

ARNOLD & PORTER LLP

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A Compendium of Advisories on the Dodd-Frank Act

By the Attorneys of Arnold & Porter LLP



Dear Clients and Friends,

Passage of the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act, the most far-reaching financial regulatory legislation since the Great Depression, has set the stage for major adjustments in the financial services industry. The Act impacts regulation, supervision, and in some cases the structure of financial sector companies. It regulates executive compensation and corporate governance, inside and outside the financial services industry.

For affected businesses, the challenges of complying with possibly as many as 400 studies and new regulations in a 2,300-page bill are both numerous and daunting.

To help understand the complexities of the new legislation, Arnold & Porter LLP is offering a collection of Advisories on various aspects of the Act. These range from the Financial Stability Oversight Council/Systemic Risk Determination Process to the Consumer Financial Protection Bureau; from fair lending issues to restrictions embodied in the new "Volcker Rule." They also include the Act's impact on derivatives, capital, and compensation.

We hope you will find our Advisories useful. Please feel free to contact us or any of our colleagues in the financial services practice at Arnold & Porter for further information.

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Congress Finalizes Landmark Financial Regulatory Reform Legislation

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

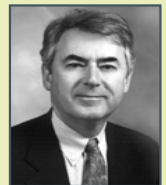
The legislation will also affect companies outside of the financial services industry. For example, every public company will be affected by Title IX of the Act's executive compensation and corporate governance reforms. Title I of the Act's creation of a new systemic risk council to monitor macroeconomic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

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

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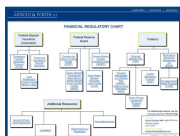
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Financial Regulatory Chart

Financial Regulatory Reform: For Arnold & Porter's latest resources on this topic including Advisories, upcoming events, and publications, please visit [Financial Regulatory Reform](#). Also visit our [Financial Regulatory Chart](#), which aggregates information on US government programs.

Title I. Financial Stability

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

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

Title I defines "nonbank financial companies" as those companies, other than bank holding companies or their subsidiaries with either (i) revenues from activities that are

financial in nature that comprise at least 85 percent of the consolidated annual gross revenues of the company; or (ii) consolidated assets that are financial in nature that comprise at least 85 percent of the consolidated assets of the company. Activities that are "financial in nature" are those listed in section 4(k) of the Bank Holding Company Act of 1956, as amended—primarily banking, insurance, securities, and passive merchant banking activities.

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

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

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

¹ The voting members are:

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

The nonvoting members will include the Director of the newly created Office of Financial Research, the Director of the newly created Federal Insurance Office, a state insurance commissioner, a state banking supervisor, and a state securities commissioner.

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

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

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

a nonbank financial company supervised by the Federal Reserve, or a company that controls a nonbank financial company supervised by the Federal Reserve, is *not* required to conform its activities to those financial activities listed in section 4(k) of the Bank Holding Company Act.

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

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

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

² In addition, in section 616(d) of the Act, the Federal Deposit Insurance Act is amended to require the appropriate federal banking agency for a bank holding company or savings and loan company, or insured depository institution not a subsidiary of a bank holding company or savings and loan holding company (e.g., an industrial bank) to require that such bank holding company, savings and loan holding company or parent company of an insured depository institution act as a source of strength to its insured depository institution subsidiary.

immediately effective for hybrid capital instruments issued on or after May 19, 2010, by depository institution holding companies (except small bank holding companies with less than \$500 million in assets) and nonbank financial companies supervised by the Federal Reserve. For hybrid capital instruments issued before May 19, 2010, by depository institution holding companies with total consolidated assets of \$15 billion or more and nonbank financial companies supervised by the Federal Reserve, the requirement to exclude pre-May 19, 2010-issued hybrid capital instruments from Tier 1 capital will be phased in incrementally over a period of three years, beginning January 1, 2013. For hybrid capital instruments issued before May 19, 2010, by depository institution companies with total consolidated assets of less than \$15 billion as of December 31, 2009, and by companies that were mutual holding companies on May 19, 2010, there is no requirement to deduct pre-May 19, 2010-issued hybrid capital instruments from Tier 1 capital.

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

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

for the leverage and risk-based capital requirements of the Collins Amendment other than those relating to the treatment of the deduction of hybrid capital instruments from Tier 1 capital, whether issued before or after May 19, 2010.

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

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

Title II. Orderly Liquidation Authority

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

In light of its exceptional nature, liquidation of a company under Title II of the Act must be approved by the Federal Reserve, the FDIC, and the Treasury Secretary (in consultation with the President). If the failing company does

not consent to the appointment of the FDIC as receiver, the Treasury Secretary must petition the District Court for the District of Columbia for an order authorizing the appointment. The District Court's determination is reviewable by the Court of Appeals for the DC Circuit, whose decision is in turn subject to discretionary review by the US Supreme Court.

Liquidation pursuant to Title II must comply with several mandatory terms:

- The FDIC must ensure that shareholders do not receive any payment until after all other claims are fully paid, that unsecured creditors bear losses in accordance with the Title's priority provisions, and that managers responsible for the company's failure are removed.
- The FDIC may also hold directors and officers of companies placed into receivership personally liable for damages arising from gross negligence and may recover compensation previously paid to senior executives and directors "substantially responsible" for the failure of the company.

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

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

Title III of the Act abolishes the Office of Thrift Supervision (OTS) and allocates its responsibilities, personnel, and assets among the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the FDIC. The Federal Reserve assumes responsibility for supervision of savings and loan holding companies and their nonbank subsidiaries, while federal savings associations and state savings associations become the responsibility of the OCC and the FDIC, respectively. Prospectively, OTS rulemaking authority is divided between the Federal Reserve and the OCC, and the new position of "Deputy Comptroller for the Supervision and Examination of Federal Savings Associations" is created at the OCC. Existing OTS regulations, orders, legal actions,

guidance, and similar materials remain in force until altered or otherwise acted on by the Federal Reserve, the OCC, or the FDIC. These changes generally become effective one year from enactment of the legislation, which may be extended by the Treasury Secretary for up to six additional months (Transfer Date). The abolition of the OTS would become effective 90 days after the Transfer Date. The Director of the newly created Consumer Financial Protection Bureau would then replace the Director of the OTS on the FDIC Board of Directors.

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

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

Title IV. Regulation of Advisers to Hedge Funds and Others

Title IV of the Act amends the Investment Advisers Act of 1940 (Advisers Act) to impose Securities and Exchange Commission (SEC) registration, reporting, and record-keeping obligations on investment advisers to "private funds" that have assets under management in the United States of \$150 million or more, subject to limited exemptions. Advisers to such funds (which include hedge funds, private equity funds, and other private funds not subject to an exemption) will be subject to Advisers Act regulation through elimination of the "private adviser" exemption in the Advisers Act that

applies to investment advisers who, during the course of the preceding 12 months, had fewer than 15 clients (with a fund counting as a single client) and who do not hold themselves out to the public as an investment adviser or act as an investment adviser to a registered investment company. Elimination of the “private adviser” exemption applies to investment advisers generally, not just those that act as advisers to private funds.

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

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

Records and Reports. The SEC is authorized to require advisers to private funds to maintain records and file reports with the SEC.⁴ The SEC may share this information with the

FSOC, which may use it to determine whether to designate a private investment fund as “systemically significant” and therefore subject to Federal Reserve supervision, capital requirements, risk controls, pre-packaged liquidation plan requirements, the FDIC’s orderly liquidation authority, and other significant and pervasive regulatory requirements that will apply to financial companies so designated under Titles I and II of the Act.⁵

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

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

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

Title V. Insurance

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

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

⁴ Records and reports to be maintained by an investment adviser include the amount of assets under management; use of leverage, including off-balance sheet leverage; counterparty credit risk

exposure; trading and investment positions; valuation policies and practices; types of assets held; side arrangements or side letters, whereby certain fund investors obtain more favorable rights than others; trading practices; and other information that the SEC, in consultation with the FSOC, determines is necessary or appropriate in the public interest or for the assessment of systemic risk.

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

⁶ The SEC recently adopted new rules that provide additional safeguards when a registered adviser has custody of client funds or securities.

able to recommend to the FSOC that it designate an insurer, including its affiliates, as an entity subject to regulation by the Federal Reserve as a nonbank financial company. The Act does not specify a timeframe for the Treasury Secretary to issue regulations to establish the FIO.

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

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

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

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

Moratorium for Certain Deposit Insurance Applications. For example, Title VI imposes a three-year moratorium on the ability of the FDIC to approve a new application for

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

Enhanced Regulation of Holding Company Entities. In order to aid a consolidated supervisor's ability to identify and address risk throughout an organization, the Act also removes limitations under the Gramm-Leach-Bliley Act on the ability of a federal banking agency to obtain reports from, examine, and regulate all subsidiaries of a bank or savings and loan holding company it supervises. The Act also provides that the lead federal banking agency for each depository institution holding company (which would be the Federal Reserve or the OTS prior to the Transfer Date and would be the Federal Reserve in all cases after the Transfer Date) must examine the permissible activities of each non-depository institution subsidiary, other than a functionally regulated subsidiary, of that holding company to determine whether those activities present safety and soundness risks to any depository institution subsidiary. Thus, any affiliate of a depository institution would be made subject to the same standards and examined with the same frequency as the depository institution itself within the same holding company structure. This approach is intended to ensure that the placement of an activity in a holding company structure could not be used to arbitrage between different supervisory regimes or approaches.

Volcker Rule. Title VI also contains the so-called “Volcker Rule.” Under these provisions, subject to certain exemptions, federal regulators must issue regulations to prohibit “banking entities” (i.e., insured depository institutions, their holding companies, non-US banks with branches or agency offices in the US, and any affiliate or subsidiary of such entities) from engaging in proprietary trading,⁷ sponsoring or investing in hedge funds and private equity funds, and having certain financial relationships with those hedge funds or private equity funds for which they serve as investment manager or investment adviser. A systemically significant non-bank financial company supervised by the Federal Reserve that engages in such activities would be subject to rules establishing enhanced capital standards and quantitative limits, but such activities would not be prohibited.

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

- The purchase, sale, acquisition, or disposition of obligations of the United States, Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution; and state or municipal obligations.
- Transactions in connection with underwriting or market-making-related activities, to the extent that any such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.
- Hedging activities designed to mitigate risks associated with individual or aggregated positions.
- Transactions on behalf of customers.
- Investments in small business investment companies; investments designed primarily to promote the public welfare; or investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure.
- The purchase, sale, acquisition, or disposition of securities and other instruments by a regulated insurance company for the general account of the company and by any affiliate of such regulated insurance company, subject to certain requirements.
- Organizing and offering a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, provided certain requirements set forth in the law are met. These requirements include that the banking entity provide *bona fide* trust, fiduciary, or investment advisory services; that the fund be organized and offered only in connection with the provision of such services and only to persons that are customers of such services of the banking entity; and that the banking entity not acquire or retain more than a specified *de minimis* ownership interest in the fund.
- Proprietary trading conducted solely outside of the United States by a banking entity pursuant to Section 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, unless the entity is controlled by a banking entity organized in the United States.
- The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund by a banking entity pursuant to Section 4(c)(9) or 4(c)(13) of the Bank Holding Company Act solely outside of the United States, provided that no ownership interest in such hedge fund or private equity fund is offered or sold to United States residents and the banking entity is not controlled by a banking entity organized in the United States.
- Other activity as permitted by regulators.

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

⁷ “Proprietary trading,” for purposes of the Volcker Rule, means engaging as a principal for an entity’s “trading account” in purchases or sales of securities, derivatives, commodity futures, options on such instruments, and any other financial instrument that the appropriate federal banking agencies, the SEC, and the CFTC may, by rule, determine. “Trading account,” for purposes of the Volcker Rule, means any account used to take positions principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and such other accounts as the regulators may determine.

- Would involve or result in a material conflict of interest (as defined by regulators) between the banking entity and its clients, customers, or counterparties;
- Would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as defined by regulators); or
- Would pose a threat to the safety and soundness of such banking entity or to the financial stability of the United States.

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

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

The Act also would, among other things:

- Expand existing restrictions on bank transactions with affiliates by adding credit exposure from a securities borrowing or lending transaction or derivative transaction to the list of inter-affiliate "covered transactions" in Section 23A of the Federal Reserve Act, and by defining an investment fund for which a member bank is an investment adviser as an affiliate of the member bank under Section 23A;
- Expand the type of transactions subject to insider lending limits to include derivatives transactions, repurchase agreements, reverse repurchase agreements, and securities lending or borrowing transactions;
- Tighten national bank lending limits by treating credit exposures on derivatives, repurchase agreements, reverse repurchase agreements, and securities lending or borrowing transactions as extensions of credit for purposes of national bank lending limits; and
- Require that insured state banks may engage in derivatives transactions (as defined under national bank lending limits laws) only if the law with respect to lending limits of the state in which the insured state bank is chartered takes into consideration credit exposure to derivative transactions.

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

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

Title VII of the Act provides for unprecedented and substantial regulation of the over-the-counter derivatives market, including swaps. In an effort to provide additional "transparency" to financial markets, the Act increases the regulatory requirements imposed on various financial entities that utilize derivatives products. More specifically, the Act

regulates “swap dealers” and “major swap participants,” whose definitions would likely include banks, large hedge funds, and possibly even large insurance and some finance companies. Requirements imposed on entities that fit within the definition of swap dealers and major swap participants include registration requirements, posting of margin for trades, capital requirements, reporting and recordkeeping requirements, and business conduct standards. Certain “end-user” businesses could be exempt from many of the above requirements if their positions in derivatives are determined to be for hedging and commercial risk mitigation purposes.

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

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

Title VIII. Payment, Clearing, and Settlement Supervision

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

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

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

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

Credit Rating Reforms

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

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

Regulation of Broker-Dealers and Investment Advisers

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

On a more substantive basis, the Act extends the protections of the Securities Investor Protection Act by permitting both

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

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

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

- Codifies the SEC’s whistleblower program and strengthens it by providing for substantial awards, the creation of a fund for such awards, and sanctions for retaliatory firings, including attorneys’ fees and double the amount of lost income;
- Amends the Securities Act, Exchange Act, Investment Company Act, and Advisers Act so that in an SEC enforcement action, persons may be held liable for knowingly or recklessly providing substantial assistance to a violator;
- Strengthens oversight of municipal securities markets by requiring persons who advise municipalities on bond issuances, or who otherwise participate in or solicit issuances (including guaranteed investment contract brokers, swap advisors, and finders), to register with the SEC;
- Requires the SEC to issue rules to provide for public disclosure of aggregate short sale data for individual securities at least each month; and
- Requires broker-dealers to inform customers (i) that they may elect not to allow their fully paid securities to be used in connection with short sales; and (ii) that the broker may receive compensation if they are so used.

The Act directs numerous organizational changes within the SEC. Notably, it directs the SEC’s Divisions of Trading and Markets and Investment Management to have their own

examination staffs, streamlines and accelerates the process for rule changes by self-regulatory organizations, codifies the establishment of the SEC's Investor Advisory Committee, and creates an Investor Advocate's Office to assist and represent the interests of retail investors.

Executive Compensation and Governance Reforms

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

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

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

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

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

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

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

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

- Require "covered financial institutions" to disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements sufficient to determine whether the compensation structure provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or could lead to material financial loss to the covered financial institution; and
- Prohibit any incentive-based payment arrangement that such regulators determine encourages "inappropriate

risks” by covered financial institutions, by providing an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or that could lead to material financial loss to the covered financial institution.

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

Title X. Bureau of Consumer Financial Protection

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

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

- The Electronic Funds Transfer Act;
- The Equal Credit Opportunity Act;
- The Fair Credit Reporting Act;
- The Fair Debt Collection Practices Act;
- The Real Estate Settlement Procedures Act;
- The Truth in Lending Act;

- The Truth in Savings Act; and
- The Interstate Land Sales Full Disclosure Act (added during conference).

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

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

The regulations issued by the CFPB would apply to any “covered person,” which is defined as any person engaged in offering or providing a consumer financial product or service (generally not including otherwise-regulated securities and insurance activities) and an affiliate that acts as a service provider to such a person. However, the Act makes it clear that the CFPB does not have authority over commercial transactions or the sale of nonfinancial goods or services. For example, the CFPB generally may not exercise authority with respect to a merchant, retailer, seller, or broker of nonfinancial goods or services. At conference, payday lenders, money remitters, check cashers, and private student loan providers were explicitly added to the

supervision of the CFPB, while motor vehicle dealers were excluded. Pawn shop lenders do not appear to be subject to the supervision of the CFPB. Motor vehicle dealers and their financing operations are exempt to the extent that the source of the motor vehicle dealer's financing is a third party; however, motor vehicle dealers continue to be subject to FTC jurisdiction, and the FTC is given Administrative Procedure Act rulemaking powers over them.

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

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

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

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

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

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

A state attorney general may bring a civil action in the name of the state to enforce regulations that the CFPB issues, but not the provisions of Title X itself, against a federally

chartered institution. To that end, the visitorial standard for federally chartered institutions will remain the standard set forth in the 2009 US Supreme Court case *Cuomo v. Clearing House Association, L.L.C.* Under that standard, a state attorney general may bring a judicial action against a federally chartered institution to enforce an applicable law.

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

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

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

Title XI of the Act requires the Federal Reserve to establish by regulation policies and procedures governing emergency lending programs. The programs must be of “broad based” applicability and designed to provide liquidity and not to aid a failing financial company. The programs must also be designed to ensure that the security for emergency loans

is sufficient to protect taxpayers from losses and that the programs are terminated in a timely and orderly fashion. The Federal Reserve may not establish any emergency lending programs without the prior approval of the Treasury Secretary.

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

Title XII. Improving Access to Mainstream Financial Institutions

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

Title XIV. Mortgage Reform and Anti-Predatory Lending Act

Title XIV creates new standards and prohibitions for residential mortgage lending to be supervised by the CFPB. These standards are designed to prevent the practices that were prevalent during the subprime mortgage crisis. Mortgages will be subject to a federal standard that would require the loans to reasonably reflect a borrower’s ability

to repay. A consumer may assert a lender's violation of this "ability to repay" standard as a defense to a foreclosure. A mortgage that fits certain qualifications will be presumed to meet this standard. These qualifications include:

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

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

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

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

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Dodd-Frank Act Addresses Systemic Risk

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

The Financial Stability Oversight Council

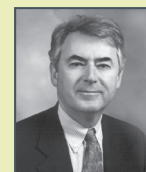
At the core of Dodd-Frank's systemic risk monitoring and mitigation framework lies the Financial Stability Oversight Council (FSOC), chaired by the Secretary of the Treasury (Treasury Secretary) and consisting of 15 members: 10 voting and 5 nonvoting. The voting members, in addition to the Treasury Secretary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

- The Federal Reserve;
- The Office of the Comptroller of the Currency;
- The Securities and Exchange Commission;

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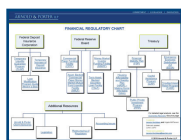
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Financial Regulatory Chart

Financial Regulatory Reform: For Arnold & Porter's latest resources on this topic including Advisories, upcoming events, and publications, please visit [Financial Regulatory Reform](#). Also visit our [Financial Regulatory Chart](#), which aggregates information on US government programs.

- The Federal Deposit Insurance Corporation (FDIC);
- The Commodity Futures Trading Commission;
- The Federal Housing Finance Agency;
- The National Credit Union Administration Board; and
- The newly created Consumer Financial Protection Bureau.

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

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

Defining Systemic Risk

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

is predominantly engaged in financial activities in the United States, including through a US branch.

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

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

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

- Any other risk-related factors the FSOC deems appropriate.¹

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

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

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

In addition, the Federal Reserve may require a company determined to be of systemic risk to establish such an intermediate holding company to segregate its financial activities. Moreover, the Federal Reserve *must* require that such a company establish an intermediate holding company if

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

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

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

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

¹ With respect to a foreign nonbank financial company, the FSOC will consider the same factors as for a US nonbank financial company, and also the extent to which the company is subject to prudential standards in its home country. In addition, the Council also will evaluate the specific impact of the company’s activities on the US economy, including the amount and nature of the company’s US financial assets and liabilities, and any other factors the FSOC deems appropriate.

FSOC may, by a two-thirds vote, including the affirmative vote of the Treasury Secretary, decide to rescind any such determinations. In addition, a nonbank financial company may appeal any final determination in the district court of its home office, or in the District Court of the District of Columbia, requesting an order requiring that the final determination be rescinded. The district court will review the FSOC's decision under the "arbitrary and capricious" standard.

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

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

As noted above, the Act appears to presume that "large bank holding companies"—defined as bank holding companies with more than \$50 billion in total consolidated assets as of

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

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

Impact of Systemic Risk Designation

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

In formulating the new stringent liquidity and capital requirements for large bank holding companies and systemically significant nonbank financial companies, members of the FSOC and

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

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

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

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

Early Remediation. In order to minimize the possibility that financial distress at a systemically significant company will lead to insolvency and eventually undermine the country’s financial stability, large bank holding companies and nonbank financial companies determined to be of systemic risk may be subject to regulations, promulgated by the Federal Reserve in consultation with the FSOC and the FDIC, that provide for early remediation in the event that such financial distress occurs. Similar to prompt corrective action regulations in place for banking organizations, these remediation regulations

must define specific prudential measures for the company to take, such as increasing capital and liquidity, that grow increasingly stringent as the company’s financial condition declines. However, the US government is prohibited from providing financial assistance to the company.

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

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

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

- Information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company;
- Full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company;
- Identification of any cross-guarantees tied to different securities, identification of major counterparties, and a process for determining to whom the collateral of the company is pledged; and
- Any other information that the Federal Reserve and the FDIC may jointly require by rule or order.

The Federal Reserve is to require each nonbank financial company determined to be of systemic risk and each large bank holding company periodically to submit a copy of its resolution plan to the Federal Reserve, the FSOC, and the FDIC. The FSOC may make recommendations to the Federal Reserve concerning implementation of this requirement.

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

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

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

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

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

Implementation

Will the systemic risk determination process and the ability of the Federal Reserve and other federal regulators to intervene proactively in these nonbank companies in order to address material risks to the US financial system avert another economic crisis such as the one that started two years ago? Perhaps not completely, but the regulators now will have at their disposal more tools than the federal government has had in the past to handle a situation with a financial company that is in financial distress. As we have seen in the past two years, at times the federal government has appeared to have only two choices: either infuse massive amounts of taxpayer money into systemically significant companies (such as AIG), or stand by and let such a company file for bankruptcy protection (such as Lehman Brothers). If all the new tools provided under Title I still prove ineffective to deal with a systemically significant yet troubled financial company, Title II of the Act² provides for the US government to close and liquidate the troubled company.

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

However, for bank holding companies and their insured depository institutions, many of these requirements are not

² Title II of the Act is discussed in detail in an advisory, "Dodd-Frank Act Creates New Resolution Process for Systemically Significant Institutions," available at: http://www.arnoldporter.com/public_document.cfm?id=16155&key=12F3.

new. In particular, the imposition of more stringent prudential standards such as capital and liquidity, could have been imposed by the Federal Reserve and other banking regulators under their current powers, on a case-by-case basis, through enforcement orders issued to ensure the safety and the soundness of the particular bank holding company and its insured depository institution companies. Other requirements, such as the resolution plan requirements and the “Hotel California” provision, are new.

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

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

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

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

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Dodd-Frank Act Creates New Resolution Process for Systemically Significant Institutions

In the wake of the collapse of Lehman Brothers and the near-collapse of AIG, Bear Stearns, and Merrill Lynch, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) creates a new resolution mechanism for institutions whose failure would jeopardize the stability of the US financial system. This new “orderly liquidation authority” (OLA), which replaces the bankruptcy process for affected entities, is vested in the Federal Deposit Insurance Corporation (FDIC) and is in many regards similar to the FDIC’s existing resolution authority over insured depository institutions. While this new authority is expected to be used only under extraordinary circumstances, its provisions create new considerations and risks for counterparties to systemically significant entities and new liabilities for directors and officers of failed systemically important enterprises.

