the proposed rules acknowledge, by definition, it is difficult to anticipate the scenario that will give rise to an extreme financial crisis. Thus, preparing for relevant contingencies may prove difficult.
- *Internal Controls.* The proposed rules would require the Covered Companies to create internal systems for developing the living wills and updating them. Boards and management will need to anticipate and plan for this at the beginning of the process.
- *Confidentiality.* Both the resolution plans and the credit exposure reports require each Covered Company to disclose a significant amount of information to the Federal Reserve and the FDIC. As a result, there is the potential for public exposure of confidential data. The proposed rules permit a Covered Company to request confidential treatment of the information pursuant to existing Freedom of Information Act rules and the applicable agency rules, but it is not clear how, or if, this will be implemented.
- *Limited to the Bankruptcy Code.* The proposed rules contemplate that each resolution plan address the rapid and orderly resolution of the Covered Company pursuant to the Bankruptcy Code. It is unclear how the resolution plans are intended to interact with the receivership process of the Orderly Liquidation Authority under Title II of Dodd-Frank, which is a different regime than the Bankruptcy Code.
- *Consistency.* Firms should consider whether the disclosures in their living wills are consistent with disclosures in securities offerings and other public documents.

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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