Eligible Entities. The resolution process created by Title II will apply to US “financial companies” only. In this context, a “financial company” is (i) a bank holding company; (ii) a nonbank financial company supervised by the Board of Governors of the Federal Reserve System (Federal Reserve) that has been determined under procedures established in Title I of the Act as being of systemic risk; (iii) any other company that is “predominantly engaged” in activities that the Federal Reserve has determined are financial in nature or incidental thereto for purposes of the Bank Holding Company Act (BHCA); and (iv) any subsidiary of the foregoing that is predominantly engaged in activities that the Federal Reserve has determined are financial in nature or incidental thereto for purposes of the BHCA, other than an insured depository institution or an insurance company. The FDIC, in consultation with the Secretary of the Treasury (Treasury Secretary), must promulgate regulations on how a company will be identified as “predominantly engaged” in financial activities or activities incidental thereto, but in no case can the FDIC define as “predominantly engaged,” any company that has consolidated revenues from such activities of less than 85 percent of total consolidated revenues. Governmental entities, Farm Credit System institutions, and entities supervised by the Federal Housing Finance Agency (such as Fannie Mae and Freddie Mac) are specifically excluded from Title II’s provisions. A company that becomes

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Financial Regulatory Chart

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

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subject to an OLA proceeding is referred to as a “Covered Financial Company.”

Appointment of FDIC as Receiver. The recommendations necessary to appoint the FDIC as receiver under Title II vary depending on the type of entity involved, although in every instance the actual determination to appoint a receiver is made by the Treasury Secretary, in consultation with the President. For financial companies, the FDIC and the Federal Reserve are responsible for deciding whether to recommend to the Treasury Secretary that the appointment of the FDIC as receiver is appropriate. For broker-dealers, the Securities and Exchange Commission (SEC) and the Federal Reserve, in consultation with the FDIC, have that responsibility. For insurance companies, the Director of the new Federal Insurance Office (created by the Act) and the Federal Reserve, in consultation with the FDIC, are the relevant parties. A two-thirds vote is required of each applicable entity for a recommendation to be approved and sent to the Treasury Secretary. This approval process should result in the use of the OLA in only the most exigent of circumstances, although there can be no guarantee of such restraint.

Standards to be Applied. A recommendation to the Treasury Secretary that the FDIC be appointed receiver under the OLA must be in writing and must contain eight elements:

- An evaluation of whether the financial company is “in default or in danger of default,” as that term is defined in the Act;
- A description of the effect that the default of the financial company would have on US financial stability;
- A description of the effect that the default of the financial company would have on economic conditions or financial stability for low income, minority, or underserved communities;
- A recommendation regarding the nature and the extent of actions to be taken under the OLA regarding the financial company;
- An evaluation of the likelihood of a private sector alternative to prevent the default of the financial company;
- An evaluation of why a case under the bankruptcy code is not appropriate for the financial company;
- An evaluation of the effects on creditors, counterparties, and shareholders of the financial company and other market participants; and
- An evaluation of whether the company satisfies the definition of “financial company.”

The Treasury Secretary in turn, in consultation with the President, must determine that:

- The financial company is in default or in danger of default;
- The failure of the financial company and its resolution under otherwise applicable federal or state law would have serious adverse effects on financial stability of the United States;
- No viable private sector alternative is available to prevent the default of the financial company;
- Any effect on the claims or interests of creditors, counterparties, and shareholders of the financial company and other market participants as a result of actions to be taken under the OLA is appropriate, given the impact that any action taken under the OLA would have on the financial stability of the United States;
- Any action under the OLA would avoid or mitigate such adverse effects;
- A federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to that regulatory order; and
- The company satisfies the definition of “financial company.”

If these findings are made by the Treasury Secretary, the appointment of the FDIC as receiver may proceed. Immediate reports to Congress regarding the determination to invoke Title II’s powers are required, as is a review by the Comptroller General of the United States. Ongoing supervision of the process by various Inspectors General

is also provided for in the legislation.

Judicial Review of Appointment of a Receiver. Decisions to appoint the FDIC as receiver under the OLA are appealable to the US District Court for the District of Columbia under an expedited review process. Subsequent review by the Court of Appeals and, at its discretion, the US Supreme Court is also available. If the Covered Financial Company, acting through its board of directors, consents to the appointment of the FDIC as receiver, then no judicial review is available. Courts are otherwise enjoined from restraining or affecting the FDIC's exercise of its authority under Title II, except as specifically provided for in the legislation.

Safe Harbor for Consent to Appointment of a Receiver. If the Covered Financial Company, acting through its board of directors, consents to the appointment of the FDIC as receiver, the directors are shielded from liability for such action. However, as noted below, directors may face personal liability for their actions as directors of a Covered Financial Company taken prior to the appointment of the receiver.

Treatment of Broker-Dealers and Insurance Companies. If the FDIC is appointed receiver of a broker-dealer pursuant to Title II, the FDIC must appoint the Securities Investor Protection Corporation (SIPC) as trustee for the liquidation. The liquidation will then proceed according to regulations that the Act requires the FDIC and SEC, in consultation with the SIPC, to promulgate. An insurance company that is a Covered Financial Company must be liquidated or rehabilitated under applicable state insurance law. If the appropriate state insurance regulator fails to commence such a liquidation or rehabilitation within a specified period, the FDIC is authorized to act in its place.

Objectives of the FDIC as Receiver. As receiver, the FDIC must exercise its powers under the OLA so as to mitigate risk to US financial stability and to minimize moral hazard. In so doing, the FDIC must ensure that

- Creditors and shareholders will bear the losses of the financial company;
- Management responsible for the condition of the financial company will not be retained; and

- The FDIC and other appropriate agencies will take all steps necessary and appropriate to assure that all parties, including management, directors, and third parties, having responsibility for the condition of the financial company bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility.

Consistent with these guidelines, Title II requires that resolutions conducted pursuant to the OLA result in no cost to the taxpayer.

In its role as receiver, the FDIC is to consult with other agencies, including relevant financial regulatory agencies, the SEC, and the SIPC, as appropriate.

Time Limit. The FDIC's appointment as receiver must end within three years after the date of the appointment, although that period may be extended for up to two additional years. The FDIC must promulgate rules on the termination of receiverships under Title II.

Funding. The cost of resolving an entity under the OLA is paid from the "Orderly Liquidation Fund" (Fund) established by Title II. The Fund remains unfunded until *after* the commencement of an OLA proceeding, at which point the FDIC is authorized to borrow from the US Treasury to obtain funding for the liquidation process. However, the FDIC may not access the Fund until it has submitted an acceptable "Orderly Liquidation Plan" to the Treasury Secretary, and even then the amount that may be accessed is limited until a repayment plan has been established between the FDIC and the Treasury Secretary. If the assets of the liquidated entity prove insufficient to repay the amounts owed to the Fund following the liquidation process, the FDIC must charge risk-based assessments to make up for the shortfall. Creditors who received more in the OLA process than they would have received under an ordinary liquidation are assessed first, followed by an assessment against bank holding companies with total consolidated assets of \$50 billion or more and any nonbank financial companies supervised by the Federal Reserve.

If there is still a deficiency, then the FDIC could assess other nonbank financial companies with total consolidated assets of \$50 billion or greater, even if not supervised by the Federal Reserve. The FDIC must promulgate regulations on how these risk-based assessments will be levied.

Mandatory Actions. Title II specifies certain actions that must be taken by the FDIC in the context of a Title II receivership. In particular, in exercising its authority under Title II, the FDIC must:

- Determine that any action is necessary for purposes of the financial stability of the United States, and not for the purpose of preserving the covered financial company;
- Ensure that the shareholders of a covered financial company do not receive payment until after all other claims and the Fund are fully paid;
- Ensure that unsecured creditors bear losses in accordance with the priority of claim provisions in Title II;
- Ensure that management responsible for the failed condition of the company is removed;
- Ensure that the members of the board of directors responsible for the failed condition of the company are removed; and
- Not take an equity interest in or become a shareholder of any company or its subsidiary.

These requirements are designed in large part to ensure that Covered Financial Companies and the individuals perceived to be responsible for such companies' insolvency shoulder as much of the cost of resolution as possible.

Upon appointment of the FDIC as receiver under Title II, any pending actions under the Bankruptcy Code or the Securities Investor Protection Act (SIPA) with respect to the Covered Financial Company are subject to dismissal. To the extent any assets of the company vested in another party as a result of the commencement of the bankruptcy or SIPA proceeding, such assets re-vest in the company. As such, an effort to place an institution preemptively into a bankruptcy or SIPA proceeding so as to trigger any contractual remedies prior to the commencement of an action under Title II would likely be ineffective.

Powers of the FDIC as Receiver. As receiver, the FDIC succeeds to all rights, titles, powers, and privileges of the company for which it has been appointed receiver. The FDIC may operate the company as it sees fit, subject to the goals of the OLA, including the sale or transfer of the company's assets. In disposing of the Covered Financial Company's assets, the FDIC must:

- Maximize the net present value return from the sale or disposition of assets;
- Minimize the amount of any loss realized in the resolution of cases;
- Mitigate the potential for serious adverse effects to the financial system;
- Ensure timely and adequate competition and fair and consistent treatment of offerors; and
- Prohibit discrimination on the basis of race, sex, or ethnic group in the solicitation and consideration of offers.

Resolution of Subsidiaries: Under certain circumstances, and with the consent of the Treasury Secretary, the FDIC may appoint itself receiver of a subsidiary of a company for which it has been appointed receiver pursuant to Title II, in which case the provisions of Title II will also apply to resolution of the subsidiary. Insured depository institutions, insurance companies, and broker-dealers (if the broker-dealer has been deemed a Covered Financial Company) are *not* "subsidiaries" for the purpose of OLA, as such entities are already subject to specialized resolution procedures provided for in Title II and elsewhere.

Bridge Financial Companies: The FDIC is authorized to establish bridge institutions as necessary to facilitate the orderly liquidation of a Covered Financial Company. Such institutions must be sold, merged, or liquidated within five years of their creation.

Repudiation of Contracts: The FDIC's broad powers to conduct the affairs of the institution include the power to repudiate any contract that it deems burdensome, if repudiating such a contract would promote the orderly administration of the affairs of the company. The FDIC also has the power to avoid fraudulent and preferential transfers,

similar to the authority of a debtor-in-possession or trustee in bankruptcy. In fact, with respect to the definitions of fraudulent and preferential transfers, the statute largely mirrors the provisions contained in the Bankruptcy Code. As with bankruptcy proceedings, transfers involving Qualified Financial Contracts (QFCs)—generally meaning securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, or similar agreements as determined by statute and regulation—are not avoidable by the FDIC, except in instances where there was actual intent to hinder, delay or defraud.¹ Although the Act incorporates wholesale certain provisions of the Bankruptcy Code with respect to defenses to various preference actions, it notably omits section 546(e), frequently referred to as the “settlement defense,” which is a defense to the avoidance of certain settlement payments. While other language in the Act arguably accomplishes the same result as the omitted provision, it is unclear how this difference will be interpreted in practice.

Satisfaction of Claims: Similar to the Bankruptcy Code and the Federal Deposit Insurance Act, the Act provides certain statutory procedures that must be observed with respect to the determination and satisfaction of claims, including certain notice requirements. The FDIC is given the authority to review claims and make determinations in respect of the allowance and disallowance of claims. In satisfying creditor claims, the FDIC must apply the claims priorities set forth in Title II. These priorities require, among other things, that for unsecured claims against a Covered Financial Company the costs of the receivership be afforded first priority, with claims owed to the United States afforded a second priority. The FDIC typically must respect properly perfected security interests and, to the extent the FDIC repudiates existing contracts or arrangements, the affected counterparties may seek damages from the FDIC, albeit in limited scope. Creditors are also allowed, in most instances and subject to specified conditions, to offset amounts owed to the Covered Financial Company with claims that have been allowed against such company.

¹ Pursuant to rulemakings mandated by the Act, financial companies will be required to maintain records of QFCs to assist the FDIC in exercising its receivership authority under Title II.

“D’Oench, Duhme” Doctrine: Significantly, Title II incorporates a simplified version of the so-called “D’Oench, Duhme” doctrine that is applied in bank receivership situations. Under the OLA version of this doctrine, any “agreement that tends to diminish or defeat” the FDIC’s interest in an asset acquired by it as receiver is void unless the agreement

- Is in writing;
- Was executed by an authorized officer or representative of the company in receivership, or confirmed in the ordinary course of business by the company; and
- Has been, since the time of its execution, an official record of the company or the party claiming under the agreement provides documentation, acceptable to the FDIC, of such agreement and its authorized execution or confirmation by the covered financial company.

Companies that enter into or have existing agreements with entities that could become Covered Financial Companies should take care to observe these requirements in order to avoid difficulties in a receivership setting.

Litigation Authority: The FDIC’s powers under the OLA are particularly broad with respect to litigation—both defensively and offensively. As receiver, the FDIC may request a stay of up to 90 days of any ongoing litigation to which the Covered Financial Company is a party, and courts are obliged to grant that request. Any causes of action for tort claims arising from fraud or similar intentional conduct against a Covered Financial Company may be brought by the FDIC as receiver for as long as five years after the applicable statute of limitations has expired under state law. The FDIC is also authorized to seek recovery from individuals associated with the Covered Financial Company to the extent such individuals contributed to the company’s insolvency. Specifically:

- The FDIC may commence actions against directors and officers of a Covered Financial Company to recover damages on behalf of the Covered Financial Company attributable to gross negligence by such individuals.
- Subject to the FDIC rulemaking required by the Act, the FDIC may also recover up to two years’ worth of

compensation (or an unlimited period in the case of fraud) from current and previous directors and senior executive officers of a Covered Financial Company to the extent such directors or officers were directly responsible for the failed condition of the company.

In particularly egregious cases, the FDIC (or the Federal Reserve, as appropriate) may prohibit directors and senior executive officers from participating in the affairs of a financial company for two years or more, similar to the power already vested in the federal banking agencies with respect to insured depository institutions. The FDIC and the Federal Reserve must jointly issue rules addressing the terms and conditions of such prohibitions.

* * *

The new resolution process created by Title II, though similar to bankruptcy in many regards, incorporates modified elements of the existing bank-resolution process and introduces new considerations and risks for individuals and entities that deal with potential Covered Financial Companies. Counterparties to potential Covered Financial Companies will want to review existing and future agreements with such companies to ensure compliance with the modified “D’Oench, Duhme” doctrine discussed above. Directors and officers of potential Covered Financial Companies will wish to review and understand the liability they could face in the event of a liquidation under the OLA, such as the forfeiture of past compensation. And industry participants will wish to review, and possibly comment on, the various rulemakings required under Title II, which will be critical to a better understanding of how these new provisions will be applied.

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

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

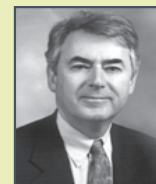
Savings and loan holding companies (SLHCs) and their savings institution subsidiaries will be subject to new regulatory regimes under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act). This change is chiefly due to the fact that the Act abolishes the Office of Thrift Supervision (OTS) and moves examination, supervision, and regulation responsibilities to the Board of Governors of the Federal Reserve System (Federal Reserve) for SLHCs, and to either the Office of the Comptroller of the Currency (OCC) for federal savings institutions or the Federal Deposit Insurance Corporation for state savings institutions. However, because of the unique nature of SLHCs, particularly those that are grandfathered from the activities restrictions of the Home Owners' Loan Act (HOLA), there are some other significant provisions in the Act that may impact SLHCs and their subsidiaries more disproportionately than other types of holding companies.

Historical Role of SLHCs

SLHCs and their subsidiaries have always occupied a unique niche in the financial system. Savings institutions have historically focused on providing mortgage loans and housing-related products and services. While these powers have been broadened in recent years to include a wide variety of consumer lending and some commercial lending powers, the Qualified Thrift Lender Test, which requires savings institutions to retain at least 65 percent of its qualified assets in mortgage and consumer related assets, has kept these institutions mostly focused in the housing finance area.

Furthermore, until 1999, when the Gramm-Leach-Bliley Act was enacted, savings institutions could be owned by any type of company, and those companies were not subject to restrictions on their activities as had been the case with bank holding companies. With the enactment of the Gramm-Leach-Bliley Act, companies acquiring savings institutions

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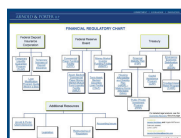
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were required to limit their activities to those permitted to financial holding companies under the Bank Holding Company Act. However, those companies which owned a savings institution as of May 4, 1999, were “grandfathered” and not subject to those activity restrictions unless certain requirements were not met.

Because the OTS had experience supervising holding companies that engaged in a variety of activities, insurance and securities companies in particular favored owning savings institutions over commercial banks. Thus, many “grandfathered” SLHCs are insurance companies or securities companies. In addition, there are other “grandfathered” savings and loan holding companies which are engaged in activities such as manufacturing and energy generation—activities clearly beyond those permitted to financial companies. Unfortunately, because the financial crisis in part was caused by a collapse of the housing market, savings institutions were hit hard in the past two years. Several of the largest and most visible financial collapses in 2008 and 2009 involved savings institutions and SLHCs—Washington Mutual, Lehman Brothers Holdings, Inc., and American International Group, Inc. Thus, it was generally assumed that as part of financial reform, the OTS was to be abolished, and increased (and arguably different) regulation had to be imposed on the thrift industry.

Impact of the Act on SLHCs and their Subsidiaries—Change in Regulatory Regimes

Accordingly, under the Act, one year after enactment, the responsibilities of the OTS, which oversees SLHCs, charters federal savings institutions and examines and regulates federal and state chartered savings institutions, are transferred to other agencies and the OTS is abolished 90 days after the date of the transfer.

The examination and supervision of SLHCs will move to the Federal Reserve. However, SLHCs would continue to operate under the provisions of the HOLA. Those SLHCs that are “grandfathered” for purposes of the HOLA’s activity restrictions would remain so grandfathered and thus could continue to engage in any activity. Nevertheless, as the regulator of SLHCs, the Federal Reserve will examine and supervise SLHCs, and it should be expected that the Federal Reserve will be a much more rigorous regulator than the OTS. The Federal Reserve will have authority to assess SLHCs with total

consolidated assets of \$50 billion or more to recoup the total expenses that the Federal Reserve estimates are necessary or appropriate to carry out its supervisory and regulatory responsibilities with respect to SLHCs.

Examination and supervision of federal savings institutions will move to the OCC, and fall under the responsibility of a new Deputy Comptroller for the Supervision and Examination of Federal Savings Associations. Federal savings institutions would continue to operate under the provisions of the HOLA, as interpreted by the OCC. Any new regulations applying to savings institutions pursuant to the HOLA would be issued by the OCC. Federal supervision and examination of state-chartered savings institutions will be transferred to the FDIC. The states would continue to have authority—including examination authority—over the institutions they charter. With the abolishment of the OTS, the OTS seat on the Federal Deposit Insurance Corporation (FDIC) board will go to the director of the new Consumer Financial Protection Bureau.

There are some additional restrictions placed on SLHCs. For example:

- All SLHCs will for the first time be subject to consolidated capital requirements, which presumably will be modeled after those applicable to bank holding companies.¹ “Grandfathered” savings and loan holding companies that engage in nonfinancial activities would be required to establish an intermediate holding company, if the Federal Reserve determines that the establishment of such a company is necessary for the agency to appropriately supervise activities that are determined to be financial, or to ensure that the Federal Reserve’s supervision does not extend to the nonfinancial activities of such company.
 - The internal financial activities of a grandfathered savings and loan holding company and its affiliates, such as internal treasury, investment, and employee benefit functions, are not required to be transferred into this intermediate holding company.
 - Underwriting or selling insurance is considered a financial

¹ See Arnold & Porter LLP Advisory, “Dodd-Frank Act Mandates Stricter Capital Requirements for Financial Institutions,” devoted to the capital provisions of the Dodd-Frank Act for additional information on the consolidated capital requirement as well as the requirement that SLHCs serve as a “source of strength,” available at: http://www.arnoldporter.com/public_document.cfm?id=16152&key=23C0.

activity as defined in section 4(k) of the Bank Holding Company Act so it would appear that there would be no need for an intermediate holding company with respect to an SLHC owned by an insurance company unless that SLHC engaged in a large number of nonfinancial activities, thus making it appropriate to require a walling off of the company's financial activities.

- The so-called “source of strength” doctrine is made statutory and applied for the first time to SLHCs, which means that SLHCs will now have to serve as a source of strength to their savings institutions subsidiaries. In addition, the doctrine is expanded to include a requirement that a grandfathered savings and loan holding company also must serve as a source of strength to any intermediate holding company that it directly or indirectly controls.
- All financial companies, including SLHCs, are prohibited from merging or consolidating with, acquiring all or substantially all of the assets of, or otherwise acquiring control of, another company, if the total consolidated liabilities of the acquiring financial company upon consummation of the transaction would exceed 10 percent of the aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction. In this connection, with respect to insurance companies, the term “liabilities” is to be defined by the Federal Reserve by regulation “in order to provide for consistent and equitable treatment of such companies.”

There also are additional operational restrictions placed on savings institutions:

- The ability of federal savings institutions to branch interstate, subject to the provisions of Section 5(r) of the HOLA, is preserved. However, so are the multistate multiple savings and loan holding company restrictions in the HOLA—which impose activity restrictions similar to those of a bank holding company on any SLHC if it were to acquire and maintain two savings institution subsidiaries.
- Conversions of charters are prohibited without approval of the regulators if the institution is subject to an enforcement action.
- In interstate transactions, the depository institutions involved must be “well capitalized” and “well managed,”

a stronger standard than currently in place.

- Federal savings institutions would be subject to national bank lending limits, which are revised (as are Regulation O provisions) to include derivative, repurchase, reverse repurchase, securities lending, and securities borrowing transactions.
- The number of “covered transactions” subject to the restrictions of Section 23A of the Federal Reserve Act would be increased to include:
 - An affiliate’s use of debt obligations as collateral;
 - Transactions between a member bank and an affiliate (or a subsidiary) involving the borrowing or lending of securities resulting in credit exposure by the member bank or any subsidiary; and
 - Derivative transactions between a member bank (or its subsidiary) and an affiliate resulting in credit exposure to the member bank or subsidiary.
- Loans issued by member banks on behalf of affiliates, credit exposures resulting from securities lending or borrower transactions and derivative transactions would be required to be secured at all times. The scope of Section 23A also is extended to include investment funds where a member bank or affiliate serves as an adviser.

While there is no requirement that SLHCs convert to bank holding companies or that savings institutions convert to commercial banks, the US General Accountability Office (GAO) is required to undertake a study to determine if savings institutions still should enjoy their status as “nonbanks” for purposes of the Bank Holding Company Act. The GAO is to determine the adequacy of federal bank regulation of federal savings institutions and other insured savings institutions and the potential consequences of subjecting those institutions (actually, the owners of those institutions) to the requirements and restrictions of the Bank Holding Company Act.

Other Possible Impacts on SLHCs: Could They Be of Systemic Risk?

In addition to the changes in regulatory regimes and operational standards, SLHCs could be impacted by the systemic risk and resolution authority provisions of the Act. Under the systemic risk provisions of the Act, the Federal Reserve is given the authority

to impose additional supervision over large interconnected bank holding companies, as well as over nonbank financial companies that are determined by the new Financial Stability Oversight Council (FSOC) to pose a threat to the financial stability of the United States. These enhanced requirements include increased capital requirements, leverage and concentration limits, liquidity requirements, submission of a resolution plan, credit exposure report requirements, enhanced public disclosures, short-term debt limits, and overall risk management requirements.

- SLHCs are considered “nonbank financial companies” under these provisions. However, a vote of two-thirds of the FSOC, including the chair (the Secretary of the Treasury) would be needed for any particular nonbank financial company to be determined to be of systemic risk to the US economy. This determination can be appealed.
- In making this determination, the FSOC must consider the following:
 - The degree of leverage at the company;
 - The amount and nature of the company’s financial assets;
 - The amount and types of the company’s liabilities, including the degree of reliance on short-term funding;
 - The extent and type of the company’s off-balance sheet exposures;
 - The extent and type of the transactions and relationship of the company with other significant nonbank financial companies and significant bank holding companies;
 - The importance of the company as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the US financial system;
 - The importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of the company would have on the availability of credit in such communities;
 - The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
 - The degree to which the company is already regulated by one or more primary federal regulatory agencies;

- The operation of or ownership interest in any clearing, settlement or payment business;
- The extent to which (i) assets are managed rather than owned by the company; and (ii) ownership of assets under management is diffuse; and
- Any other risk-related factors that the FSOC deems appropriate.

It is expected that regulations will be issued which will illuminate how these factors will be applied and weighed by the FSOC. However, it is expected that only the very largest SLHCs would be evaluated by the FSOC to determine whether they present systemic risk.

Nevertheless, the Act also gives the FSOC the ability to recommend to the primary financial regulatory agencies (defined as the federal banking, securities, commodities and housing regulators, and state insurance commissioners) that they impose new or heightened standards and safeguards for a financial activity or practice conducted by financial companies under their respective jurisdictions. Thus, even if a particular SLHC is not targeted for heightened supervision by the Federal Reserve as a systemic risk, there still could be additional regulation imposed on a particular financial activity in which an SLHC might directly or indirectly engage.

In the event one or more of such companies are determined to present a systemic risk, and the FSOC determines that a condition, practice or activity of that particular nonbank financial company does not comply with Title I or rules or orders prescribed thereunder, or otherwise “poses a grave threat to the financial stability of the United States,” it may, after notice and opportunity for comment, order the nonbank financial company to sell off certain assets or sell or terminate certain operations (presumably even if that nonbank financial company is an SLHC and the operation in question is permissible for that SLHC). An order may be issued without the opportunity for a hearing if expeditious action is needed to protect the public interest.

In addition, the FDIC is given the authority to liquidate SLHCs where a systemic risk determination has been made if the Secretary of the Treasury, upon the recommendation of the FDIC and the Federal Reserve and in consultation with the President, finds that the company is in default or in danger of

default, the failure of the company and its resolution under applicable Federal or State law would have serious adverse effects on US financial stability and the appointment of the FDIC would avoid or mitigate such adverse effects.

For SLHCs that are insurance companies, however, the FDIC would not be appointed the receiver upon such a determination by the Secretary of the Treasury. Furthermore, the determination that the company be placed into a receivership cannot be made without the approval of the director of the new Federal Insurance Office. If this hurdle is met, the insurance company then would be liquidated under applicable state insurance law, unless the appropriate state insurance regulator does not take steps to place the insurance company into liquidation proceedings by 60 days after the date that the Secretary of the Treasury has made the receivership determination. In that event, the FDIC would have the authority to stand in the place of the state insurance regulator and file the appropriate judicial action in the appropriate state court to place such company into liquidation under the applicable state insurance law.

The FDIC is authorized to assess financial companies, including SLHCs, to recoup funds expended on the resolution of financial companies. While assessments first are to be made against large bank holding companies and nonbank financial companies that have been determined to present systemic risk, if there is a deficiency, then the FDIC could assess other nonbank financial companies. Thus, an SLHC could be subject to this special assessment whether or not it has been determined to present a systemic risk. However, the FDIC is required to undertake a risk-based assessment and one of the factors to be taken into account by the FDIC in deciding whether to assess an insurance company is the extent to which the insurance company was “assessed pursuant to applicable state law to cover (or reimburse payments made to cover) the costs of the rehabilitation, liquidation, or other State insolvency proceeding with respect to one or more insurance companies.”

Impact of the Volcker Rule on SLHCs and their Subsidiaries

SLHCs also will be subject to the Volcker Rule, which prohibits “banking entities” from engaging in proprietary trading or acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring a hedge fund or a

private equity fund. For an SLHC that is, or is owned by, an insurance company, however, the Volcker Rule may have little practical effect.²

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

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² See Arnold & Porter LLP Advisory, “Banking Entities, Other Significant Financial Service Companies to Face Significant Restrictions Under New ‘Volcker Rule,’” available at: http://www.arnoldporter.com/public_document.cfm?id=16129&key=1J1.

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

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

Background

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

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

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

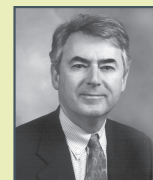
In addition, a systemically significant *nonbank* financial company subject to supervision by the Federal Reserve Board (Federal Reserve)² that engages in such activities will be subject to rules establishing enhanced capital standards and quantitative limits on these types of activities, but such activities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

- 1 In general, institutions that function solely in a trust or fiduciary capacity will not be deemed “banking entities.”
- 2 The Act provides that nonbanking financial companies meeting specified criteria can be designated as “systemically significant” and be subject to supervision by the Federal Reserve.

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

I. Proprietary Trading Restrictions

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

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

- Transactions in government securities, agency securities, and state and municipal obligations;
- Transactions in connection with underwriting or market-making-related activities to the extent

they are "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties";

- Risk-mitigating hedging activities designed to reduce specific risks of a firm's individual or aggregated positions or holdings;
- Transactions on behalf of customers;
- Investments in small business investment companies and certain enterprises devoted to the public interest;³
- Transactions by any regulated insurance company directly engaged in the business of insurance for the general account of the company or by its affiliates (also for the general account of the company), as permitted by relevant state insurance company investment laws and regulations (subject to additional review by the appropriate Federal banking agencies, after consultation with the Act's new systemic risk council and state insurance commissioners);
- Proprietary trading by a banking entity conducted solely outside of the United States pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act,⁴ unless the banking entity is directly or indirectly controlled by a banking entity organized in the United States; and
- Other activity as permitted by regulation.

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

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

⁴ 12 U.S.C. § 1843(c)(9), (13).

II. Restrictions on Relationships with Hedge Funds and Private Equity Funds

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

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

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

- Organizing and offering a fund, even to the extent of sponsorship, as long as the fund and entity do not share a name or name variant, and the following conditions are met:
 - The fund is organized and offered only in connection with the provision of bona fide trust, fiduciary or investment advisory services;
 - The banking entity may not acquire or retain an equity, partnership or other ownership interest in the fund;
 - However, “de minimis investments” (as defined by regulators) would be permitted. Such investments

would have to be immaterial to a banking entity, could not, in the aggregate, exceed 3 percent of a banking entity’s Tier I Capital, and could not exceed 3 percent of the total ownership interests in any one fund. Subject to similar restrictions, a banking entity would also be permitted to make “seed” investments (i.e., initial investments of up to 100 percent of a fund for the purpose of establishing it and providing it with sufficient initial equity for investment to permit it to attract unaffiliated investors). The banking entity would then be required to reduce or dilute its investment to permitted levels within one year after the fund’s establishment (with the possibility of a two-year extension).

- The banking entity, and its affiliates, comply with restrictions on transactions with such fund under Sections 23A and 23B of the Federal Reserve Act, as described below;
- The banking entity may not guarantee the fund, or any fund in which the fund invests, against losses or to a minimum performance;
- The banking entity discloses to prospective and actual investors, in writing, that the fund’s losses are borne solely by investors and not by the banking entity, and otherwise complies with rules that the regulators may issue to ensure that losses are so borne;
- No director or employee of the banking entity may have an ownership interest in the fund, unless they directly provide investment advisory or other services to the fund.
- Acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring, a hedge fund or private equity fund by a banking entity solely outside of the United States pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, provided that no ownership interest in such fund is offered for sale or sold to a US resident and that the banking entity is not directly or indirectly controlled by a banking entity organized in the United States;

- Other activities that regulators have determined would promote safety and soundness of the entity and financial stability as a whole.

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

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

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

- Prohibited from entering into a “covered transaction” as defined by Section 23A of the Federal Reserve Act.⁵ Thus, the banking entity and its affiliates could not, among other things, extend credit to the fund, or enter purchase and repurchase agreements with the fund.⁶
- Subject to Section 23B of the Federal Reserve Act.⁷ Thus, in certain other transactions between the banking entity (or its affiliate) and the fund, the terms must be not less favorable to the banking entity than those prevailing between non-affiliates, and restrictions apply to fiduciary investments in the fund.

If a nonbank financial company supervised by the Federal Reserve engages in similar activities, it will be subject to

⁵ 12 U.S.C. § 371c.

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

⁷ 12 U.S.C. § 371c-1.

additional capital requirements and restrictions to address the same types of conflicts of interest that banking entities would face in such transactions.

IV. Loan Securitization

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

Challenges of Implementation

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

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

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

Special considerations will also apply in the context of international banking. Under Sections 4(c)(9) and 4(c)(13) of

the Bank Holding Company Act,⁸ bank holding companies (including non-US banks regulated as such) may, as permitted by the Federal Reserve, acquire ownership or control of nonbanking companies that do not do business in the United States (except as an incident to their non-US operations), or that are organized outside of the United States and that primarily conduct their business outside of the United States.

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

⁸ 12 U.S.C. § 1843(c)(9), (13).

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

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

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Dodd-Frank Act Mandates Stricter Capital Requirements for Financial Institutions

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) imposes a number of more stringent capital requirements on financial companies, as well as other companies—including swap dealers and nonbank financial companies that are determined to be of systemic risk. The so-called “Collins Amendment” has introduced the most publicized of these requirements and is likely to have the most immediate impact. However, there are a number of other provisions in the Act that likely will result in financial companies needing to raise additional capital. Furthermore, at the same time financial companies will be working to comply with the capital requirements established under the Act, they may find their efforts complicated by revisions to existing international capital standards currently being considered by the Basel Committee on Banking Supervision that would also require increased capital.

The Collins Amendment

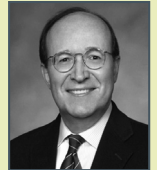
The Collins Amendment, incorporated into the Act as part of Section 171, is designed to ensure that “financial institutions hold sufficient capital to absorb losses during future periods of financial distress,” a goal that the amendment’s proponents have deemed especially important in light of the Act’s prohibition of taxpayer bailouts of financial companies.¹ The amendment is also intended to protect against regulatory arbitrage (“shopping” among regulators for more favorable treatment) and prevent the excessive leverage accumulated by large nonbank financial institutions during the financial crisis.²

Section 171 directs federal banking agencies to establish minimum leverage and risk-based capital requirements on a consolidated basis for insured depository institutions, their holding companies (including US intermediate holding companies owned by foreign organizations), and nonbank financial companies that have been determined to be systemically significant by the Financial Stability Oversight Council (FSOC). The section creates two floors for leverage and risk-based capital requirements:

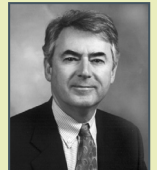
¹ Letter by Sheila Bair to Sen. Collins, Cong. Rec. S.3460 (May 10, 2010).

² *Id.*

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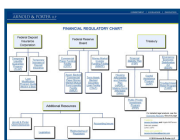
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Financial Regulatory Chart

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- (1) They may not be less than the leverage and risk-based capital requirements, respectively, established for insured depository institutions; and
- (2) They may not be quantitatively lower than the leverage and risk-based capital requirements, respectively, in effect for insured depository institutions as of the date of the Act's enactment.

Essentially, the Act requires regulators, at a minimum, to apply to bank holding companies and other systemically significant nonbank financial companies the same capital and risk standards that they apply to banks insured by the Federal Deposit Insurance Corporation. One important implication of this requirement is that hybrid capital instruments, such as trust preferred securities, will no longer be included in the definition of tier 1 capital. Under existing regulations for bank holding companies, tier 1 capital, which drives the numerator in the leverage and risk-based capital ratios, includes common stock, retained earnings, certain types of preferred stock, and trust preferred securities. Since trust preferred securities currently are not counted as tier 1 capital for insured banks, the effect of Section 171 is that they will no longer be included as tier 1 capital for bank holding companies.

The exclusion of trust preferred securities from tier 1 capital could significantly erode the regulatory capital cushions of bank holding companies that have traditionally relied on trust preferreds. In order to meet capital requirements under forthcoming regulations, bank holding companies may be forced to raise other forms of tier 1 capital, for example by issuing perpetual non-cumulative preferred stock. Since common stock must typically constitute at least 50 percent of tier 1 capital, many bank holding companies and systemically significant nonbank companies may also be forced to consider dilutive secondary offerings of common stock.

In order to ease this compliance burden, Section 171 contemplates a number of exemptions and phase-in periods. For example, the following companies are completely exempt from the requirements of Section 171:

- Certain small bank holding companies;³ and

³ This exemption applies to small bank holding companies subject to the Small Bank Holding Company Policy Statement of the Board of Governors of the Federal Reserve System. This includes bank holding companies with pro forma consolidated assets of less than \$500 million that (i) are not engaged in significant nonbanking

- All federal home loan banks.

In addition, all Troubled Asset Relief Program (TARP) securities (regardless of the size of the institution) are exempted from the requirements of Section 171.

Furthermore, depository institution holding companies with assets less than \$15 billion (as of December 31, 2009), as well as organizations that were mutual holding companies on May 19, 2010, are completely exempted from the required "regulatory capital deductions" with respect to securities issued before a cutoff date of May 19, 2010. While the term "regulatory capital deduction" is not defined in the Act, it appears to refer to the capital deductions arising from the exclusion of trust preferreds and other hybrid securities from tier 1 capital.

The section does apply retroactively to all debt or equity issued after the cutoff date by holding companies with consolidated assets of over \$15 billion as of December 31, 2009 and by large nonbank financial companies determined to be of systemic risk. However, the section provides for a three-year phase-in period beginning in 2013 for regulatory capital deductions required for debt or equity issued by these institutions before the cutoff date. Furthermore, subject to the exceptions noted above, thrift holding companies and other depository institution holding companies not supervised by the Board of Governors of the Federal Reserve System (the Federal Reserve) as of the cutoff date would not be subject to the general leverage and risk-based capital requirements until five years after enactment, but would be subject to the three year phase-in period for regulatory capital deductions beginning in 2013. Finally, US intermediate holding companies of foreign banks that have relied on Federal Reserve Supervision and Regulation Letter SR-01-1, which exempts such intermediate holding companies from the Federal Reserve's capital adequacy guidelines, would not be subject to the requirements of Section 171 until five years after enactment (except for capital requirements affecting securities issued after the cutoff date, which would be immediately applicable).

activities either directly or through a nonbank subsidiary; (ii) do not conduct significant off-balance sheet activities; and (iii) do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission.

In addition to the Collins Amendment requirements, Section 171 requires the federal banking agencies to develop capital requirements applicable to insured depository institutions, depository institution holding companies, and nonbank financial companies determined to be of systemic risk that address the risks that the activities of such institutions pose, not only to the institution engaging in the activity, but also to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or the activity. These rules would address the risks arising from:

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

Other Provisions on Capital Requirements

The Act also contains a number of other provisions that address capital requirements.

For example, the Federal Reserve is directed to impose more stringent risk-based capital requirements and leverage limits on those systemically significant nonbank financial companies it supervises and on other bank holding companies with total consolidated assets of at least \$50 billion (unless it determines that doing so is not appropriate in light of the company's activities). It is also permitted to require a minimum amount of contingent capital (a type of debt security that is designed to convert into equity when a particular trigger is met) that is convertible to equity in times of financial stress. The Federal Reserve may impose these heightened prudential standards either on its own initiative or pursuant to recommendations by the FSOC. For purposes of determining whether these capital requirements are met, the Act requires that the computation take into account a company's off-balance sheet activities (unless the Federal Reserve grants an exemption).

Title VI of the Act, which reforms the regulation of insured depository institutions and their holding companies, also permits the Federal Reserve and the Office of Thrift Supervision, respectively, to issue regulations relating to the capital requirements of bank holding companies and thrift holding companies. As noted in the Arnold & Porter Advisory on the regulation of thrift holding companies under the Act, the Act will for the first time subject all thrift holding companies to consolidated capital requirements, as established pursuant to the Collins Amendment.⁴ Title VI directs the federal banking agencies to seek to make such holding company capital requirements (as well as the capital requirements for insured depository institutions) countercyclical so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction. Finally, Title VI requires a thrift holding company—as well as a bank holding company—to serve as a source of financial strength for its depository institution subsidiary. Any company that directly or indirectly controls an insured depository institution that is not a subsidiary of a bank or thrift holding company must also serve as a source of financial strength for the depository institution.

Furthermore, the Act requires regulators to issue capital requirements for registered swap dealers and major swap participants in connection with their derivatives activities. In setting these capital requirements, regulators must take into account the risks associated with the other types of activities engaged by the swap dealer or major swap participant that are not otherwise subject to regulation, and must ensure that the requirements are appropriate for the risks associated with non-cleared swaps held by the swap dealer or major swap participant.

Required Studies on Capital Requirements

The Act also requires regulators to conduct various studies relating to capital requirements. For example, one provision requires the US Comptroller General to review the capital requirements applicable to US intermediate holding companies of foreign depository institution holding companies. The FSOC is also required to conduct a study of the feasibility, benefits, costs, and structure of a contingent capital requirement for nonbank financial companies

⁴ Available at: http://www.arnoldporter.com/public_document.cfm?id=16144&key=4E0.

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supervised by the Federal Reserve and large bank holding companies subject to heightened prudential standards.

The Comptroller General is also directed to conduct a study on the inclusion of hybrid capital instruments, such as trust preferred securities, in tier 1 capital. The study is specifically required to consider the consequences of disqualifying trust preferred securities from tier 1 capital and whether such disqualification could lead to the failure or undercapitalization of banking organizations. The study would be due to Congress within 18 months of the Act's enactment and must contain recommendations as to legislative or regulatory action with respect to the treatment of hybrid capital instruments. However, it is unknown whether the outcome of the study would result in any changes to the Collins Amendment's requirements or the other capital requirements imposed by the Act.

While financial institution capital has always been a key regulatory concern, the recent economic crisis has focused even more attention on its critical role. The capital provisions of the Act promise changes in determining the appropriate quantity and quality of regulatory capital, both in the short and long term, and likely will result in many companies needing to issue additional capital to remain in compliance. This need may well be magnified if the capital rules currently being considered by the Basel Committee are adopted.

Arnold & Porter has represented issuers and underwriters in numerous issuances of common and preferred stock, trust preferred securities, long-term subordinated debt and other capital instruments. We can assist in determining how pending bills and regulations may affect your business and industry. For further information, please contact your Arnold & Porter attorney or:

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Financial Regulatory Reform: Tightening the Regulation of Affiliate Transactions, Extensions of Credit to Insiders, and Lending Limits

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) tightens the affiliate transaction rules contained in Sections 23A and 23B of the Federal Reserve Act and the related insider lending rules of Section 22(h) of the Federal Reserve Act, primarily to cover derivative and repurchase transactions entered into with affiliates. The Act also will make it more difficult to obtain exemptions from these rules from the federal bank regulators for specific transactions or groups of transactions. These changes, which are effective one year after the transfer date (which is one year after enactment, unless the Treasury Secretary extends it for up to six months), will affect those entities that have in place derivatives transactions with affiliates. Accordingly, a review of these arrangements may be advisable. However, all institutions covered by these rules will be impacted by the changes in the exemption authority and process.

Affiliate Transaction Rules

Historically, the primary federal statutory provisions governing transactions involving an insured depository institution (including its subsidiaries, collectively referred to as an “institution” below) and its affiliates are Sections 23A and 23B of the Federal Reserve Act, both of which are implemented by Regulation W of the Federal Reserve Board (Federal Reserve). Section 23A defines certain types of transactions as “covered transactions,” imposes quantitative limits on an institution’s covered transactions with any one affiliate and with all affiliates combined, and requires that certain types of covered transactions of an institution be secured by no less than a certain amount of collateral of specific quality. Section 23B generally requires that certain transactions (which include “covered transactions” and more) involving an institution and its affiliates be on terms and under circumstances that are at least as favorable to the institution as those for comparable transactions with nonaffiliates. By their terms, Sections 23A and 23B apply only to “member banks” (i.e., national banks and state member banks). But Section 18(j)(1) of the Federal Deposit Insurance Act applies these provisions to state nonmember banks,

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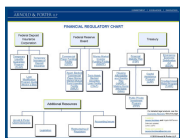
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and Section 11(a) of the Home Owners' Loan Act (HOLA) applies them to savings associations.

Section 22(h) of the Federal Reserve Act, which is implemented by Regulation O, imposes certain restrictions, such as quantitative limits and prohibition on preferential terms, on a member bank's extensions of credit to insiders (including executive officers, directors, principal shareholders (other than parent holding companies), and companies and other related interests under their control). Section 22(h) applies to state nonmember banks by virtue of Section 18(j)(2) of the Federal Deposit Insurance Act, and to savings associations by virtue of Section 11(b) of the HOLA.

Under the law as currently in place, the Federal Reserve Board was to adopt final rules by May 12, 2001 to address credit exposure arising from derivative transactions between institutions and their affiliates as covered transactions. To that end, Regulation W, which implements the provisions of Sections 23A and 23B, makes a distinction between credit derivatives and other types of derivatives. Specifically, a credit derivative where an institution agrees to protect a nonaffiliate from a default on, or decline in value of, an obligation of an affiliate of the institution, is considered a guarantee by the institution on behalf of the affiliate, and thus is a covered transaction subject to the quantitative limits and collateral requirements of Section 23A. With respect to other types of derivative transactions (such as an interest rate swap), Regulation W currently only subjects them to the market terms requirements of Section 23B and requires institutions to maintain policies and procedures for managing the related credit exposure. Section 22(h) did not specifically address derivative transactions at all.

The Act amends Sections 23A and 23B in several ways to make them more stringent. First, the Act expands the definition of what is considered an "affiliate." The Act also expands the types of transactions covered by the restrictions of Sections 23A and B, primarily to make sure that all types of derivatives transactions are so covered. Collateral requirements also are strengthened. And finally, the Act restrict the ability of the Federal Reserve to exempt transactions from the restrictions of Sections 23A and 23B.

1. **Definition of Affiliate.** The Act broadens the definition of affiliate to include any investment fund (whether it is a registered investment company or not) for which an institution or any affiliate thereof serves as an investment adviser. As a result, a hedge fund or private equity fund to which an institution or an affiliate of the institution serves as an investment adviser would be an affiliate of the institution.
2. **Covered Transactions.** The Act also broadens the types of transactions covered by the affiliate transaction rules of Section 23A and 23B as follows:
 - An institution's purchase of assets from an affiliate subject to an agreement by the affiliate to repurchase would fall under the "loan or extension of credit" type of covered transaction, which also is subject to the collateral requirements. This likely would affect the types of assets used and the margin required in repurchase transactions between institutions and their affiliates.
 - The Act would clarify that an institution's acceptance of debt obligations issued by an affiliate, even if such obligations are not considered securities, as collateral for an extension of credit to a nonaffiliate would be a covered transaction.
 - A securities lending or borrowing transaction or a derivative transaction with an affiliate would be a covered transaction to the extent that the transaction causes the institution to have credit exposure to the affiliate. Such a covered transaction also would be subject to the collateral requirements. Importantly, the Act clearly eliminates the Federal Reserve's authority to make any distinction between a credit derivatives and other types of derivatives, such as interest rate swaps, because the statutory language itself specifically defines credit exposure arising from derivative transactions with affiliates as a type of covered transaction subject to the quantitative limits and collateral requirements of Section 23A. Of course, issues remain, such as how to quantify the credit exposure arising from a derivative transaction. Presumably, the Federal Reserve would need to issue regulations to resolve these issues.

3. Collateral Requirements. The Act tightens the collateral requirements of Section 23A by:

- Clarifying that debt obligations issued by an affiliate of an institution, even if such obligations are not considered securities, may not be used to meet the collateral requirements for a covered transaction between the institution and any of its affiliates.
- Providing that the collateral requirements (with respect to both quality and quantity) must be met “at all times,” not just “at the time of the transaction.” Therefore, if the value of the collateral declines for any reason, additional collateral would need to be provided so that the covered transaction is collateralized in an adequate amount. Under the current statutory language, collateral that is retired or amortized after the time of the transaction must be replaced, but no additional collateral is required if the market value of the collateral posted at the time of the transaction declines to a level lower than that required at the inception of the transaction.

4. Treatment of Transactions with Financial Subsidiaries.

Under the current statutory language, a financial subsidiary of an institution is treated as an affiliate (whereas other subsidiaries of an institution that are not depository institutions are not so treated), but certain exceptions apply to an institution’s covered transactions with a financial subsidiary of the institution. The Act would eliminate these exceptions. As a result, a financial subsidiary of an institution would be treated the same way as any other affiliate. Specifically, there would no longer be an exception that would allow the aggregate amount of covered transactions between an institution and a financial subsidiary of the institution to exceed 10 percent of the institution’s capital and surplus, and the retained earnings of the financial subsidiary would no longer be excluded in calculating the institution’s investment in securities issued by the financial subsidiary (which is a covered transaction).

The elimination of these exceptions would appear to have the practical effect of limiting the expansion of any financial subsidiary of an institution. As the retained

earnings of a financial subsidiary increases, the value of the parent institution’s investment in the financial subsidiary would increase under the amended Section 23A to a level over 10 percent of the parent institution’s capital and surplus, unless other business activities of the parent institution also contribute substantially to the growth of its capital and surplus. Therefore, to comply with the 10 percent limit, the financial subsidiary would have to pay out at least some of its net income to the parent institution as dividends instead of reinvesting all of it in the expansion of the financial subsidiary.

5. Exemptive Authority. Perhaps one of the most important changes made by the Act is to restrict the ability of the Federal Reserve to issue exemptions from the restrictions of Section 23A. The Act does so in a number of ways:

- Under the current statutory language, the Federal Reserve may provide for exemptions from Section 23A by regulation or by order. The Act would only allow the Federal Reserve to provide for exemptions by regulation, except that the Federal Reserve could continue to issue exemptive orders with respect to specific transactions of state member banks. In addition, the Act would require the Federal Reserve to provide the Federal Deposit Insurance Corporation (FDIC) with 60 days’ notice before issuing any exemptive regulation or order. During the 60-day period, the FDIC could make a written objection to the exemption if it determines that the exemption presents an unacceptable risk to the Deposit Insurance Fund.
- For certain institutions, the authority to exempt specific transactions from Section 23A by order would be shifted to the Office of the Comptroller of the Currency (OCC), with respect to national banks and federal savings institutions, and the FDIC, with respect to state nonmember banks and state chartered savings institutions. The Federal Reserve’s concurrence would be required for any such order issued by the OCC or the FDIC. The same procedures whereby the FDIC could object to the Federal Reserve’s exemptive regulations apply

to any OCC exemptive order under Section 23A. Furthermore, before the FDIC itself could issue any exemptive order under Section 23A, it would need to find that the order does not present an unacceptable risk to the Deposit Insurance Fund. As a result, the issuance of an exemptive order under Section 23A would in effect require the approval or non-objection of the Federal Reserve and the FDIC, plus the OCC in the case of a federally chartered institution—a much more difficult process.

- The Federal Reserve could issue regulations or interpretations regarding how a netting agreement may be taken into account in determining the amount of a covered transaction. An interpretation on this issue with respect to a specific institution would need to be issued jointly with the institution's primary federal regulator.
- The Federal Reserve could continue to issue exemptive regulations under Section 23B, subject to the same procedures whereby the FDIC could object to the Federal Reserve's exemptive regulations under Section 23A. No agency would have the authority to issue an order to exempt a specific transaction under Section 23B.

Extensions of Credit to Insiders

In addition to the changes made to Sections 23A and 23B, the Act broadens the definition of "extension of credit" in Section 22(h) to include credit exposure that arises from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction. As a result, if a transaction between an insured depository institution and an insider of the institution gives rise to such credit exposure, the institution would need to comply with the restrictions of Section 22(h) with respect to the transaction.

Arnold & Porter provides advice to financial institutions on affiliate transactions. Members of our financial services group have held senior positions at the Federal Reserve and have been involved in interpreting Sections 23A and 23B in that connection. We are available to answer questions raised by these provisions of the Act, and to assist in determining how these provisions may affect your business. For further information, please contact your Arnold & Porter attorney or:

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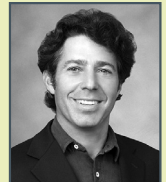
Dodd-Frank Wall Street Reform and Consumer Protection Act to Significantly Impact Derivatives Trading of Banks

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

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

¹ "US Companies May Face \$1 Trillion in Additional Capital and Liquidity Requirements as a Result of Financial Regulatory Reform, According to ISDA Research," *ISDA News Release*, New York, NY, June 29, 2010 at 1.

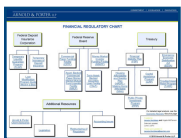
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the definitions of swap dealers and MSPs should be interpreted in a broad or narrow fashion. It would be prudent for banks to participate in the rulemaking process to help ensure that these definitions are not unnecessarily expansive.

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

Swap Dealer Definition and its Potential Implications for Banks

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

The swap dealer definition provides a carve out for banks that enter into a swap with a customer in connection with originating a loan with the same customer. This carve out,

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

Major Swap Participant Definition and its Potential Implications for Banks

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

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

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

Banks Divesting Certain Swaps Activities

One of the most contentious and important sections of the

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

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

Banks Must be Proactive in the Rulemaking Process

The new legislation of the OTC markets will substantially change the costs associated with trading derivatives products as well as regulatory requirements for participants in OTC transactions. As discussed, the extent to which costs and regulatory requirements will increase will depend on how the CFTC, SEC and federal banking regulators decide to interpret the new legislation. Rulemakings on most of the provisions of Title VII are required to be released by the agencies no later than 360 days after Title VII’s enactment. If the agencies determine to take an expansive approach in

drafting the rules many participants, including banks, may be required to register with the CFTC or SEC to participate actively in the derivatives market. The costs and ongoing regulatory compliance associated with OTC trades will also likely increase substantially for banks. Therefore, banks would be advised to consider participating in the rulemaking process to help ensure that agencies adopt a reasonable and balanced approach to implementing these new regulatory requirements.

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

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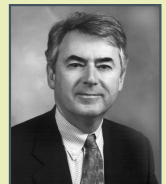
New Financial Regulatory Reform Act: Has it Materially Altered the Preemption Landscape for Federally Chartered Institutions?

The final financial regulatory reform legislation, now named the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), contains provisions specifically addressing federal preemption of state law with respect to the provision of financial services to consumers. With limited exceptions for “inconsistent” state laws, the new federal consumer protection requirements and implementing regulations of the planned Consumer Financial Protection Bureau (CFPB) will not preempt state law. This construct is generally consistent with existing federal consumer protection law in the financial services area: the “inconsistent” preemption trigger governs most preemption under the Truth in Lending Act (TILA), Truth in Savings Act (TISA), and a number of other federal financial services statutes aimed at protecting consumers.

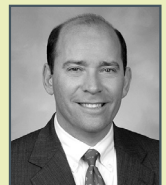
However, the Act not only establishes the “inconsistent” standard for its own new consumer protection mandates, but also amends the National Bank Act (NBA), 12 U.S.C. § 21 *et seq.*, and the Home Owners’ Loan Act (HOLA), 12 U.S.C. § 1461 *et seq.*, through “clarifying” standards for preemption of state law as applied to national banks and federal savings banks. These standards, which are essentially those contained in the prior Senate version of the legislation, in some respects narrow the circumstances under which the NBA and the HOLA may be deemed to preempt state law as applied to national banks and federal savings banks. Moreover, in a highly significant change, the Act eliminates those statutes’ preemptive effect with respect to operating subsidiaries of those federally chartered financial institutions. As a result, the circumstances under which national banks and federal savings banks may offer consumer products and services on a uniform, nationwide platform may be more limited and the costs of providing such services may be increased.

The provisions concerning preemption, like most of the CFPB-related provisions in the Act, become effective no earlier than six months, and no later than 18 months (absent congressional approval for an extension to 24 months) after the date the Act is signed into law.

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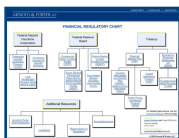
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Preemption of State Law by Federal Consumer Protection Laws, Including the Reform Act Itself

Under the new Act:

- The Act's substantive consumer protection requirements (statutory and regulatory) will preempt only "inconsistent" state laws, and only to the extent of the inconsistency. State laws providing greater protection for consumers are not deemed "inconsistent" for this purpose. The CFPB will have the authority to make determinations of whether a specific state law is "inconsistent" with the new federal requirements.
- Other than through amendments made to the Alternative Mortgage Transaction Parity Act of 1982, 12 U.S.C. § 3801 *et seq.*, there is no change to the preemption standards or preemptive effect of the existing federal "enumerated consumer laws" (which include the TILA, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Electronic Funds Protection Act, and the TISA, among others).
- To accommodate the states, if a majority of states adopt a resolution requesting a new or modified consumer protection regulation, the CFPB will have to propose such regulation, taking into account any views expressed by the other federal banking regulators.

Clarification of Preemption Standards Under the NBA and HOLA

The Act amends both the NBA and the HOLA to add "clarifying" standards for preemption of "state consumer financial laws." As defined in the Act, a "state consumer financial law" is a state law that "directly and specifically regulates the manner, content, or terms and conditions of any financial transaction...or any account related thereto, with respect to a consumer." This definition is somewhat ambiguous in scope, but its focus on consumers indicates that other state banking-related laws (bank registration requirements, etc.) may continue to be preempted without regard to the Act.

- As amended, the NBA and the HOLA will no longer preempt state law as applied to state-chartered subsidiaries and affiliates of national banks or federal savings banks (unless such entities are themselves national banks or federal savings banks). This is a highly significant change in the law and effectively reverses the holding of *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1 (2007), in which the US Supreme Court held that state law is preempted as applied to an operating subsidiary of a national bank to the same extent as it is preempted for the national bank itself.
- With respect to national banks and federal savings banks themselves, the NBA and HOLA (and their respective implementing regulations) will be deemed to preempt a state consumer financial law *only if*: (i) the state law would have a discriminatory effect on a national bank or federal savings bank in comparison with the effect of the law on a bank chartered by that state; (ii) under the legal standard for preemption articulated in *Barnett Bank v. Nelson*, 517 U.S. 25 (1996), the application of the state law would "prevent or significantly interfere with" a national bank's or federal savings bank's exercise of a federally granted power; or (iii) the state law is preempted by another federal law.
- A determination of preemption under these NBA and HOLA standards may be made either by a court, or, subject to certain procedural limitations, by the Comptroller of the Currency (Comptroller).¹ In particular, the Comptroller's decisions must be made on a "case-by-case" basis; thus, presumably, they must address the impact of the NBA or the HOLA on a particular state consumer financial law as applied to a particular national bank or federal savings bank.
- Importantly, these NBA and HOLA preemption standards would not apply to any contract entered into by a national bank, federal savings bank, or affiliate or subsidiary thereof prior to the enactment of the legislation. The scope of this preservation of the preexisting preemption

¹ Only the Comptroller himself would have authority to make such preemption determinations. That authority would "not be delegable to another officer or employee."

standards is not entirely clear, but Congress' apparent intent is not to interfere with the expectations of the parties to a contract with respect to the law applicable to their agreement. It may be argued, therefore, that the new preemption standards do not apply to any actions taken by a national bank or federal savings bank in connection with the performance of obligations or the exercise of rights under credit card, deposit account, and similar agreements made with customers prior to the legislation's enactment.

- Importantly, the Act's preemption provisions will *not* affect the ability of any depository institution to "export" the interest rates permissibly charged in the state in which it is located to customers located in other states. Thus, with respect to interest rates specifically, federal law will continue to preempt the application to a depository institution (subject to certain exceptions) of usury laws of states other than the one in which the institution is located.

Comptroller Determinations of Preemption

- As noted, the Comptroller's decisions on NBA and HOLA preemption are to be made on a "case-by-case" basis. However, there is some leeway in the Act for broader determinations, if the Comptroller involves the CFPB. Specifically, the Comptroller may, in making a preemption finding regarding the state consumer financial law of a particular state, also determine that another state's similar law is similarly preempted, provided that the Comptroller (i) first consults with the CFPB; and (ii) takes its views into consideration.
- The Comptroller's authority to determine that a state consumer financial law is preempted by the NBA or HOLA is also limited by the requirement that there be "*substantial evidence*, made on the record of the proceeding," supporting the finding of preemption under the *Barnett Bank* preemption standard.
- All preemption determinations of the Comptroller will have to be published on a quarterly basis, and must be reviewed periodically. The required reviews will involve a notice-and-comment process which, for each preemption

determination, will occur within (i) the first five years after issuance, and (ii) at least once during every subsequent five-year period. The Comptroller will have to report to Congress on whether, based on such reviews, the Comptroller intends to continue, rescind, or propose to amend any of the existing preemption determinations.

Preservation of State Enforcement Authority

- The Act authorizes state Attorneys General to bring civil actions in the name of their states to enforce the Act's consumer protection mandates and the implementing regulations of the CFPB.
- State Attorneys General will have to consult with the CFPB and the "prudential" (primary) regulator of an entity prior to initiating any enforcement actions against such entity.
- With respect to enforcement actions against national banks and federal savings banks (but not other institutions), state Attorneys General may not simply allege a general violation of the Act but, rather, must allege a violation of a *specific implementing regulation* promulgated by the CFPB.
- As a further limitation on state actions against national banks and federal savings banks, the Act preserves the Supreme Court's ruling in *Cuomo v. Clearing House Association, L.L.C.*, 129 S. Ct. 2710 (2009), that state Attorneys General may sue national banks for violations of non-preempted state law, but may not conduct examinations or pre-litigation investigations of national banks. The Act extends this ruling to cover federal savings banks as well.

Implications for National Banks and Federal Savings Banks

Very likely, the most significant aspect of the above-described changes for national banks and federal savings banks will be the elimination of preemption under the NBA and the HOLA for such institutions' operating subsidiaries. This change may prompt many national banks and federal savings banks to "roll up" their operating subsidiaries to make them bank divisions, rather than separate entities organized under state law. There could be efficiency losses and operational costs associated with such "roll-ups," and those will need to be weighed against

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the efficiency and operational benefits of the nationwide uniform regulation resulting from federal preemption of the various states' laws.

With respect to the substantive standards for preemption under the NBA and the HOLA, the Act's impact on national banks will to some extent be limited by the fact that the NBA amendments primarily codify existing precedent (i.e., *Barnett Bank*). For federal savings banks, however, which arguably have enjoyed a broader scope of preemption than is provided by the *Barnett Bank* "prevent or significantly interfere" standard, the impact could be greater. Specifically, federal savings banks have operated pursuant to a "field preemption" standard under the preemption regulations of the Office of Thrift Supervision (OTS), see e.g., 12 C.F.R. §§ 557.11; 560.2(a), which permits a finding of preemption without demonstrating a "conflict" between federal and state law.

The Act does not explicitly dictate any change to the current preemption regulations of the Office of the Comptroller of the Currency (OCC) under the NBA or the parallel OTS preemption regulations under the HOLA. However, both sets of regulations will need to be revisited to determine their continued viability in light of the Act. Under those regulations, certain types of state laws are categorically preempted, which may be deemed inconsistent with the Act's requirement that the Comptroller's preemption determinations be made on a "case-by-case" basis. Further, the OTS regulations expressly rely on the "field preemption" standard and thus would appear to require revision at least to conform to the *Barnett Bank* standard. An assessment of the continued viability of OCC and OTS preemption regulations will be a key focus for the agencies as they work on implementing the various mandates of and changes to current law contained in the Act. Of course, the political climate may influence the outcome of this assessment.

On the litigation front, all financial institutions subject to the Act's new consumer protection provisions, including but not limited to national banks and federal savings banks, can expect an increase in aggressive plaintiffs' activities and the advent of broader actions by state Attorneys General. Defending against these actions on grounds of

federal preemption will require both a solid understanding of preexisting precedent and the analytical skill to demonstrate that these "clarifying" tests for preemption are met.

* * *

Arnold & Porter LLP's financial services litigation team is widely recognized for its successful preemption challenges to state and local enforcement actions against federally chartered financial institutions. In a series of cases, the Arnold & Porter team, including lawyers from the firm's Washington, DC, New York, and Los Angeles offices, has achieved major victories for national banks, savings and loan institutions, and credit unions threatened with overreaching state and local actions. The firm was recently included in the National Law Journal's 2010 "Appellate Hot List" for its work in the financial services sector, highlighting its success in the area of preemptive litigation for national banks. In addition, members of our financial services team held senior positions with the OCC, which will be required to implement these standards. We would be pleased to assist with questions on these matters.

If you would like more information about any of the matters discussed in this advisory, please contact your Arnold & Porter attorney or:

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

The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) will touch off a major reorganization in the federal regulation of consumer financial products and services. The Act establishes the Consumer Financial Protection Bureau (CFPB) to serve as the primary regulatory authority over consumer financial products, and nearly every federal consumer financial protection statute. The CFPB will police activities relating to financial products and services for unfair, deceptive, and abusive acts or practices, and routinely examine large depository institutions, and nondepository entities for compliance with federal consumer financial laws. Although the impact of the CFPB is not completely clear, its existence almost certainly will result in an increased focus on consumer protection in the financial services industry and likely will create some uniformity in supervision and enforcement between depository and nondepository participants. The identity of the first Director of the CFPB (Director) will help to define the direction and tone of the CFPB's expressed powers.

Creation of the CFPB

The CFPB will be established and housed within the Federal Reserve System, but operate as an autonomous agency. The Board of Governors of the Federal Reserve System (Federal Reserve) will fund the CFPB from the earnings of the Federal Reserve System. The Federal Reserve, however, will have no authority over officers of the CFPB, and will be unable to approve or reject the CFPB's rules or orders.

Director. The CFPB will be headed by a single director appointed for a five-year term by the President of the United States, with the consent of the US Senate. The Director will have a large concentration of regulatory power. For example, he or she will be able to annually determine the amount of Federal Reserve funding that will be "reasonably necessary"

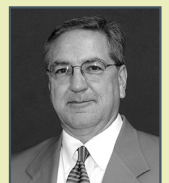
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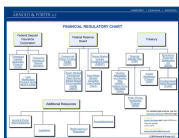
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in a given year, limited only by an annual funding cap.¹ The Director will be responsible for executing the CFPB's purpose of implementing and enforcing consumer financial laws on behalf of consumers, and according to the Act, on behalf of "fair, transparent, and competitive" markets. The Director will also serve as a voting member of the Financial Stability Oversight Council (FSOC), the umbrella authority created by the Act to monitor the systemic health of the US financial markets. Until the Director is formally appointed, the Secretary of the Department of the Treasury (Treasury Secretary) will serve as the interim head of the CFPB.

Designated Transfer Date. The Treasury Secretary, also will determine, not later than 60 days after the enactment of the Act, the date upon which the CFPB will be transferred authority from other regulators. This "designated transfer date" must be between six months and one year from the enactment of the Act.² Although the CFPB will be a new agency, it will be created through the merging of several existing consumer financial regulatory departments. The Federal Reserve, the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the National Credit Union Administration (NCUA), and the US Department of Housing and Urban Development (HUD) will all transfer consumer financial protection powers, and employees, from their agencies to the CFPB.

Scope of the CFPB's Authority

The CFPB will become the administrator for the "federal consumer financial laws," which include nearly every existing federal consumer financial statute, as well as new consumer financial protection mandates prescribed by the Act, such as the new mortgage loan standards set forth in Title XIV. The "enumerated consumer laws" transferred to the CFPB's authority include:

- The Alternative Mortgage Transaction Parity Act of 1982;
- The Consumer Leasing Act of 1976;

¹ This funding cap escalates from 10 percent of the Federal Reserve's operating expenses to 12 percent by 2012.

² The Treasury Secretary is authorized to request an extension which may not exceed 18 months after the enactment of the Act.

- The Electronic Fund Transfer Act;
- The Equal Credit Opportunity Act (ECOA);
- The Fair Credit Billing Act;
- The Fair Credit Reporting Act;
- The Home Owners Protection Act of 1998;
- The Fair Debt Collection Practices Act;
- Subsections (b) through (f) of section 43 of the Federal Deposit Insurance Act, requiring disclosure when a depository institution lacks federal deposit insurance;
- Sections 502 through 509 of the Gramm-Leach-Bliley Act, protecting the disclosure of nonpublic personal information;
- The Home Mortgage Disclosure Act of 1975;
- The Home Ownership and Equity Protection Act of 1994;
- The Real Estate Settlement Procedures Act of 1974 (RESPA);
- The S.A.F.E. Mortgage Licensing Act of 2008;
- The Truth in Lending Act (TILA);
- The Truth in Savings Act;
- Section 626 of the Omnibus Appropriations Act, 2009, mandating a rulemaking on unfair and deceptive mortgage lending practices; and
- The Interstate Land Sales Full Disclosure Act.

CFPB's Relationship with the Federal Trade Commission.

Notably, the Act preserves the authority of the Federal Trade Commission (FTC) to enforce the Federal Trade Commission Act (FTC Act) against nondepository entities engaged in financial activities. The FTC will transfer the authorities to prescribe rules, issue guidelines, conduct studies, and issue reports under any enumerated consumer law to the CFPB, while retaining all of its remaining consumer protection authorities. The CFPB and the FTC must negotiate an agreement for coordinating enforcement actions against nondepository entities, which must include procedures for notice between the agencies prior to the initiation of a civil action against such entities. The CFPB and the FTC also must negotiate an agreement to coordinate FTC rulemakings on unfair and deceptive acts or practices, with CFPB rulemakings

on unfair, deceptive, and abusive acts or practices (discussed below), to the extent both rulemakings apply to nondepository entities. The rulemaking agreement must include consultation between the agencies prior to a rulemaking, in order to avoid duplication of or conflict between the agencies' rules. Thus it is expected that the FTC will continue its historic role of enforcement against false and misleading marketing practices of nondepository entities, in coordination with the CFPB.

Fair Lending Limitations. The CFPB will have no authority to administer the Fair Housing Act, which will remain under the jurisdiction of HUD. Thus, despite the fair lending and antidiscrimination similarities between ECOA and the Fair Housing Act, the two statutes will be administered by different agencies.

Covered Persons. The CFPB will regulate, as covered persons, anyone who engages in offering or providing a consumer financial product or service. Service providers to covered persons, and affiliates of a covered person acting as a service provider, are also under the regulatory authority of the CFPB. A covered person broadly includes those engaged in the following consumer financial activities:

- Extending consumer credit and servicing loans;
- Extending or brokering leases of property that are the functional equivalent of purchase finance arrangements;³
- Providing real estate settlement services (other than appraisal of real or personal property);
- Engaging in deposit-taking activities, transmitting or exchanging funds, or acting as a custodian of consumer funds;
- Selling, providing, or issuing stored value or payment instruments, unless the seller does not exercise substantial control over the terms and conditions of the stored value;
- Providing check cashing, check collection, or check guaranty services;

³ Covered leasing activities must be on a non-operating basis, with an initial term of at least 90 days, and for leases involving real property, the transaction must be intended to result in the ownership of the real property.

- Providing payments or other financial data processing products or services to a consumer by any technological means;
- Providing individual financial advisory services to consumers, including credit counseling or debt management;⁴
- Maintaining or providing consumer credit information to make a decision regarding the offering of a consumer financial product or service;
- Collecting debt related to any consumer financial product or service; and
- Offering any other financial product that is permissible for a bank or financial holding company to offer where the CFPB determines such activity will likely have a material impact on consumers.

Exclusions. While the scope of the CFPB's authority is very broad, there are numerous parties who are specifically excluded from coverage. Most of these exclusions only apply to the extent that the parties are not engaged in offering a consumer financial product or service, or are not separately subject to an enumerated consumer law. Excluded parties include:

- Merchants, retailers, and sellers of nonfinancial goods or services;
- Motor vehicle dealers⁵ (except for motor vehicle dealers who provide mortgages, or who extend retail credit directly to consumers without assigning that credit to a third party);
- Persons regulated by the Securities and Exchange Commission, Commodity Futures Trading Commission, or state securities commissions;
- Persons regulated by a state insurance regulator;
- Persons regulated by the Farm Credit Administration;
- Real estate agents, brokers, and appraisers;
- Manufactured home retailers;
- Accountants;

⁴ This covered activity does not include newspaper and magazine publications, when they publish general market information.

⁵ Motor vehicle dealers will remain under the regulatory authority of the FTC.

- Tax preparers (when not extending credit such as through a refund anticipation loan);
- Attorneys;
- Employee benefit and compensation plans; and
- Tax-exempt organizations.

The CFPB also may exempt any covered person or financial product from regulatory coverage based on the size of that person and the extent to which existing law provides adequate protections.

For merchants and retailers, the applicability of their exclusion may be conditioned upon the size of the merchant's or retailer's business. Merchants and retailers are excluded from the CFPB's regulatory coverage if they offer credit solely for the purpose of enabling a consumer to purchase a nonfinancial good or service. If this extension of credit contains any of the following characteristics, however, the merchant or retailer will be subject to the CFPB's coverage:

- The merchant or retailer's extension of credit (or collection of debt):
 - a) Is sold or conveyed to another person (except for delinquent debt);
 - b) Significantly exceeds the market value of the good or service provided; or
 - c) Is subject to a finance charge.

If a merchant or retailer extends credit that only contains the third characteristic, a finance charge, then that merchant will remain excluded from the CFPB's coverage only if that merchant or retailer is "not engaged significantly in offering consumer financial products or services." The Act does not define the scope of those who are "not engaged significantly in offering consumer financial products or services," but this designation does explicitly include "small businesses" as defined in Section 3 of the Small Business Act. However, larger merchants and retailers will need to determine whether they are exempt from CFPB regulation, as the CFPB provides rulemakings on the matter. Regardless, all merchants and retailers that offer credit would still be subject to the enumerated consumer laws under the CFPB's purview.

Regulatory Powers of the CFPB

The CFPB is granted *exclusive* authority to promulgate regulations, issue orders, and provide guidance to administer the federal consumer financial laws.

Rulemaking Authority. When promulgating a regulation, the CFPB must consider the potential costs and benefits to both consumers and covered persons, including the reduction of access by consumers to consumer financial products. The CFPB must particularly consider the impact of a proposed rule on consumers in rural areas and depository institutions with less than \$10 billion in total assets. The CFPB may not establish an interest rate limit (a usury prohibition) for extensions of credit.

While broad, the CFPB's rulemaking authority is subject to some consultation and review by other federal agencies. The CFPB must consult with federal banking regulators or other appropriate federal agencies prior to proposing a rule, in order to confirm the consistency of the rule with the objectives of those agencies. The consulted regulator or agency may provide a written objection to a proposed rule of the CFPB, and the CFPB must address this objection in the adopting release of the disputed final rule. Additionally, the FSOC may set aside a final regulation of the CFPB if the FSOC decides, by two-thirds vote, that the regulation would put the safety and soundness of the financial system of the United States at risk.

Despite these limits, the CFPB is granted several powers to support its rulemaking and regulatory functions. For example, the CFPB has general authority to monitor for risks to consumers in the offering of consumer financial products or services. As part of this monitoring function, the CFPB may require covered persons to file reports, and participate in interviews and surveys.

Assessment of Existing Regulations. The CFPB will also have five years to conduct a complete assessment of each significant regulation or order transferred to the authority of the CFPB under an enumerated consumer law. This assessment must provide a public comment period, in which recommendations can be made to modify, expand, or eliminate any significant regulation implementing an enumerated consumer law.

Among the significant rules that must explicitly be modified by the CFPB are disclosure regulations implementing TILA and RESPA. The CFPB must propose a single integrated disclosure that will satisfy both TILA requirements, and RESPA good faith estimate and settlement statement requirements no later one year after the designated transfer date. The single disclosure should partially alleviate a disclosure process that was often criticized in the mortgage industry as duplicative. However, other major regulations also may be revamped under the CFPB's review power.

Unfair, Deceptive, and Abusive Acts or Practices.

Another power granted to the CFPB is the authority to prohibit the commission of a particular act or practice on the grounds that it is unfair, deceptive, or abusive. This authority expands the unfair and deceptive acts or practices (UDAP) doctrine, initially grounded in Section 5 of the FTC Act. The Act adds the term "abusive" to the UDAP doctrine, and defines the term as an act or practice that:

- Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
- Takes unreasonable advantage of:
 - A lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
 - The inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or
 - The reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

It appears from the definition of "abusive" that the term is aimed at situations in which a consumer lacks understanding of a consumer financial product, and a covered person was the cause of this lack of understanding. On its face, the definition could apply to the provision of complicated disclosure terms, the provision of terms that are not translated to the native language of a consumer, or even an agreement that the consumer fully understands, but that the CFPB feels is not reasonably in the consumer's interest. Depending on

how the CFPB interprets this definition of abusive, certain consumer financial products could be curtailed.

Consumer Education. The CFPB will also focus its resources on educating and empowering consumers to make better informed financial decisions. The CFPB will establish an Office of Financial Education that will seek to provide opportunities for consumers to have access to financial counseling, information on understanding credit histories and scores, mainstream banking services, and strategies for debt reduction. In addition, the CFPB will establish separate offices to address the particular consumer financial education needs of service members and older Americans.

Examination Authority of the CFPB

The CFPB has primary examination authority over certain nondepository entities, and certain depository institutions.

Nondepository Entities. The CFPB will conduct periodic examinations for consumer financial law compliance of the following nondepository entities:

- Mortgage originators, mortgage brokers, and servicers;
- Larger participants of a market for "other" consumer financial products;
- Private education loan providers;
- Payday lenders; and
- Covered persons whom the CFPB determined has engaged in conduct that poses risk to consumers.

It is unclear which entities would be covered by the term "larger participants" in a market for other consumer financial products, and that will be spelled out further in regulations. However, it almost certainly will be large nondepository entities, such as large captive finance companies or larger players in the prepaid market. The CFPB may require any nondepository entity to file reports to determine whether the entity is a covered person subject to examination. The CFPB may (but is not required to) also prescribe registration requirements for all nondepository covered persons in consultation with state agencies.

Large Depository Institutions. For depository institutions, examination authority for compliance with consumer financial laws will be divided between the primary federal banking regulators, and the CFPB on the basis of the institution’s total asset size. Depository institutions with total assets greater than \$10 billion (Large Depository Institutions), will be subject to consumer financial compliance examination by the CFPB. The CFPB must coordinate its examination of a Large Depository Institution with examinations conducted by the institution’s federal and state banking regulators. If the supervisory determinations of the CFPB and a federal banking regulator are in conflict, then the Large Depository Institution may request a joint statement from the conflicting regulators. If the regulators are unable to resolve the conflict, then the institution may file an appeal with a governing panel consisting of representatives from the CFPB, the conflicting

regulator, and a federal banking regulator not involved in the dispute. Through majority vote, the governing panel will provide a final determination to the supervisory conflict.

Smaller Depository Institutions. A depository institution with total assets of \$10 billion or less (Smaller Depository Institution) will continue to be exclusively examined for compliance with federal consumer financial laws by the institution’s primary federal banking regulator. The examinations must include the CFPB’s input concerning the scope, conduct, and contents of the examination and its resulting report.

Enforcement Authority of the CFPB

The CFPB’s enforcement authority over covered persons is delegated as follows:

Covered Person	Primary Enforcement Authority	Secondary Enforcement Authority
Nondepository Entities	<ul style="list-style-type: none"> ■ CFPB has exclusive authority to enforce federal consumer financial laws, except where the FTC continues to have enforcement authority. ■ CFPB and the FTC will coordinate enforcement actions through a negotiated agreement. 	<ul style="list-style-type: none"> ■ Any federal agency authorized to enforce a federal consumer financial law may recommend in writing that the CFPB initiate an enforcement proceeding.
Large Depository Institutions (Total Assets Greater than \$10 Billion)	<ul style="list-style-type: none"> ■ CFPB has primary authority to enforce federal consumer financial laws. 	<ul style="list-style-type: none"> ■ Any federal agency (other than the FTC) that is authorized to enforce a federal consumer financial law may recommend in writing that the CFPB initiate an enforcement proceeding. ■ If the CFPB does not initiate an enforcement proceeding within 120 days, then that agency may initiate an enforcement proceeding.
Smaller Depository Institutions (Total Assets of \$10 Billion or Less)	<ul style="list-style-type: none"> ■ Federal banking regulator of the depository institution shall have exclusive authority to enforce federal consumer financial laws. 	<ul style="list-style-type: none"> ■ CFPB shall notify the federal banking regulator in writing when there is reason to believe that a material violation of a federal consumer financial law has occurred.

Through its enforcement authority, the CFPB may conduct hearings and adjudication proceedings, issue subpoenas, issue civil investigative demands, and issue cease and desist orders. The CFPB may also commence civil actions to impose a civil penalty for violations of a federal consumer financial law. If the civil action is based upon an alleged violation of Title X of the Act, then the statute of limitations for such an action is three years after the date of the discovery of the violation. State attorneys general or state regulators may bring a civil action to enforce Title X with respect to any entity that is state-chartered, incorporated, licensed, or otherwise authorized to do business under state law. A state attorney general may also bring a civil action against a national bank or federal savings association to enforce a regulation promulgated under Title X, but not to enforce a provision of Title X.

Consumers do not have a private right of action under Title X, but they may send their complaints to the CFPB. Indeed, the Act requires that the CFPB facilitate the centralized collection of consumer complaints, instead of being disbursed among the various regulatory agencies. The CFPB must provide a timely response to consumer complaints, detailing the steps that have been taken in response to the complaint. Large Depository Institutions are required to provide timely responses to the CFPB, or any federal banking regulator that inquires about a consumer complaint. It is likely that consumer complaints will drive the focus of the CFPB's enforcement efforts, as well as perhaps its future rulemakings.

Damages and Penalties. Relief arising from an administrative proceeding or court action may include:

- Rescission or reformation of contracts;
- Refund of moneys or return of real property;
- Restitution;
- Disgorgement or compensation for unjust enrichment;
- Payment of damages;
- Public notification of the violation;
- Limits on the covered person's activities or functions; and
- Civil money penalties, as follows:

- First Tier: Up to \$5,000 per day for any violation of a law rule, final order, or condition imposed in writing by the CFPB;
- Second Tier: Up to \$25,000 per day for *recklessly* engaging in a violation of a federal consumer financial law; and
- Third Tier: Up to \$1,000,000 per day for *knowingly* violating a federal consumer financial law.

The CFPB, state attorney general, or state regulator may pursue the costs of prosecuting an action from a defendant, but they may not pursue punitive damages. For alleged criminal violations, the CFPB will refer the matter to the US Attorney General.

Impact of the CFPB

Given the broad reach of the language creating the CFPB, the impact of the CFPB will be significant. However, the parameters and degrees of that significance are difficult to measure at this time. It is clear that nondepository providers of consumer financial products will, for the first time, be systematically supervised in a manner more similar to that of financial institutions. Complaints likely will be dealt with more systematically and disclosures will be revamped. However, the CFPB, through the Director, has broad powers to dictate its concentrated consumer financial protection authority beyond these areas. One issue of particular concern is Congress' removal of language contained in the House version of the Act that would have prohibited the CFPB from requiring the offering of a standard consumer financial product. As a result, the CFPB could use its broad powers to impose mandates relating to "plain vanilla" financial products.

It is true that Title X of the Act contains several potential checks against the CFPB that could limit its authority. First, the mandated assessment of all significant federal consumer financial regulations could allow industry commenters to encourage the CFPB to identify and address outdated, unnecessary, or unduly burdensome regulations, which is a stated objective of the agency. Second, in any rulemaking, the CFPB must conduct a cost-benefit analysis of the effects of a rule on both consumers and covered persons, with particular consideration to the reduction of access to

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consumer financial products. Third, although less likely to be used, the FSOC can set aside a regulation if it places safety and soundness at risk, and federal banking agencies may formally object to CFPB rulemakings that are inconsistent with the agencies' objectives. Finally, each of the dozens of rulemakings that the CFPB must conduct will allow for public comment periods, where industry stakeholders may express their concerns.

The initial direction and tone of the CFPB undoubtedly will be established by the forthcoming Director. Presently, the appointment of the CFPB's first director is the most influential indicator of the CFPB's ultimate regulatory impact. The Director will set the culture and policies for how the CFPB's authorities will be applied. Therefore, concerned industry stakeholders may wish to consider expressing their views early during the period that the CFPB is being organized and the Director is being appointed and confirmed, as well as during later rulemaking public comment periods.

Arnold & Porter LLP provides advice in the consumer financial area and defends companies against unfair and deceptive practices allegations. Several firm colleagues have held positions at the FTC and the federal bank regulatory agencies with responsibilities in these areas. We are available to respond to questions raised by these provisions of the Act, or to provide any assistance to companies that will be affected by the CFPB as it is established and rulemakings are issued. We also can assist in determining how the Act may affect your business and ensuring that your business is compliant. For further information, please contact your Arnold & Porter attorney or:

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Dodd-Frank Act Grants Expansive Fair Lending Enforcement and Rulemaking Authority to the Bureau of Consumer Financial Protection

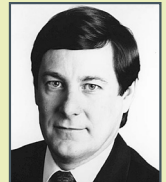
The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) expands upon and complicates the applicable regulatory and enforcement framework in the fair lending area. The Act charges the newly created Bureau of Consumer Financial Protection (CFPB) with carrying out, coordinating, and enforcing the requirements of most but not all of the existing fair lending laws as well as with promulgating regulations to implement new federal requirements. Not only that, it also creates a special Office of Fair Lending and Equal Opportunity to coordinate all these efforts. Nevertheless, the Act allows the Fair Housing Act—one of the primary federal fair lending laws—to remain within the purview of the Department of Housing and Urban Development (HUD), thus maintaining a complicated parallel fair lending enforcement scheme.

Most of these statutory reforms will become effective on the “designated transfer date,” which can be no earlier than 180 days nor later than 12 months after the Act’s enactment (extendable to up to 18 months after the Act’s enactment by the Secretary of the Treasury). However, regulations necessary for the implementation of many of the new requirements may not ultimately be issued until well after that time. Lenders that have fair lending responsibilities would be advised to carefully review these provisions and, if appropriate, anticipate changes that may need to be made to their fair lending programs to comply with these reforms.

Definition of Fair Lending

The Act provides a definition for “fair lending.” This definition states that “fair lending” consists of “fair, equitable, and nondiscriminatory access to credit for consumers.” Furthermore, the Act grants broad general oversight of the “fair lending” area to the CFPB. Existing federal fair lending laws do not appear to contain a particular definition of the term, and thus we believe this definition provides the CFPB with a broadly-worded mandate that may be adapted to encompass a variety of activities related to fair lending that may not have been previously considered as covered, including suitability standards. By themselves, the Act’s definition of

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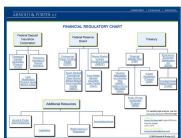
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“fair lending” and consolidation of most fair lending regulation within the CFPB may focus attention on this area.

Office of Fair Lending and Equal Opportunity

The Act not only gives the CFPB the general authority to oversee the fair lending area, it establishes an Office of Fair Lending and Equal Opportunity (Office) within the CFPB to be responsible for that area. The Office must be established within one year of the designated transfer date, as described above. The duties of the Office include:

- Providing oversight and enforcement of federal laws, including the Equal Credit Opportunity Act (ECOA) and the Home Mortgage Disclosure Act (HMDA), to ensure fair, equitable, and nondiscriminatory access to credit;
- Coordinating the fair lending efforts of the CFPB with other federal and state regulators;
- Working with private industry and fair lending advocates to promote fair lending compliance and education; and
- Providing annual reports to the US Congress on the efforts of the CFPB to fulfill its fair lending mandate.

The Act also requires the CFPB to publish a report within two years of the Act’s enactment that examines, among other things, whether federal regulators have access to information sufficient to provide them with assurances that private education loans are provided in accordance with fair lending laws.

Amendments to the Equal Credit Opportunity Act

The Act also introduces a number of significant amendments to ECOA, which prohibits discrimination in credit transactions on the basis of a number of protected grounds (e.g., race, color, religion, national origin, gender, marital status, or age). While ECOA in its current form grants rulemaking authority to the Board of Governors of the Federal Reserve System (Federal Reserve), the Act amends ECOA to grant primary rulemaking authority to the CFPB. The Federal Reserve is also required to issue rulemakings to implement ECOA with respect to motor vehicle dealers, who are exempted from regulation by the CFPB.

The Act further amends ECOA to create a new section on small business loan data collection in order to facilitate the identification of the “business and community development needs...of

women-owned, minority-owned, and small businesses” and to enforce fair lending laws with respect to these businesses. This section imposes information-gathering requirements on financial institutions (broadly defined under this section as any entity that engages in any financial activity) with respect to credit applications made by women- or minority-owned businesses and other small businesses (as defined by the Small Business Act). A financial institution must annually submit to the CFPB data on each such application’s loan size and purpose, the action taken with respect to the application, the gross annual revenue of the business applying for the loan, and the race, sex, and ethnicity of the principal business owners, among other details. The Act requires the CFPB to make such data publicly available on an annual basis. Since financial institutions must compile and maintain this data in accordance with regulations issued by the CFPB, the new data collection requirements will not become effective until after the designated transfer date.

Amendments to the Home Mortgage Disclosure Act

The Act also amends HMDA, which requires covered depository institutions to maintain and disclose certain data on home mortgage applications. The Act transfers overall responsibility for HMDA’s implementation from the Federal Reserve to the CFPB. The amendments also create additional data collection and reporting requirements for depository institutions to include for each loan purchased or originated (including loans for which the institution received completed applications):

- The age of the borrower or applicant;
- The credit score of the borrower or applicant;
- The total points and fees payable at origination of the mortgage;
- The difference between the annual percentage rate associated with the loan and a benchmark rate for all loans;
- The value of the collateral pledged for the loan;
- The presence of contractual terms that would allow payments that are not fully amortizing; and
- The number of months after which an introductory rate may change.

With the exception of data on an applicant's or borrower's age, the newly required data would not need to be disclosed to the CFPB until the first January after the nine month period that begins when the CFPB first issues final regulations on the required disclosures (for which regulations the Act does not provide a deadline).

The CFPB, in consultation with the Bureau of the Census and certain other agencies, also is directed to develop methods to facilitate the matching of addresses with census tracts to facilitate compliance with HMDA requirements (and presumably with Community Reinvestment Act requirements).

Enforcement of Fair Lending Laws

As before, enforcement duties under the amended ECOA are shared among the federal banking agencies with respect to financial institutions within their regulatory jurisdictions. The CFPB is granted concurrent authority to enforce compliance with ECOA with respect to consumer transactions. The Federal Trade Commission is also permitted to enforce ECOA, including any related rules prescribed by the CFPB, with respect to institutions, such as retailers and other nonbank lenders, for which enforcement is not specifically committed to another federal agency.

Enforcement of HMDA, as amended, remains with the federal banking agencies for depository institutions, along with the National Credit Union Administration for credit unions and HUD for other nonbank lenders. The CFPB is also granted the ability to discretionarily exercise "principal authority to examine and enforce compliance by any person with the requirements" of HMDA.

The federal banking agencies may also elect to refer violations of ECOA and HMDA (along with other "enumerated consumer laws") by financial institutions to the CFPB, in addition to HUD (and it appears they will still be required to make referrals to the Department of Justice). Note that the Act does not amend the Fair Housing Act, so enforcement of and referrals for violations of that law will continue to be handled by HUD. Finally, the Act provides the CFPB with the authority to conduct joint investigations with HUD and the Justice Department with respect to fair lending matters.

As this advisory highlights, the Act ushers in a number of significant reforms to fair lending compliance. Lenders with fair lending responsibilities should review these reforms carefully and, if appropriate, contemplate changes that may need to be made to fair lending programs in order to comply with the Act's new fair lending requirements.

Arnold & Porter regularly assists lenders in complying with the fair lending laws, and is available to respond to questions raised by these provisions, or to help guide your business in compliance with them. For further information, please contact your Arnold & Porter attorney or:

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Mortgage Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act Will Affect Mortgage Brokers, Lenders, Appraisers, Settlement Service Providers, and Others

Title XIV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) adds disclosure and substantive rules relating to mortgage lending that will affect mortgage brokers, lenders, appraiser settlement services providers, and others participating in mortgage lending. The new Consumer Financial Protection Bureau (CFPB) will have implementing rulemaking authority in this area which will be effective on the “designated transfer date.”¹ Furthermore, the provisions of Title XIV will themselves generally become effective within 12 months after the CFPB’s designated transfer date.

The following advisory is a summary of the substantive provisions of Title XIV that will affect mortgage originators and other mortgage loan service providers.

General Scope of Provisions

The provisions of Title XIV apply to most originators making residential mortgage loans. The term “mortgage originator” is defined broadly to include more loan origination participants than traditionally were covered by the term originator.

- The Act generally defines a mortgage originator as a person who, for pay, performs, or represents to the public that he or she performs, any of the following activities:
 - Takes a residential mortgage loan application;
 - Assists a consumer in obtaining or applying to obtain a residential mortgage loan; or
 - Offers or negotiates terms of a residential mortgage loan.

A person who merely performs clerical tasks for a mortgage originator is not a mortgage originator. Typical mortgage originators include brokers and loan officers.

¹ The Secretary of the Treasury, in consultation with certain agencies, must establish the “designated transfer date,” which must be no earlier than 180 days nor later than 12 months from the date the Act is enacted, extendable to no later than 18 months after enactment.

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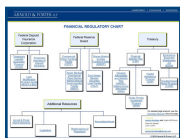
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- The Act defines a “residential mortgage loan” as a closed-end consumer loan secured by a mortgage (or other equivalent security interest) on a dwelling (or residential property that includes a dwelling). Importantly, the definition does not include home equity lines of credit (HELOC). But note that some of the requirements of the Act apply to both residential mortgage loans, as defined, and open-end loans (including HELOCs).

New Requirements for Mortgage Originators

Title XIV imposes the following new substantive requirements on mortgage originators:

- **Qualification.** The Act requires a mortgage originator to (a) be qualified and, when required, registered and licensed; and (b) include on all loan documents his or her unique identifier issued by the Nationwide Mortgage Licensing System and Registry.
- **Prohibition on Steering Incentives.** The Act prohibits a mortgage originator from receiving any compensation that varies based on the terms of a mortgage loan (other than the principal amount). The Act also requires anti-steering regulations to be promulgated in order to reduce the likelihood that a consumer would be steered toward loans with disadvantageous terms. The text states that those regulations are to be issued by the Board of Governors of the Federal Reserve System (Federal Reserve). However, because the Act specifically transfers responsibility for this title to the CFPB, it is possible that the regulations will be promulgated by the CFPB. The Act grants a consumer the right to assert a violation of these regulations as an affirmative defense in a foreclosure action without regard to the statute of limitations.
- **Limits on Compensation.** The Act would only allow a mortgage originator to be paid an origination fee by the consumer. This limitation would not apply if:
 - The mortgage originator does not receive any compensation directly from the consumer; and
 - The consumer does not make an upfront payment of discount points, origination points, or fees (except for exemptions that the Federal Reserve or more likely the CFPB may provide for by regulation).
 Yield spread premiums (YSPs) are prohibited if the total

amount of direct and indirect compensation from all sources permitted to a mortgage originator would vary based on the terms of the loan (other than the principal amount).

- **Ban on Unfair and Deceptive Practices.** The Act gives the Federal Reserve (but presumably again this is the CFPB) the authority to promulgate regulations to ban acts or practices of mortgage originators that it finds to be unfair, deceptive, abusive, predatory, or necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers.

Minimum Standards for Mortgages

In addition to the imposition of new requirements on mortgage originators, Title XIV imposes new minimum standards for mortgage loans that are designed to discourage creditors from making some of the unconventional or hybrid loans that have been considered by many observers to have been a primary reason for the mortgage crises. These standards include the following:

- **Ability to Repay.** No creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan and all applicable taxes and insurance over the loan term. If the property securing the proposed loan is subject to more than one lien (i.e., the property has both a first and a second lien on it), the creditor must make this determination with respect to all the loans secured by liens on that same dwelling. Violation of these rules are an assertable defense by a consumer in a foreclosure action without regard to the statute of limitations.
 - The creditor must consider credit history, current income, expected income, current obligations, debt-to-income ratio, employment status, and financial resources other than the house being mortgaged, among other underwriting criteria.
 - The creditor must verify income or assets, except with respect to refinancing of government guaranteed loans if:
 - The consumer is not 30 days or more past due on the existing loan;
 - The refinancing does not increase the principal

balance on the loan (except for fees and charges allowed by the federal agency);

- Total points and fees (other than *bona fide* third party charges not retained by the mortgage originator, creditor, or affiliate), do not exceed 3 percent of the total new loan amount;
- The interest rate on the refinance loan is lower than the interest rate of the originated loan (unless the refinancing involves converting an adjustable rate to a fixed rate);
- The refinancing is subject to a fully amortizing payment schedule;
- The terms of the refinance do not include a balloon payment; or
- Both the original loan and the refinance loan meet the requirements to be government guaranteed or insured.

There are several specific provisions relating to how a creditor must determine the borrower's ability to repay with respect to certain unconventional loans, including variable rate loans that defer repayment of any principal or interest, interest-only loans, and negative amortization loans. These rules would require the creditor to consider higher payments that the consumer would have to make but for the "unconventional" characteristics.

- **Safe Harbor Rules.** A creditor may presume that any residential mortgage loan it makes meets the "ability to repay" described above if the loan is a "qualified mortgage loan." To be a "qualified mortgage loan," it must possess the following parameters:
 - It must not permit negative amortization or, subject to certain exceptions, deferred principal;
 - Subject to certain exceptions, it must not require any balloon payment (defined as a scheduled payment that is more than twice as large as the average of earlier scheduled payments);
 - The income and assets relied on to qualify the borrower must be verified and documented;
 - Underwriting must be based on full amortization over the loan term;

- The debt-to-income ratio must not exceed certain guidelines to be set by regulation;
- Total points and fees must not exceed 3 percent of the total loan amount (with certain exceptions allowed for smaller loans in rural areas); and
- The loan term must not exceed 30 years, subject to certain exceptions.

Certain reverse mortgages and mortgages with balloon payments may be considered "qualified mortgages" under regulations to be promulgated that are to be consistent with these factors.

- **Refinance of Hybrid Loans with Current Lender.** The Act also sets forth factors to consider in determining a borrower's ability to repay when the creditor considers an application for refinancing of an existing hybrid loan made by the creditor into a standard loan. Under this provision, if there would be a reduction in monthly payment and the borrower has not been delinquent on any payment on the existing hybrid loan, the creditor, in determining the borrower's ability to repay, may: (i) consider the borrower's good standing on the existing mortgage; (ii) consider if the extension of new credit would prevent a likely default should the original mortgage reset and give such concerns a higher priority; and (iii) offer rate discounts and other favorable terms to such borrower that would be available to new customers with high credit ratings. It appears that the Act would allow the creditor to consider the borrower's ability to repay with a standard loan relative to the borrower's ability to repay under the existing hybrid loan, although the statutory language does not specifically say so.
- **Limits on Prepayment Penalties.** The Act also provides that no prepayment penalty may be allowed on a loan that is not a qualified mortgage loan. A prepayment penalty may be imposed on a qualified mortgage, but it would be subject to limits decreasing over a three year period from 3 percent of the loan balance to 1 percent of the loan balance. Moreover, a creditor may not offer a residential mortgage loan with a prepayment penalty without also offering one without a prepayment penalty.
- **Prohibition on Single Premium Credit Insurance.** No creditor may finance, with respect to any residential

mortgage loan or any HELOC secured by a consumer's principal dwelling, credit insurance paid as a lump sum, except for certain credit unemployment insurance sold by unaffiliated third parties.

- **Limitation on Arbitration.** No residential mortgage loan or open-end loan secured by a consumer's principal dwelling may include terms requiring arbitration or any other non-judicial procedure for resolving disputes. However, a consumer may agree to such a resolution method after a dispute arises.
- **Disclosures Regarding Negative Amortization.** Negative amortization loans secured by a dwelling, whether closed-end or open-end, would require additional disclosures regarding the impact of negative amortization.
- **Disclosures Regarding Anti-Deficiency Laws.** If a residential mortgage loan is protected by state anti-deficiency laws (i.e., state laws that provide that, in the event of foreclosure on the residential property of a consumer securing a mortgage loan, the consumer is not liable for any deficiency between the sale price obtained on such property through foreclosure and the outstanding loan balance), the creditor or mortgage originator must provide notice of such protection, and if a refinancing would cause the borrower to lose such protection, the creditor or mortgage originator in the refinancing must provide notice of such loss of protection.
- **Reset of Hybrid Adjustable Rate Mortgages.** Six months' notice is required for changing from a fixed rate to a floating rate on a hybrid adjustable rate mortgage. Similar notices also may be required by regulation for non-hybrid adjustable rate mortgages.
- **More Disclosure Requirements.** The Act also requires certain new disclosures to be provided at the closing of a mortgage loan and on periodic statements (or coupon books).
 - New information that must be provided at the closing include:
 - Information regarding settlement charges, including the aggregate amount of such charges, and the amount included in the loan and that to be paid at the closing;

- The approximate wholesale rate of funds in connection with the loan;
 - Mortgage originator compensation;
 - Total interest payments over the loan term as a percentage of the loan principal; and
 - Certain monthly payment information for variable rate loans with escrow accounts.
- New information that must be provided on periodic statements to be provided during each billing cycle include:
 - The amount of the loan principal;
 - The current interest rate;
 - The date on which the interest rate may reset or adjust;
 - Any prepayment fee;
 - Any late fee;
 - A phone number and an email address the borrower may use to obtain information on the loan;
 - Information on credit counseling agencies; and
 - Any other information required by regulation.
 - **Lender Rights.** One provision in the Act favoring lenders is that if a borrower has been convicted of obtaining a residential mortgage loan by actual fraud, the lender may not be held liable for any violations of the Truth in Lending Act (TILA) with respect to that loan.

New Provisions Relating to High-Cost Mortgages

Title XIV also expands the applicability of the "high rates, high fees" provisions of TILA, added by the Home Ownership and Equity Protection Act (HOEPA). Currently, HOEPA and Section 32 of Regulation Z (which implements HOEPA) cover certain "high rates, high fees" loans, but generally, these current laws only apply to refinancing and home equity installment loans. The Act would make HOEPA apply to all "high-cost mortgages," including purchase money mortgages, and also add further consumer protections, as summarized further below.

- **Definition of High-Cost Mortgage Expanded.** Under the Act, a high-cost mortgage is redefined to be a loan (whether

closed-end or open-end) that is secured by the consumer's principal dwelling and that fits under any of the following:

- The annual percentage rate (APR) exceeds the average prime offer rate (i.e., a rate which will be published by the Federal Reserve, and then by the CFPB after the transfer of functions) for a comparable transaction by more than 6.5 percent if the loan is secured by a first mortgage, or by more than 8.5 percent if secured by a second mortgage;
- The total points and fees exceed (i) 5 percent of the loan amount if the loan is \$20,000 or more; or (ii) the lesser of 8 percent of the loan amount or \$1,000 if the loan amount is less than \$20,000; or
- Prepayment penalties exceed more than 2 percent of the amount prepaid.

■ **Restrictions on High-Cost Mortgages.** If a loan is considered a high-cost mortgage:

- The loan cannot be subject to any balloon payment (i.e., a scheduled payment that is more than twice as large as the average of earlier scheduled payments).
- Late fees are limited.
- Acceleration of any high-cost mortgage is restricted.
- Points and fees on a high-cost mortgage may not be financed.
- Pre-loan counseling is required.

Creation of Office of Housing Counseling

Title XIV establishes the Office of Housing Counseling (Office) within the US Department of Housing and Urban Development (HUD). The Office will have primary responsibility within HUD for all activities and matters relating to homeownership counseling and rental housing counseling. Some of the provisions relating to the Office may impact mortgage originators. For example:

- The CFPB is directed to revise the Special Information Booklet required by Section 5 of The Real Estate Settlement Procedures Act (RESPA) (renamed Home Buying Information Booklet under the Act) to meet the new contents requirement of Title XIV. The Office is required to contribute to this revision. In addition to the information currently required, the updated booklet must include such information as:

- Additional details on the nature and purpose of the costs incident to a real estate settlement on a federally related mortgage loan (which is defined in RESPA and covers most mortgage loans), including both general information about the mortgage process and specific information concerning balloon payments, prepayment penalties, the advantage of prepayment, and the trade-off between closing costs and the interest rate over the life of the loan;
- An explanation of certain things a consumer should consider in shopping for a loan, including the ability to repay, and loan terms such as prepayment penalties and balloon payments;
- An explanation of the right of rescission as to certain transactions;
- An explanation of the nature of a variable rate mortgage, a HELOC, and real estate appraisal; and
- Information about homeownership counseling services and the consumer's responsibilities, liabilities, and obligations.

- HUD is directed to take actions to inform potential homebuyers of the availability and importance of obtaining an independent home inspection, including the publication of certain booklets. Lenders approved by the Federal Housing Administration are required to provide such booklets to prospective homebuyers.

New Provisions Relating to Mortgage Servicing

Title XIV of the Act also imposes additional requirements relating to mortgage servicing, mostly relating to the establishment and maintenance of escrow accounts.

- **Mandatory Escrow Account.** A creditor is required to establish an escrow account for the payment of taxes, insurance premiums, and other required assessments with respect to a closed-end loan secured by a first lien on the principal dwelling of a consumer, if:
 - Federal or state law requires such an escrow account;
 - The loan is made, guaranteed, or insured by a state or federal governmental lending or insuring agency;
 - The APR on the loan exceeds the average prime

offer rate for a comparable transaction by at least 1.5 percentage points for a loan that does not exceed the applicable conforming loan limit, or by at least 2.5 percentage points for a loan exceeding the applicable conforming loan limit; or

- Any regulation requires such an escrow account.

The Act allows for the Federal Reserve (which again presumably will be the CFPB) to allow for exceptions from this requirement for creditors operating in rural and underserved areas that retain their loans in portfolio. In addition, new or modified requirements may be imposed if such modifications would be in the interests of consumers and in the public interest.

- If required, the escrow account generally must be maintained for at least five years from the loan closing, unless (i) the borrower has sufficient equity in the dwelling to no longer be required to maintain private mortgage insurance; (ii) the borrower becomes delinquent on the loan; (iii) the borrower otherwise has not complied with a legal obligations as established by rule; or (iv) the mortgage is terminated.
- The creditor must provide certain disclosures regarding the mandatory escrow account at least three business days before the closing (or as otherwise provided by regulation), including the amount required to be placed in escrow at closing, the amount required for the first year, and the estimated monthly payment into escrow.
- Where establishment of an escrow account is not mandatory, the creditor or servicer must give the borrower disclosures regarding the responsibilities of the borrower and the implications if an escrow account is not maintained.
- If an escrow account is established, the repayment schedule must take into account the monthly escrow payments.
- A servicer of a federally related mortgage may not obtain force-placed hazard insurance unless the borrower fails to comply with the insurance requirements after the servicer has sent two written notices to the borrower.
- Escrowed amounts must be refunded to the borrower within 20 business days of loan pay-off.
- The Act also requires that servicers generally credit a payment to the consumer's loan account as of the date of receipt, unless any delay in crediting does not result in any charge to the consumer or the reporting of negative information to a consumer reporting agency.
- A creditor or servicer of a home loan also must provide an accurate payoff balance within seven business days after receiving a written request.

Appraisal Activities

Finally, Title XIV contains new rules governing the appraisal of residential property securing mortgage loans.

- **Appraisal Required for Higher Risk Loans.** The Act prohibits creditors from making a “higher risk” (which is a wording change from “subprime”) mortgage loan to any consumer without obtaining a written appraisal of the property to be mortgaged in accordance with the following requirements:
 - The appraisal is performed by a qualified appraiser who conducts a physical property visit of the interior of the property; and
 - A second appraisal is performed if the loan is to finance the purchase of the mortgaged property from a person who purchased the property at a price lower than the current sale price less than 180 days earlier.

For this purpose, a qualified appraiser is defined as one that is licensed by the state and conforms with the applicable rules. A higher risk loan is defined as a residential mortgage loan secured by a principal dwelling with an APR that exceeds the average prime offer rate for a comparable transaction by at least 1.5 percentage points in the case of a first lien loan having an original principal amount not exceeding the applicable conforming loan limit, or by at least 2.5 percentage points for a first lien loan exceeding the applicable conforming loan limit, or by at least 3.5 percentage points for a subordinate lien loan.

- **Unfair and Deceptive Practices.** Certain practices compromising appraisal independence are considered unfair and deceptive under the Act, including:
 - A person with an interest in the credit transaction,

compensating or otherwise influencing the appraiser;
and

- Mischaracterizing or inducing any mischaracterization of the appraised value of the mortgaged property.
- **Conflict of Interests Prohibited.** The Act prohibits an appraiser from being involved in appraising the principal dwelling of a consumer offered as security for a consumer loan if the appraiser has an interest in the property or transaction.
- **Mandatory Reporting of Appraiser Violation.** If a person involved in a mortgage transaction, such as a mortgage broker, mortgage lender, or real estate broker, has a reasonable basis to believe that the appraiser failed to comply with applicable laws or standards, that person must report such failure to the applicable state licensing agency. The Act also prohibits a creditor from extending credit on the basis of an appraisal that fails to meet certain independence standards.
- **Regulation of Appraisal Management Companies.** The Act regulates appraisal management companies (i.e., companies that oversee more than 15 certified or licensed appraisers in a state or 25 or more nationally in a year), requiring them to be registered and supervised by a state appraiser certifying and licensing agency. A company that is a subsidiary of an insured depository institution will be regulated by the federal regulator for the parent institution.
- **Automated Valuation Models.** Automated valuation models must adhere to quality control standards designed to:
 - Ensure a high level of confidence in the estimates produced by the models;
 - Protect against the manipulation of data;
 - Seek to avoid conflicts of interest; and
 - Require random sample testing and reviews performed by a licensed appraiser.
- **Broker Price Opinions.** A broker price opinion (i.e., an estimate prepared by a real estate broker, agent, or sales person that details the probable selling price of a particular piece of real estate property) may not be used as the primary basis to determine the value of a consumer's

principal dwelling for the purpose of originating a residential mortgage loan secured by that dwelling.

- **Copy of Appraisal to Borrower.** Finally, the Act amends the Equal Credit Opportunity Act to require that each creditor furnish to an applicant a copy of any written appraisal and valuation developed in connection with the applicant's application for a loan secured by a first lien on a dwelling promptly upon completion, but no later than three days prior to the loan closing (if the loan does go to closing). Currently, the creditor is required to furnish a copy of the appraisal only at the applicant's request.

Arnold & Porter represents mortgage originators and servicers in resolving issues arising under federal and state mortgage laws, as well as the fair lending laws. We also are available to respond to questions raised by the Act, or to help guide your business towards legislative and regulatory solutions. For further information, please contact your Arnold & Porter attorney or:

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Banking and Financial Company Enforcement Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) provides the Board of Governors of the Federal Reserve System (Federal Reserve) with primary enforcement authority over nonbank financial companies that the newly created Financial Stability Oversight Council (FSOC) determines should be subject to Federal Reserve supervision. The Act also delineates which regulators have primary and back-up enforcement authority over subsidiaries of nonbank financial companies and nonbank subsidiaries of depository institution holding companies.

Additionally, the Act establishes the Bureau of Consumer Financial Protection (CFPB) and provides it with the authority to enforce federal consumer financial laws through either administrative proceedings or civil actions. The CFPB will have primary authority to enforce federal consumer financial laws with respect to certain nonbank covered persons, as defined in the Act, as well as insured depository institutions or insured credit unions with total assets of more than \$10 billion. Smaller depository institutions will remain subject to the primary enforcement authority of their prudential regulators. This advisory provides a summary of the enforcement-related provisions of the Act.

Title I. Financial Stability

A. Federal Reserve's Enforcement Authority over Nonbank Financial Companies and their Subsidiaries

Title I of the Act establishes the primary and back-up enforcement authorities over nonbank financial companies that the FSOC determines should be subject to supervision by the Federal Reserve, as well as their subsidiaries. The Federal Reserve will have primary enforcement authority over nonbank financial companies that are made subject to Federal Reserve supervision. The Act provides that nonbank financial companies supervised by the Federal Reserve and their nonbank subsidiaries will be subject to the same enforcement provisions of Section 8 of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. § 1818,

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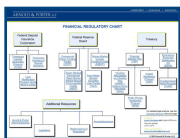
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Financial Regulatory Chart

Financial Regulatory Reform: For Arnold & Porter's latest resources on this topic including Advisories, upcoming events, and publications, please visit [Financial Regulatory Reform](#). Also visit our [Financial Regulatory Chart](#), which aggregates information on US government programs.

as if they were insured depository institutions, including cease and desist orders, removal and prohibition orders, and civil money penalties.

The Act also provides the Federal Reserve with back-up enforcement authority over “functionally regulated subsidiaries” of nonbank financial companies supervised by the Federal Reserve.¹ In this regard, the Federal Reserve may recommend to the primary federal regulator for a functionally regulated subsidiary of a nonbank financial company that an enforcement action be brought against the subsidiary if it determines that a condition, practice, or activity of the subsidiary does not comply with the regulations or orders prescribed by the Federal Reserve under the Act. If the primary federal regulator does not take a supervisory enforcement action against a functionally regulated subsidiary that is acceptable to the Federal Reserve within 60 days, the Federal Reserve will have back-up enforcement authority as if the subsidiary were a bank holding company.

B. Federal Deposit Insurance Corporation’s Back-Up Enforcement Authority to Protect the Deposit Insurance Fund

The Act expands the scope of the Federal Deposit Insurance Corporation’s (FDIC’s) existing back-up enforcement authority over insured depository institutions under Section 8(t) of the FDI Act to encompass back-up enforcement authority over

¹ The term “functionally regulated subsidiaries” means any company that is:

(i) a broker or dealer that is registered under the Securities Exchange Act of 1934;

(ii) a registered investment adviser, properly registered by or on behalf of either the Securities and Exchange Commission or any state, with respect to the investment advisory activities of such investment adviser and activities incidental to such investment advisory activities;

(iii) an investment company that is registered under the Investment Company Act of 1940;

(iv) an insurance company, with respect to insurance activities of the insurance company and activities incidental to such insurance activities, that is subject to supervision by a state insurance regulator; or

(v) an entity that is subject to regulation by the Commodity Futures Trading Commission, with respect to the commodities activities of such entity and activities incidental to such activities.

depository institution holding companies. The Act provides that if the FDIC determines that the conduct or threatened conduct of a depository institution holding company that is not in a sound condition threatens the Deposit Insurance Fund, the FDIC may take an enforcement action, provided that the appropriate federal banking agency did not act within 60 days of receiving a recommendation by the FDIC to take an enforcement action.

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

A. Federal Reserve’s Examination and Enforcement Authority Over Nonbank Subsidiaries of Depository Institution Holding Companies

Title VI of the Act requires the Federal Reserve to examine activities engaged in by a nonbank subsidiary of a depository institution holding company that are permissible for a banking institution “in the same manner, subject to the same standards, and with the same frequency” as would be required if such activities were conducted by the lead insured depository institution of the depository institution holding company. If the Federal Reserve does not conduct an examination in the required manner, the appropriate federal banking agency for the lead depository institution may recommend that the Federal Reserve perform the examination. The appropriate federal banking agency has backup examination authority if the Federal Reserve does not begin an examination within 60 days of a recommendation.

A federal banking agency that conducts an examination pursuant to its back-up examination authority may recommend to the Federal Reserve that it take an enforcement action against the nonbank subsidiary if the federal banking agency determines that the subsidiary “poses a material threat to the safety and soundness of any bank subsidiary of the depository institution holding company.” If the Federal Reserve fails to take an enforcement action within 60 days of the recommendation, the agency that made the recommendation may take the recommended

enforcement action as though the nonbank subsidiary were a bank subsidiary. These provisions will take effect on the so-called Transfer Date, which is one year after the date of enactment of the Act, unless extended.

B. Restriction on Bank Conversions

Title VI of the Act places restrictions on the conversion of banks that have outstanding enforcement actions. It provides that a national bank or federal savings association may not convert to a state bank or state savings association, and vice versa, if the institution is subject to a formal enforcement action, a memorandum of understanding with respect to a “significant supervisory matter,” or a final enforcement action by a state attorney general. However, the restriction on conversions from a federal depository institution to a state depository institution does not apply if the federal banking agency provides notice of the proposed conversion. The notice must include a plan to address the significant supervisory matter that is consistent with the safe and sound operation of the institution and the agency that issued the cease and desist order must not object to the conversion within 30 days of the notice.

Upon an application for a conversion, the institution’s current regulator must notify the prospective regulator of any ongoing supervisory or investigative proceedings that it believes are likely to result in a formal enforcement order or memorandum of understanding in the near term absent the proposed conversion. The current regulator must also provide the prospective regulator with access to all investigative and supervisory information related to the proceedings.

Title X. Bureau of Consumer Financial Protection

A. CFPB’s Enforcement Authority over Nondepository Covered Persons

Title X of the Act creates the CFPB and provides it with examination and enforcement authority over nondepository covered persons who are (i) mortgage originators, brokers, or servicers; (ii) payday lenders; (iii) private education lenders; (iv) larger participants of a market for consumer financial products; or (v) are found to engage in conduct that poses risks to consumers. The CFPB is required to issue regulations,

after consulting with the Federal Trade Commission (FTC), to further define the nondepository covered persons who are subject to the CFPB’s examination and enforcement authority within one year of the Transfer Date. The Act provides the CFPB with “exclusive” enforcement authority to enforce federal consumer financial laws against these nondepository covered persons.² The effective date of this provision is the date of enactment of the Act.

B. CFPB’s Enforcement Authority over Insured Depository Institutions and Insured Credit Unions with Assets in Excess of \$10 Billion

The Act provides the CFPB with primary authority to enforce a federal consumer financial law with respect to any insured depository institution or insured credit union with total assets of more than \$10 billion (large institution), whereas smaller institutions remain subject to the primary enforcement authority of the prudential regulator.³ Any federal agency, other than the FTC, that is authorized to enforce a federal consumer financial law may recommend to the CFPB that the CFPB initiate an enforcement proceeding against a large institution. If the CFPB does not initiate an enforcement proceeding within 120 days of receipt of such recommendation, the agency that made the recommendation may initiate an enforcement proceeding, including performing follow-up supervisory and support functions, to assure compliance with such proceeding. The prudential regulators may enforce compliance with the requirements imposed by Title X of the Act under the Federal

² The term “federal consumer financial law” is broadly defined to mean the provisions of Title X, the laws for which authorities are transferred to the CFPB, and certain “enumerated consumer laws” including the Electronic Fund Transfer Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Real Estate Settlement Procedures Act, the Truth in Lending Act, and the Truth in Savings Act, among other laws. It also includes any rule or order prescribed by the CFPB under Title X, an enumerated consumer law, or the laws for which authorities are transferred to the CFPB. Notably, it does not include the Federal Trade Commission Act, thus preserving the FTC’s authority to enforce the Federal Trade Commission Act against nonbank entities engaged in financial activities.

³ The term “prudential regulator” means the appropriate federal banking agency for insured depository institutions, insured depository holding companies, and their subsidiaries, and the National Credit Union Administration for insured credit unions.

Credit Union Act, Section 8 of the FDI Act, or the Bank Service Company Act. The effective date of this provision is the Transfer Date.

C. Prudential Regulators' Enforcement Authority over Insured Depository Institutions and Insured Credit Unions with Assets of \$10 Billion or Less

Insured depository institutions and insured credit unions with total assets of \$10 billion or less will remain subject to the primary enforcement authority of the prudential regulator, with respect to the enforcement of federal consumer financial laws. The CFPB is required to notify the prudential regulatory and recommend appropriate action when it has reason to believe that such an entity has engaged in a material violation of a federal consumer financial law. Upon receiving a recommendation, the prudential regulator must respond to the CFPB within 60 days. Notably, the Act provides that a service provider to "a substantial number" of insured depository institutions and insured credit unions with total assets of \$10 billion or less will be subject to the enforcement authority of the CFPB.

D. Interagency Dispute-Resolution Process

The Act contains an interagency dispute-resolution process in connection with an examination of a large institution, which is immediately effective upon enactment of the Act. The CFPB and the prudential regulator of a large institution are required to coordinate and conduct simultaneous examinations of the entity unless the entity requests the examinations to be conducted separately. If the proposed supervisory determinations of the CFPB and a prudential supervisor conflict, the entity may request that the agencies present a joint statement of coordinated supervisory action within 30 days. The insured depository institution or insured credit union may appeal to a three person governing panel if the agencies fail to resolve their differences and issue a joint statement, or if one agency attempts to unilaterally take supervisory action without the consent of the other agency. The governing panel will consist of representatives of the CFPB and the prudential regulator who have not participated in, and do not report to a person who has participated in,

the material supervisory determinations under appeal. Additionally, the third member of the panel will consist of, on a rotating basis, either a representative of the Federal Reserve, the FDIC, the National Credit Union Administration, or the Office of the Comptroller of the Currency that is not involved in the dispute.

E. CFPB's Enforcement Powers

Subtitle E of Title X of the Act empowers the CFPB with enforcement authority that is generally similar to that of the other federal banking regulators, with a few notable exceptions. The CFPB may bring an administrative proceeding against a person or entity for a violation of a federal consumer financial law, as the federal banking agencies may do under Section 8 of the FDI Act. However, unlike the federal banking agencies, the CFPB may bring a civil action in federal district court or any other court with competent jurisdiction. When bringing a civil action, the CFPB must notify the US Attorney General and the appropriate prudential regulator. The CFPB may represent itself in such proceedings. The statute of limitations on bringing an action under Title X of the Act is three years after the date of discovery of the violation to which an action relates.

The Act provides that the CFPB may engage in joint investigations with the Secretary of the US Department of Housing and Urban Development, the US Attorney General, or both. The CFPB may also issue subpoenas for testimony or documents, issue civil investigative demands, and conduct hearings and adjudicative proceedings. The process for initiating a hearing or appealing the decision of a hearing is similar to the process governing the federal banking agencies.

The CFPB may seek the following relief in an administrative proceeding or court action:

- Rescission or reformation of contracts;
- Refund of money or return of real property;
- Restitution;
- Disgorgement or compensation for unjust enrichment;
- Payment of damages or other monetary relief;

- Public notification of the violation;
- Limits on the activities or functions of the person; and
- Civil money penalties.

The CFPB's restitution authority appears to be broader than that of the federal banking agencies because it does not require the agency to prove that the respondent was unjustly enriched in connection with a violation or practice or that the violation or practice involved a reckless disregard for the law, applicable regulations, or prior order.

F. Preservation of State Enforcement Powers

The Act specifically authorizes state attorneys general and other state regulators to bring civil actions or other appropriate actions available under state law to enforce the provisions of Title X or regulations issued thereunder. A state regulator may bring a civil action to enforce the provisions of Title X with respect to any entity that is state chartered, incorporated, licensed, or otherwise authorized to do business under state law. The Act does not alter or limit the authority of a state attorney general or any other regulatory agency to bring an action arising solely under a law in effect in that state.

Before initiating an administrative proceeding or court action against a covered person, a state attorney general or state regulator must provide prior notice to the CFPB and the prudential regulator. However, if such notice would be impracticable, the state attorney general or state regulator may provide the notice immediately upon instituting the action or proceeding. The notice must identify the parties, the alleged facts, and whether there may be a need for coordination. The CFPB may intervene, remove the action to the appropriate US district court, and be heard on all matters arising in the action.

We hope that you find this brief summary helpful. We can assist you in determining how the enforcement provisions of the Act may affect your business or industry. For further information, please contact your Arnold & Porter attorney or:

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ADVISORY

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Whistleblower Incentives and Protections in the Financial Reform Act

Employers subject to the regulations of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) should be aware that the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) was recently passed in Congress and signed by the President on July 21, 2010. The Act will create new financial incentives and protections for employees who disclose information about alleged violations of commodities and securities laws that subsequently lead to successful SEC or CFTC enforcement actions. Protections also are provided to employees of providers of consumer financial products and services that report violations of consumer financial protection laws and regulations. Each of these provisions must be implemented by the SEC, the CFTC, and the newly created Consumer Financial Protection Bureau (the Bureau) through the rulemaking process within 270 days of the enactment of the legislation.

Financial “Bounties” for Employees to Disclose Information

Spurred by the perceived failures of regulatory agencies to discover improprieties in the securities and commodities markets, Congress sought to create a whistleblower program to incentivize individuals to assist with government investigations. The Act would authorize the CFTC and SEC to provide monetary rewards to whistleblowers who provide “original information” that assists in a successful enforcement action under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 leading to the recovery of greater than US\$1 million in aggregate. These provisions would authorize the agencies to pay bounties ranging, at their discretion, from a minimum of 10 percent to a maximum of 30 percent of the total collected monetary sanctions from a corporation to any individual or group that discloses such “original information.”

These new monetary incentives will likely increase the number of employees who report information to the SEC or CFTC; they provide a financial award for any fruitful tips and, in combination with the additional protections discussed in this advisory, may offset the perceived risk to employees of filing reports that might have otherwise jeopardized their current or future employment.

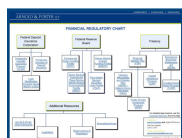
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Whistleblowers are allowed to make their initial reports on an anonymous basis if they are represented by counsel, and the SEC and the CFTC are prohibited from disclosing any information “which could reasonably be expected to reveal the identity of a whistleblower.” In addition to these provisions, the SEC Enforcement Division has recently adopted a range of new tools designed to encourage individual cooperation with SEC investigations, ranging from the adoption of criteria to evaluate cooperation by individuals to deferred and non-prosecution agreements to facilitation of immunity requests.

Congress modeled the new whistleblower program after the successful Internal Revenue Service (IRS) Whistleblower Program, created in 2006, which mandated a minimum award percentage for successful tips and led to an increase in the number of tips received by the IRS regarding violations of tax laws. This new program has also been compared to the qui tam provisions of the False Claims Act, under which there have been large settlements in areas such as healthcare. There is certainly the potential that the program could be a boon to law enforcement in connection with laws such as the Foreign Corrupt Practices Act, under which there have been numerous recent large settlements. Given the key role of counsel in protecting the identity of the whistleblower, it is not unreasonable to expect that qui tam relators counsel, who have profited handsomely from the False Claims Act, will see this as a new opportunity for additional clients.

Prohibition on Reprisal for Employee’s Disclosure of Alleged Wrongdoing

Further encouraging employees to report allegedly improper actions by their employers, the Act expands on whistleblower protections in the Sarbanes-Oxley Act (SOX) by prohibiting employers from retaliating against employees who have acted lawfully in providing information to the SEC or CFTC about alleged commodities and securities violations. Employers would be barred from firing, demoting, or otherwise discriminating against an employee based on that employee’s lawful disclosure of information or assistance with an investigation of either the SEC or the CFTC.

Under the Act, employees who have been discharged or discriminated against are given a private right of action to sue their employers for retaliation. Unlike the SOX whistleblower provisions, the Act does not require the exhaustion of administrative remedies. While the precise type of violation

necessary to trigger the statute of limitations lacks clarity in the Act’s language, the Act appears to permit an employee who alleges that he or she suffered an adverse employment action based on providing information to or assisting the SEC or CFTC to file a complaint directly in federal court if the employee reported the alleged violation (1) to the CFTC, for a period of up to two years after the alleged retaliatory act transpired; or (2) to the SEC, the later of (a) six years after the alleged retaliatory act, (b) three years after the employee reasonably should have discovered the retaliatory act, or (c) no later than 10 years after the alleged violation of the securities laws. These limitations periods are significantly longer than provided for in the SOX whistleblower provisions.

An employer found liable for retaliating against a whistleblowing employee could be ordered to pay substantial damages and take certain actions including:

- Reinstating the employee with the same seniority status that the employee would have had if the alleged discrimination had never occurred;
- Paying the employee back pay with interest for claims relating to commodities violations or double back pay (i.e., twice the amount in the SOX provision) with interest for claims relating to securities violations; and
- Compensating the employee for litigation costs, expert witness fees, and reasonable attorneys’ fees.

Finally, the provisions require that the SEC and/or CFTC hold all information provided by a whistleblowing employee in strict confidence. This stipulation may be particularly burdensome to employers as an employee suing under the Act retains his or her right to sue under any other applicable state or federal law, without such claim being preempted.

Consumer Financial Services Employee’s Protection from Retaliation

Aside from creating the private right of action for whistleblowers, the Act creates protections for employees of providers of consumer financial products and services that will be regulated by the Bureau. Specifically, under the title providing for the creation of the Bureau, a consumer financial services employee may file a complaint with the US Department of Labor (DOL) against his or her employer if he or she believes that he or she has been discharged, demoted, or otherwise discriminated against for:

- Providing information, directly or indirectly, to the employer, the Bureau, or any other government authority relating to any violation of any law or regulation subject to the jurisdiction of the Bureau;
- Testifying in enforcement proceedings;
- Filing or instituting any proceeding under any federal consumer financial law; or
- Objecting to participate in any activity that he or she reasonably believes to be a violation of a law or regulation enforceable by the Bureau.

Such a complaint must be filed with DOL within 180 days of the adverse employment action. The Secretary of Labor shall investigate the matter so long as the employee plausibly asserted that one of the four protected activities contributed to the discharge or discrimination and the employer cannot satisfy the high burden of proving that it would have taken the same action regardless of the employee's participation in that protected activity. If the Secretary finds a violation, he or she has the power to order remedies, including ordering the employer to abate the reprisal, to reinstate the employer to his or her previous position and providing the employee with missed compensation and benefits from the reprisal period, and ordering the employer to pay compensatory damages.

Additionally, the complaining employee will accrue a private cause of action within 90 days of receiving a written determination or if the Secretary fails to issue an order within 210 days of the submission of the complaint. The complaining employee will be allowed to file a private civil lawsuit in federal district court to seek compensatory damages and other relief. The case would be a *de novo* action, meaning that the federal court would look at the issue without regard to any prior findings by the Secretary of Labor. Federal district courts have jurisdiction to hear all cases arising out of this whistleblower provision without regard to the amount in controversy, and the employee or the employer may elect to have the case tried before a jury.

Liability for a Subsidiary's Actions under the Sarbanes-Oxley Act

In addition to creating its own new protections for whistleblowers, the Act also reinforces whistleblower provisions of SOX. SOX contains a provision providing whistleblower protection from retaliation for employees of

publicly traded companies who have provided the SEC with information relating to securities fraud. The new legislation confirms those protections extend to the employees of subsidiaries "whose financial information is included in the consolidated financial statements of [a publicly] traded company" rather than merely direct employees of the publicly traded companies.

The statute is now clear that a subsidiary may not terminate or otherwise discipline an employee who has provided information to the SEC, federal prosecutors, or Congress. If the employee sues, the company may be forced to provide back pay, reinstate the employee, and pay the employee's attorney and court costs. Thus, public companies should carefully monitor proper compliance with SOX's whistleblower provisions by their subsidiaries.

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

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Private Fund Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), which was signed by the President and became law on July 21, 2010, will significantly increase federal regulation and oversight of private investment funds and their managers.

Title IV of the Act, the Private Fund Investment Advisers Registration Act of 2010, amends the Investment Advisers Act of 1940 (Advisers Act) to impose US Securities and Exchange Commission (SEC) registration, reporting, and record keeping obligations on investment advisers to “private funds” (which include hedge funds, private equity funds, and other private funds) that have assets under management in the United States of \$150 million or more, subject to certain limited exemptions.

The Act specifies records to be maintained by advisers to private funds and grants broad authority to the SEC to require reports by, and conduct inspections of, private fund advisers. Information obtained by the SEC may be shared with the Financial Stability Oversight Council (FSOC) to assist in determining whether to designate a private investment fund or its investment adviser as “systemically significant” and therefore subject to supervision by the Board of Governors of the Federal Reserve System (Federal Reserve), capital requirements, risk controls, pre-packaged liquidation plan requirements, the orderly liquidation authority of the Federal Deposit Insurance Corporation (FDIC), and other significant and pervasive regulatory requirements that will apply to financial companies so designated under Titles I and II of the Act.

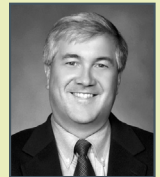
The effective date of Title IV is one year after enactment of the Act except as otherwise provided, but an investment adviser to a private fund is permitted to register under the Advisers Act during the one-year transition period, subject to SEC rules.

The provisions in Title IV, and other provisions of the Act that affect private funds and their advisers, are discussed in this advisory.

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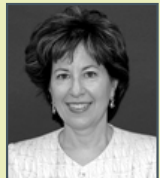
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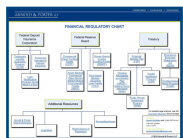
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Title IV. The Private Fund Investment Advisers Registration Act

Amendments to Impose Advisers Act Requirements on Advisers to Private Funds

Advisers to “private funds”¹ will become subject to Advisers Act regulation under the Act through an amendment that eliminates the current exemption in Section 203(b)(3) of the Advisers Act for investment advisers who, during the course of the preceding 12 months, had fewer than 15 clients (with a fund counting as a single client), and who do not hold themselves out to the public as an investment adviser nor act as an investment adviser to a registered investment company or a business development company. The elimination of the “private adviser” exemption from registration applies to investment advisers with less than 15 clients generally and not just to private fund advisers. Newly registered advisers will become subject to existing Advisers Act disclosure, record-keeping, custody, antifraud, and compliance requirements, as well as the additional requirements for private fund advisers discussed below.

Exemptions from Advisers Act Registration

In general, most advisers to hedge funds and private equity funds will be required to register with the SEC as investment advisers. However, the Act carves out a series of exemptions from the registration requirements of the Advisers Act, based upon assets under management or type of private fund.

- ***Registration Exemption for Investment Advisers that Act as Advisers Solely to Venture Capital Funds.*** The Act exempts from registration an investment adviser that acts as an investment adviser solely to one or more “venture capital funds” (to be defined by SEC rule not later than one year after enactment). The SEC must require such advisers to maintain records and provide to the SEC annual or other reports.
 - ***Exemption for Investment Advisers to Small Business Investment Companies.*** Investment advisers, other than those that are regulated or have elected to be regulated as business development companies, who solely advise small business investment companies (SBIC) are exempt from Advisers Act registration.³
 - ***Exemption for Investment Advisers to Family Offices.*** The Act amends the definition of an “investment adviser” to exclude any “family office,” as defined by SEC rule, regulation, or order. Any SEC rule, regulation, or order defining the term “family office” must be consistent with prior SEC exemptive orders and must recognize the range of organizational, management, and employment structures and arrangements employed by family offices. In addition, under a grandfathering provision, the definition of “family office” must not exclude any person who was not registered or required to be registered under the Advisers Act on January 1, 2010 solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to, certain enumerated categories of investors.⁴ A family office that would not be a family office but for the grandfathering provision is deemed to be an investment adviser for purposes of the antifraud provisions in paragraphs (1), (2), and (4) of Section 206 of the Advisers Act. These provisions are designed to eliminate the need for individual case-by-case SEC exemptive orders for family offices.⁵
 - ***Limited Exemption for Foreign Private Advisers.*** The Act exempts any investment adviser that is a “foreign private adviser” from Advisers Act registration. The term “foreign private adviser” refers to any investment adviser
- ***Registration Exemption for Investment Advisers with under \$150 Million in US Assets under Management that Act as Advisers Solely to Private Funds.*** The Act directs the SEC to create an exemption from registration for any investment adviser that acts solely as an investment adviser to private funds and that has assets under management in the United States of less than \$150 million. (However, as discussed below, investment advisers that have clients *other than* private funds would be subject to SEC or state registration requirements based upon other asset thresholds.) The SEC must require advisers to such “mid-sized” funds to maintain records and provide the SEC with annual or other reports as determined by the SEC.²

who: (1) has no place of business in the United States; (2) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser; (3) has aggregate assets under management attributable to US clients and US investors in private funds advised by the investment adviser of less than \$25 million (or such higher amount as the SEC may, by rule, deem appropriate); and (4) neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to any investment company registered under the Investment Company Act or to a company that has elected to be a business development company. Because this exemption has several conditions, many foreign advisers may be required to register with the SEC. Foreign advisers that do not fall within the exemption but nevertheless have a limited number of US investors or assets under management in the US and limited US contacts may wish to evaluate whether to discontinue providing services to US clients.

- **Elimination of Intrastate Exemption for Private Fund Advisers.** Investment advisers to private funds will no longer be permitted to rely on the intrastate exemption from Investment Adviser Act registration applicable to advisers whose clients reside in the state in which such adviser maintains its principal place of business.⁶

Federal and State Jurisdiction

At the present time, investment advisers with assets under management of less than \$25 million are generally not permitted to register with the SEC, but are instead subject to state registration. The Act effectively raises this threshold to \$100 million in most cases by providing that an adviser with assets under management of greater than \$25 million and up to \$100 million (or a higher amount set by SEC rule) that is required to be registered and subject to examination under the laws of the state in which it has its principal office and place of business may not register with the SEC. However, if the investment adviser would be required to register with 15 or more states, then the adviser is permitted to register with the SEC. In addition, as has previously been the case, SEC

registration is required if the adviser acts as an investment adviser to a registered investment company or a business development company.

This provision applies generally and is not limited to advisers to private funds. The increase in the statutory assets under management threshold may require many mid-sized investment advisers to register with the states rather than the SEC.

Record-Keeping, Reporting, and Registration Requirements

The Act gives the SEC authority to require advisers to private funds to maintain records and file reports with the SEC. These requirements, which will be further established by SEC rule, must include, for each private fund managed by the adviser, a description of:

- The amount of assets under management;
- Use of leverage, including off-balance sheet leverage;
- Counterparty credit risk exposure;
- Trading and investment positions;
- Valuation policies and practices;
- Types of assets held;
- Side arrangements or side letters;
- Trading practices; and
- Other information that the SEC, in consultation with the FSOC, determines is necessary or appropriate in the public interest or for the assessment of systemic risk.

The SEC may establish different reporting requirements for different classes of fund advisers, based upon the type or size of private fund being advised. The records of a private fund maintained by a registered private fund adviser are subject to periodic, special, and other examinations by the SEC.

Although the Act does not include specific requirements for disclosure to investors in private funds, there appears to be nothing prohibiting the SEC from requiring additional disclosures to investors and prospective investors pursuant to its authority under Sections 204, 206(4), and 211(a) of the Advisers Act.

Information Sharing

The SEC must make available to the FSOC all reports and records filed with or provided to the SEC by a registered private fund adviser for the purpose of assessing systemic risk of a private fund. These reports will be used in connection with the FSOC's determination of whether to designate a private investment fund as "systemically significant" and therefore subject to Federal Reserve supervision. Private funds that are so designated may be subject to heightened prudential standards, including capital requirements, risk controls, pre-packaged liquidation plan requirements, the FDIC's orderly liquidation authority, and other significant and pervasive regulatory requirements that will apply to financial companies so designated under Titles I and II of the Act.

Protection of Confidential and Proprietary Information

Because records and reports of a private fund are deemed to be records and reports of its registered adviser, the SEC and the FSOC will have access to a private fund's records. However, the Act protects confidential and proprietary information included in reports and records filed with or provided to the SEC by a registered private fund adviser in the following ways:

- The SEC may not be compelled to disclose any report or information required to be filed with the SEC by a private fund adviser, except upon the request of a federal department or agency, any self-regulatory organization (SRO) within the scope of its jurisdiction, or Congress, or to comply with a court order.
- The FSOC and any department, agency, or SRO that receives reports and other information from the SEC under the Act must keep it confidential, and such reports and information are exempt from disclosure under the Freedom of Information Act (FOIA).
- The Act provides enhanced protection for "proprietary information"⁷ of a private fund adviser ascertained by the SEC from any report required to be filed with the SEC. This information is subject to the same limitations on public disclosure as any facts ascertained during an investment adviser examination under Section 210(b) of the Advisers Act.⁸

Confidential Client Information

Section 210(c) of the Advisers Act currently protects the confidential information of investment advisers' clients from unwarranted government intrusion by providing that the SEC is not authorized to require any investment adviser to disclose the identity, investments, or affairs of any client of the adviser, except insofar as the disclosure may be necessary or appropriate in a particular proceeding or investigation having as its object the enforcement of Adviser Act provisions. The Act modifies Section 210(c) by permitting the SEC to require any investment adviser to disclose the identity, investments, or affairs of any client "insofar as such disclosure may be necessary or appropriate in a particular proceeding or investigation...or for purposes of assessment of potential systemic risk." (emphasis added)

Custody of Adviser Client Accounts

The Act requires registered investment advisers to take such steps to safeguard client assets over which the adviser has custody, including verification of such assets by an independent public accountant, as the SEC may prescribe by rule. The SEC recently adopted amendments to Advisers Act custody and recordkeeping rules, effective March 12, 2010.⁹

Definition of the Term "Client"

The Act clarifies that the SEC's rulemaking authority under Section 211(a) of the Advisers Act includes authority to issue, amend, and rescind SEC rules and regulations defining "technical, trade and other terms." However, the SEC may not define the term "client" for purposes of the antifraud provisions of paragraphs (1) and (2) of Section 206 of the Advisers Act to include an investor in a private fund managed by an investment adviser if the private fund has entered into an advisory contract with the adviser. This provision is intended to avoid potential conflicts between the fiduciary duty an adviser owes to a private fund and to the individual investors in the fund (if those investors were defined as clients of the adviser). The Act recognizes that actions in the best interest of the fund may not always be in the best interests of each individual investor. However, the SEC has authority to define the term "client" to include an investor in a private fund for purposes of other sections of the Advisers Act.

Joint SEC/CFTC Rulemaking

The SEC and the US Commodity Futures Trading Commission (CFTC) must, after consultation with the FSOC, but not later than 12 months after enactment, jointly promulgate rules to establish the form and content of reports to be filed by private fund advisers with the SEC and with the CFTC by investment advisers that are registered both under the Advisers Act and the Commodity Exchange Act.

Adjustment to the “Accredited Investor” Standard

During the four-year period that begins on the date of enactment of the Act, the net worth standard for a natural person to qualify as an “accredited investor”¹⁰ under the Securities Act of 1933 (Securities Act) is \$1 million, *excluding* the value of the primary residence of the natural person.¹¹ Prior to enactment of the Act, individual investors could include their primary residence in the net worth calculation. This change, which is effective immediately, will make it harder for many individual investors to qualify as an accredited investor. Four years after enactment of the Act, the SEC must increase the net worth standard for individual investors to more than \$1 million. The change in the definition of an accredited investor applies generally and not only to private funds, and private funds and other issuers should review their offering documents accordingly. The SEC must conduct periodic reviews of the definition.¹²

Adjustment to the Qualified Client Standard

Rule 205-3 under the Advisers Act provides an exemption from the prohibition on incentive fees for “qualified clients” (as defined in the rule).¹³ The Act amends Section 205(e)¹⁴ of the Advisers Act to require the SEC to make an inflation adjustment if the SEC uses a dollar amount test, such as a net asset threshold, as a factor in any SEC rule under Section 205(e). The SEC must issue an order not later than one year after the date of enactment, and every five years thereafter, to adjust for the effects of inflation on the test.

Studies

Title IV of the Act requires the GAO to conduct studies and reports on custody rule costs, the criteria for accredited investors, and the feasibility of an SRO for private funds, and requires the SEC to conduct separate studies on short selling.

Other Provisions of Interest to Private Funds

Systemic Risk Regulation. Under Title I of the Act, the FSOC has authority to require nonbank financial companies, including private funds and their advisers, to be supervised by the Federal Reserve if the FSOC determines that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness and mix of its activities, could pose a threat to US financial stability. A private fund that becomes subject to Federal Reserve supervision in this manner may be subject to heightened prudential standards, including concentration limits, leverage limits, liquidity requirements, resolution plan, credit exposure report requirements, risk-based capital requirements, a contingent capital requirement, restrictions on management interlocks, and overall risk management requirements. Further information is available in our advisory, “Dodd-Frank Act Addresses Systemic Risk.”¹⁵

Orderly Liquidation Authority. Title II of the Act provides orderly liquidation procedures in cases where authorities find that a nonbank financial company supervised by the Federal Reserve (which could include a private fund or adviser) is in default or danger of default and that, among other things, its failure and resolution would otherwise have serious adverse effects on US financial stability. In such a case, the FDIC would be appointed as receiver with the task of liquidating the company in an orderly manner, under new statutory provisions similar to the receivership provisions in the Federal Deposit Insurance Act.

To carry out these functions, Title II creates an “Orderly Liquidation Fund” (OLF), to be funded by FDIC obligations issued to the Treasury and then repaid with proceeds from the liquidated firm’s assets. If necessary, however, assessments could be charged to “eligible financial companies,” including, potentially, private funds and advisers supervised by the Federal Reserve, and any bank holding company with total consolidated assets of \$50 billion or more. Assessments will be imposed on a graduated basis, with financial companies having greater assets and risk being assessed at a higher rate. Further information on Title II is available in our advisory,

“Dodd-Frank Act Creates New Resolution Process for Systemically Significant Institutions.”¹⁶

Over-the-Counter Derivatives Regulation. Under Title VII of the Act, new capital, margin, registration, recordkeeping, and related requirements will be imposed on “swap dealers” and “major swap participants.” Private funds could fall within the definition of a “major swap participant” and in some cases a “swap dealer.” In brief, a “swap dealer” is any person holding itself out as a dealer in swaps, who makes a market in swaps, who regularly enters into swaps as an ordinary course of business for its own account, or engages in any activity causing the person to be commonly known as a dealer or market maker. A “major swap participant” is (i) a person who maintains a substantial position in swaps (excluding any held to mitigate commercial risk); (ii) a person whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on financial stability; or (iii) a highly leveraged financial entity that is not subject to capital requirements under banking rules and that maintains a substantial position in outstanding swaps in categories determined by regulators.

Title VII establishes SEC authority over security-based swaps, and CFTC authority over others. Title VII specifies requirements for exchange trading (or trading on a swap execution facility) and centralized clearing for swaps meeting specified criteria. The CFTC and SEC will, in general, review clearing standards and determine whether a given type of swap must be cleared and/or traded on such an exchange or facility. Regulators also are authorized to establish position limits with respect to certain swap transactions, as deemed appropriate. Private funds that participate in derivatives trades may not be able to take large positions in certain swaps if the regulators decide to establish more restrictive position limits. Further information regarding the Act’s impact on derivatives trading is available in our advisory, “Dodd-Frank Wall Street Reform and Consumer Protection Act to Significantly Impact Derivatives Trading of Banks.”¹⁷

Other Provisions. Titles VII and IX include a number of other provisions of interest to private fund advisers and other investment advisers.

- **Short Sale Reporting and Disclosure.** Title IX of the Act directs the SEC to issue rules for public disclosure of aggregate short sale data for individual securities on a no-less-than-monthly basis. The disclosure must include the name of the issuer and the title, class, CUSIP number, and any additional information determined by the SEC. The Act prohibits manipulative short sales and directs the SEC to issue rules to ensure appropriate enforcement remedies are available for violations of this prohibition. It also requires broker-dealers to notify customers that they may elect not to allow their fully paid securities to be used in connection with short sales, and that the broker may receive compensation if the shares are so used.¹⁸
- **Whistleblower Incentives and Protections.** Title IX authorizes the SEC to pay bounties of up to 10 percent to 30 percent of funds collected to whistleblowers in SEC enforcement actions that result in monetary sanctions exceeding \$1 million. It also prohibits employer discrimination against whistleblowers and gives employees a private right of action against employers who retaliate against them.
- **Broader SEC Enforcement Powers.** The Act increases the jurisdictional scope and causes of action that the SEC can bring, as well as the remedies that can be imposed. Title IX:
 - Amends the Securities Act, Exchange Act, and Investment Company Act to provide that in an enforcement action by the SEC, persons may be held liable for knowingly or recklessly providing substantial assistance to another person in violation of the securities laws. The Advisers Act is amended to provide for such liability for persons that knowingly or recklessly aid, abet, counsel, command, induce, or procure a violation.
 - Permits the SEC to impose civil monetary penalties in administrative cease-and-desist proceedings against any person found to have violated securities laws. Previously, civil penalties could be imposed in administrative actions only against regulated entities (such as broker-dealers, investment advisers, and mutual funds) and associated persons.

- Extends the jurisdiction of US courts in actions or proceedings brought or instituted by the SEC or the United States alleging a violation of the antifraud provisions of the federal securities laws to cover (i) securities transactions outside the United States, where conduct within the United States constitutes “significant steps in furtherance of the violation;” or (ii) conduct occurring outside the United States that has a “foreseeable substantial effect” within the United States.
- Clarifies that controlling person liability under Section 20(a) of the Exchange Act applies in SEC enforcement actions, not only in private actions.
- Amends the Exchange Act and the Advisers Act to give the SEC authority to bar offenders from associating with a broad range of SEC-regulated entities (e.g., investment advisers, brokers, dealers, municipal securities dealers, municipal advisers, transfer agents, and nationally recognized statistical rating organizations). Previously, offenders barred for securities law violations in one type of regulated entity could find work in another part of the securities industry.
- Gives the SEC authority to subpoena witnesses located anywhere in the United States in civil actions filed in federal court.¹⁹
- Gives SEC staff 180 days after giving a Wells Notice to any person to file an enforcement action against such person or provide notice to the Director of the Division of Enforcement of its intent to not file an action. In addition, gives the SEC staff 180 days after completing an onsite examination or receiving all requested records, whichever is later, to request corrective action or provide written notice that the examination has concluded. Both deadlines are subject to additional 180-day extensions by the SEC in complex cases with notice to (and for the subsequent extensions, approval of) the SEC.
- **Broader CFTC Enforcement Powers.** Title VII of the Act significantly increases the enforcement powers of the CFTC:
 - The Act broadens the CFTC’s enforcement authority with regard to commodity futures contracts and swaps by including fraud liability provisions that parallel Section 10(b) of the Exchange Act with respect to securities. Specifically, the Act achieves this by amending Section 4b of the Commodity Exchange Act and adding language that prohibits derivatives participants from: employing any device, scheme, or artifice to defraud; making any untrue statement of material fact or omitting any statement of material fact necessary in order to make the statements made misleading; or engaging in any act, practice or course of business which operates as a fraud or deceit upon any person.
 - The Act also provides the CFTC with enforcement authority over market participants that engage in “disruptive practices.” The Act defines such disruptive practices to include: activities violating bids or offers; intentional or reckless disregard for the orderly execution of transactions during the closing period of a market; and “spoofing” (bidding or offering with the intent to cancel the bid or offer before execution).
 - The Act also expands the CFTC’s anti-manipulation authority, and broadens the types of activities that are considered manipulation. For instance, it reduces the scienter requirement for manipulation in the reporting context by changing the standard of such conduct to include acting in *reckless* disregard of the fact that such report is false, misleading, or inaccurate.
- **Miscellaneous Provisions.** Title IX also:
 - Authorizes the SEC to require earlier filing of beneficial ownership reports required by Section 13(d) of the Exchange Act (current law requires reporting “within ten days of acquisition”) and eliminates requirements to send related notices to the issuer and exchanges. A similar accelerated time frame would be allowed for “short swing” reporting under Exchange Act Section 16.
 - Requires the SEC to issue rules within one year after enactment of the Act to disqualify felons and other “bad actors” from participating in exempt offerings of

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securities made under Rule 506 of Regulation D.

- Requires persons who have custody or use of securities, deposits or credits of a registered investment company or of clients of registered investment advisers to comply with recordkeeping requirements as the SEC may prescribe and subjects such records to examinations.
- Gives the SEC authority to prohibit or impose conditions or limitations on the use of mandatory pre-dispute arbitration agreements with customers of brokers, dealers, municipal securities dealers and investment advisers.

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

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(Endnotes)

- 1 The Act defines a “private fund” as an issuer that would be an investment company under the Investment Company Act of 1940 (Investment Company Act) but for the exceptions provided in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Section 3(c)(1) excludes from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 investors and which is not making a public offering. Section 3(c)(7) excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are “qualified purchasers,” and which is not making a public offering. The term “qualified purchasers” is defined in Section 2(a)(51) of the Investment Company Act and includes institutions with \$25 million or more in investments and individuals and family companies with \$5 million or more in investments.
- 2 In prescribing regulations for advisers to such “mid-sized” private funds, the SEC must take into account the size, governance, and investment strategy of the funds to determine whether they pose systemic risk, and must provide for registration and examination procedures for the advisers of these funds that reflect the level of systemic risk posed by the funds.
- 3 The exemption applies to investment advisers who solely advise small business investment companies that are licensed under the Small Business Investment Act of 1958; entities that have received from the Small Business Administration notice to proceed to qualify for a license, which notice or license has not been revoked; or applicants affiliated with one or more licensed small business investment companies that have applied for another license, which application remains pending.
- 4 The enumerated categories of investors include:
 - (A) Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who:
 - (i) have invested with the family office before January 1, 2010; and
 - (ii) are accredited investors, as defined in Regulation D under the Securities Act or, as the SEC may prescribe by rule, the successors-in-interest thereto;
 - (B) Any company owned exclusively and controlled by members of the family of the family office, or as the SEC may prescribe by rule;
 - (C) Any investment adviser registered under the Advisers Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds

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advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represent, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice.

- 5 Many high net worth families operate offices to manage the personal and financial affairs of family members. For smaller families, the old “fewer than 15” clients exemption in Section 203 of the Advisers Act, and SEC rules which defined relatives living in a single household as one “client” for this purpose, have provided an exemption from Advisers Act registration for these “family offices.” Since the 1940s, however, the SEC has issued individual orders exempting from the Advisers Act certain family offices on a case-by-case basis (typically offices of larger, multi-generational families). The SEC in the past took the view that it did not have statutory authority to grant these exemptions by rule of general applicability, but only by individual orders.
- 6 Section 203(b)(1) of the Advisers Act exempts from registration any investment adviser all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange.
- 7 “Proprietary information” includes sensitive, non-public information regarding the investment adviser’s investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and any additional information that the SEC determines to be proprietary.
- 8 Section 210(b) of the Advisers Act generally prohibits the SEC and its staff from disclosing the existence of any examination under the Advisers Act or the results of or any facts ascertained during any such examination.
- 9 See Release IA-2968, Custody of Funds or Securities of Clients by Investment Advisers, Dec. 30, 2009, available at: <http://www.sec.gov/rules/final/2009/ia-2968.pdf>.
- 10 The term “accredited investor,” as defined in Rule 501(a) of Regulation D under the Securities Act for purposes of certain exempt offerings, includes:
 - Individuals who have a net worth, or joint worth with their spouse, above \$1 million, or have income above \$200,000 in each of the last two years (or joint income with their spouse above \$300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, executive officers or general partners of the issuer of the securities or its general partner; and
 - Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than \$5 million in assets; and qualified employee benefit plans and trusts with more than \$5 million in assets.
- 11 The SEC has issued an interpretation that the amount of any associated mortgage and other indebtedness secured by the primary residence up to its fair market value may be excluded in determining an individual’s net worth. Any excess liability should be deducted from the investor’s net worth. See Compliance Disclosure and Interpretation (CDI) 179.01 (or identical CDI 255.47).
- 12 The SEC may undertake an initial review of the definition of an “accredited investor,” as the term applies to natural persons, to determine whether the definition, excluding the requirement relating to the net worth standard described above, should be adjusted or modified, and following completion of the review, may make adjustments to the definition (except as to the net worth standard requirement) after notice and comment rulemaking. The SEC is required to conduct a review, not earlier than four years after enactment and not less frequently than every four years thereafter, of the definition of “accredited investor” in its entirety as defined in Rule 215 of the Securities Act. Upon completion of this review, the SEC may make adjustments to the definition of “accredited investor” as defined in Rule 215 after notice and comment rulemaking. (The Act does not require a review of the definition of an “accredited investor” in Rule 501(a) of Regulation D every four years. Rather, this review is only required with respect to the definition of an “accredited investor” for purposes of Rule 215, which affects the Section 4(6) exemption from registration under the Securities Act.)
- 13 Rule 205-3 generally defines a “qualified client” as one of the following:
 - (1) A natural person or company that has \$750,000 under the management of the adviser; or
 - (2) A natural person or company whom the adviser reasonably believes has (a) a net worth of more than \$1.5 million; or (b) is a “qualified purchaser” as defined in Section 2(a)(51) of the Investment Company Act; or
 - (3) An executive officer, director, trustee, or general partner of the adviser, or an employee that participates in the investment activities of the adviser with at least 12 months investment experience.
- 14 Section 205(e) of the Advisers Act permits the SEC to exempt any person or transaction from the Advisers Act limitations on incentive fees set forth in Section 205(a)(1) if the SEC determines such person does not need this protection on the basis of financial sophistication, net worth, knowledge of and experience in financial matters, and certain other factors.
- 15 Available at: http://www.arnoldporter.com/public_document.cfm?id=16151&key=17B3.
- 16 Available at: http://www.arnoldporter.com/public_document.cfm?id=16155&key=12F3.
- 17 Available at: http://www.arnoldporter.com/public_document.cfm?id=16138&key=26I2.
- 18 In addition to the rulemaking on short sale reporting and disclosure, the SEC is required to conduct a study of the feasibility, benefits and costs of requiring reporting of short sale positions to the public, or alternatively, only to the SEC and the Financial Industry Regulatory Authority. A separate study is required on the state of short selling, with consideration given to the impact of recent rule changes and failures to deliver.
- 19 Previously, the applicable federal rule of civil procedure placed a geographical limit on how far a witness could be required to travel, which meant that juries in federal court cases often watched videotaped depositions rather than live testimony. However, nationwide service of process will now be available to defendants in SEC federal court cases as well. The SEC currently has nationwide subpoena authority in administrative proceedings.

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

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

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

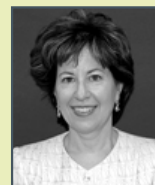
In this advisory, we discuss the executive compensation and governance provisions in the Act, together with practical suggestions that companies might consider to be ready for the new requirements. Separate sections discuss executive compensation and governance provisions that relate solely to financial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

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

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Financial Regulatory Chart

Financial Regulatory Reform: For Arnold & Porter's latest resources on this topic including Advisories, upcoming events, and publications, please visit [Financial Regulatory Reform](#). Also visit our [Financial Regulatory Chart](#), which aggregates information on US government programs.

vote on the compensation of executive officers (as disclosed under Item 402 of Regulation S-K), as well as a separate resolution to determine whether future “say-on-pay” votes should occur on an annual, biannual, or triennial basis. Companies must hold a shareholder vote no less than every six years to reconsider whether to hold the say-on-pay vote annually, biennially, or triennially. Presumably, companies may try to match shareholder votes with the objectives of their compensation programs. If, for example, a company’s pay programs emphasize multiyear performance, as is generally the case, a staggered “say-on-pay” vote may be easier to justify.

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

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

Companies should consider undertaking a comprehensive review of executive compensation with a view toward gaining shareholder support. This review should include the new executive compensation requirements added by the Act (discussed below), as well as a fresh look at the executive compensation disclosures included in last year’s proxy

statement. Companies also should strive to make their presentation of executive compensation clearer and more persuasive, providing compelling reasons for compensation decisions and analysis in the Compensation Disclosure & Analysis (CD&A) section of the proxy statement.

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

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

1 See RiskMetrics Group, *Evaluating U.S. Company Management Say on Pay Proposals*, March 16, 2009, available at: <http://www.riskmetrics.com/docs/2009EvaluatingSayOnPay> (with free registration on the site).

2 See Council of Institutional Shareholders, *Top Ten Red Flags to Watch for When Casting an Advisory Vote on Executive Pay*, Mar. 2010, available at: <http://www.cii.org/UserFiles/file/resource%20center/publications/March%202010%20-%20Say%20on%20Pay%20Checklist.pdf>.

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

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

Clawback of Incentive-Based Compensation. The Act requires the SEC, by rule, to direct national securities exchanges to prohibit the listing of any security of an issuer that does not develop and implement a policy to “clawback” compensation from current or former executive officers who received incentive-based compensation (including stock options) during the three-year period preceding the date of an accounting restatement, in excess of what would have been paid under the accounting restatement. The SEC must also direct the exchanges to require listed companies to develop and implement a policy providing for disclosure of the company’s policy on incentive-based compensation that is based on financial information required to be reported under the securities laws. No

deadline for SEC rulemaking is specified.

This provision is broader than the clawback provision in the Sarbanes-Oxley Act.³ In addition, the Act’s clawback provision applies *irrespective* of whether any misconduct occurred.⁴ Even though accounting restatements do not necessarily involve wrongdoing, the Act’s clawback provision can reach to executive officers who are not even aware of a problem.

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

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

⁴ In a recent decision, the Arizona district court denied a motion to dismiss the SEC’s complaint in an action against the former CEO of CSK Auto Corp. under the Sarbanes-Oxley Act even though the SEC had not alleged that the CEO was involved in the securities fraud or knew that the company’s financial statements were misleading. The court stated that the Sarbanes-Oxley Act requires only misconduct of the issuer, and does not require specific misconduct, or even personal awareness of financial misconduct, of the issuer’s CEO or CFO. See *SEC v. Jenkins*, No. CV 09-1510-PHX-GMS, 2010 WL 2347020 (D. Ariz. June 9, 2010). This case is not binding in other jurisdictions and could be appealed.

Listed companies may wish to consider whether protective steps, such as indemnifying executives (to the extent permitted by state law) and modifying directors and officers (D&O) liability insurance that would otherwise exclude clawback claims from coverage, can be taken to protect executives from unfair application of the provision. Companies also may decide to evaluate whether a greater proportion of executive compensation should be in the form of salary and guaranteed payments and less as incentive or equity-based compensation.

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

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

The "new" requirement in the Act that companies disclose in their proxy statement the relationship between executive compensation paid and the company's financial performance taking into account any change in its stock price takes us back to an "old" SEC rule that required companies to include a stock performance graph in their proxy statements. The SEC repealed this requirement in 2006, noting that stock performance information is widely available and that the executive compensation disclosure

contained in CD&A is intended to encourage broader discussion than just the relationship of compensation to company performance as reflected in its stock price.⁵ Currently, a performance graph is required only in the company's annual report to shareholders.⁶

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

Patrick McGurn, Special Counsel to RiskMetrics' Governance Services unit, stated in May 2010 that if pay equity disclosure were enacted into law, the result could be "the most inflammatory number that's ever been in the proxy statement."⁷ Companies should focus in advance on the calculation and consider the impression that pay equity disclosure will make on both employees and shareholders (particularly in light of the new say-on-pay requirement). Consideration should be given to factors that affect internal pay equity. For example, a company that outsources a higher proportion of jobs to lower paying jurisdictions may appear to have relatively better internal pay equity statistics than peers providing lower paying jobs. Companies also may wish to think about conducting a more meaningful internal pay equity analysis than that required by the Act. Additional internal pay equity calculations (such as comparing CEO pay to the pay of

5 See SEC Release No. 33-8732A, Aug. 29, 2006, available at: <http://edgar.sec.gov/rules/final/2006/33-8732a.pdf>, and the related proposing release, Release No. 33-8655, Jan. 27, 2006, available at: <http://www.sec.gov/rules/proposed/33-8655.pdf>.

6 Instructions 7 and 8 to Item 201(e) of Regulation S-K. A smaller reporting company, as defined by Rule 229.10(f)(1), is not required to provide the performance graph. Instruction 6 to Item 201(e).

7 See J. Jaeger, "Early Reviews on 2010 Proxy Disclosures," *Compliance Week*, June 8, 2010.

other named executive officers and other groups) may provide additional context for the required disclosure.

Disclosure of Employee and Director Hedging Activities.

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

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

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

The SEC must issue rules not later than 360 days after enactment. The rules of the SEC must provide for appropriate procedures for an issuer to cure any defect that

would be the basis for a listing prohibition. The SEC rules must permit a national securities exchange to exempt a category of issuers. In determining appropriate exemptions, the exchanges must take into account the potential impact of the requirements on smaller reporting issuers.

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

- ***Compensation Committee Independence.*** Compensation committee members of listed companies will be required to satisfy heightened independence standards to be established by the national securities exchanges.⁸ The definition of the term “independence” is consistent with that required of audit committee members under Rule 10A-3 of the Exchange Act. Listed companies should start reviewing whether the current members of the compensation committee meet the general provisions in the Act, and review the SEC's rules and listing standards once they are issued. To the extent that changes to the composition of the compensation committee are required, companies may need to recruit new members if they are unable to fill compensation committee positions with existing directors. Compensation committees will also need to update their charters when the final rules become available.
- ***Independence of Compensation Committee Consultants and Advisers.*** Compensation committees of listed companies must consider specific factors that the SEC identifies as affecting the independence of a compensation consultant, legal counsel or other adviser before selecting such person. The SEC is required to issue rules identifying the factors that affect the independence of a compensation consultant, legal counsel, or other adviser to a compensation committee of an issuer. Such factors must

⁸ The SEC must by rule direct the national securities exchanges to prohibit the listing of any equity security of an issuer (other than an issuer that is a controlled company, limited partnership, company in bankruptcy proceedings, open-ended management investment company that is registered under the Investment Company Act of 1940, or a foreign private issuer that provides annual disclosures to shareholders of the reasons that the foreign private issuer does not have an independent compensation committee) that does not comply with the requirements for compensation committee independence.

be competitively neutral among categories of consultants, legal counsel, or other advisers, and preserve the ability of compensation committees to retain the services of members of any such category.⁹

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

- **Disclosure Regarding Use of Compensation Consultants.** A listed company will be required to disclose in the proxy statement for an annual meeting occurring one year or more after enactment of the Act whether (1) the compensation committee retained or obtained the advice of a compensation consultant; and (2) any conflicts of interest arise from the consultant's work and, if so, the nature of the conflict and how it is being addressed.
- **Authority to Engage and Oversee Independent Compensation Consultants, Counsel and Other Advisers.** The compensation committee of a listed company must be granted authority, in its sole discretion, to retain

or obtain the advice of a compensation consultant, independent legal counsel, and other advisers and be directly responsible for their oversight.

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

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

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

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

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

¹⁰ For additional information, see SEC Approves Enhanced Proxy Disclosures-What to Do in Advance of Your 2010 Annual Meeting, available at: http://www.arnoldporter.com/public_document.cfm?id=15041&key=27B1.

¹¹ See, e.g., Kara Scannell, "SEC Enters Overdrive to Prepare for Overhaul," *Wall Street Journal*, July 12, 2010, available at: <http://online.wsj.com/article/SB10001424052748704799604575357322407593694.html> (noting that agency officials are committed to completing proxy access).

¹² The SEC had previously granted relief to smaller public companies from compliance with the independent auditor attestation requirement in Section 404(b). The most recent extension of the original exemption expired on June 15, 2010. The Act makes this exemption for smaller reporting companies permanent.

exemption does not in any way affect a smaller issuer's obligations under Section 404(a), which requires an annual assessment of internal controls over financial reporting.

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

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

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

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

¹³ For additional information, see "SEC Approves Enhanced Proxy

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

Disclosures—What to Do in Advance of Your 2010 Annual Meeting," available at: http://www.arnoldporter.com/public_document.cfm?id=15041&key=27B1.

- 14 The term "accredited investor," as defined in Rule 501(a) of Regulation D under the Securities Act for purposes of certain exempt offerings, includes:
- Individuals who have a net worth, or joint worth with their spouse, above US\$1 million or have income above US\$200,000 in each of the last two years (or joint income with their spouse above US\$300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, executive officers or general partners of the issuer of the securities or its general partner; and
 - Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than US\$5 million in assets; and qualified employee benefit plans and trusts with more than US\$5 million in assets.
- 15 The SEC has issued an interpretation that the amount of any associated mortgage or other indebtedness secured by the primary residence up to its fair market value may be excluded in determining an individual's net worth.
- 16 The SEC may undertake an initial review of the definition of an "accredited investor," as the term applies to natural persons, to determine whether the definition, excluding the requirement relating to the net worth standard described above, should be adjusted or modified, and following completion of the review, may make adjustments to the definition (except as to the net worth standard requirement) after notice and comment rulemaking. The SEC is required to conduct a review, not earlier than four years after enactment and not less frequently than every four years thereafter, of the definition of "accredited investor" in its entirety as defined in Rule 215 of the Securities Act. Upon completion of this review, the SEC may make adjustments to the definition of "accredited investor" as defined in Rule 215 after notice and comment rulemaking. (The Act does not require a review of the definition of an "accredited investor" in Rule 501(a) of Regulation D every four years. Rather, this review is only required with respect to the definition of an "accredited investor" for purposes of Rule 215, which affects the Section 4(6)

Changes to Section 13 and 16 Reporting. The Act gives the SEC authority to shorten the due date for filing beneficial ownership reports under Section 13(d) of the Exchange Act. Currently, the due date is within 10 days after the acquisition. It also eliminates requirements to send related notices to the issuer and exchanges. A similar accelerated time frame would be allowed for “short swing” reporting under Exchange Act Section 16.

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

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

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

- (1) Require “covered financial institutions” to disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements sufficient to determine whether the compensation structure provides an executive officer, employee, director, or principal shareholder with excessive compensation,

fees, or benefits, or could lead to material financial loss to the covered financial institution; and

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

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

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

exemption from registration under the Securities Act.)

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

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

19 The term “nonbank financial company” includes companies that are “predominantly engaged in financial activities” (as defined in the bill). The Financial Stability Oversight Council can subject certain nonbank financial companies that it determines would pose a threat to US financial stability in the event of their material financial distress to the supervision of the Federal Reserve. Such companies can be subject to stricter standards, such as the risk committee requirement. For further information, see Congress Finalizes Landmark Financial Regulatory Reform Legislation, available at: http://www.arnoldporter.com/public_document.cfm?id=16134&key=2E2.

practices. The risk committee will be responsible for the oversight of enterprise-wide risk management practices and must include such number of independent directors as the Federal Reserve may determine appropriate, and at least one risk management expert with experience in identifying, assessing and managing risk exposures of large, complex firms. The Federal Reserve must issue rules not later than one year after the “transfer date,” to take effect not later than 15 months after the “transfer date.” The “transfer date” means a date that is one year after enactment of the Act, but is subject to an additional six-month extension.

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

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New Corporate Social Responsibility Requirements: Dodd-Frank Act Mandates Disclosure to SEC of Payments to Foreign Governments and Use of Minerals from the Democratic Republic of the Congo

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), signed into law on July 21, 2010,¹ contains two provisions intended to promote greater international transparency and sensitivity to human rights by oil, gas, and mining companies as well as companies that purchase minerals from the Democratic Republic of the Congo (DRC) and surrounding areas. Both provisions affect companies that file reports with the Securities and Exchange Commission (SEC). Under Section 1502 of the Act, companies must disclose annually a description of the measures taken by the company to exercise due diligence on the source and chain of custody of certain minerals that are associated with armed conflicts in and around the DRC, some of which are used in common electronic devices. Section 1504 requires oil, gas, and mineral companies that are required to file annual reports with the SEC to disclose annually all payments made to foreign governments in connection with commercial development of certain national resources in foreign countries. The level of transparency required under both sections has far-reaching implications for companies that produce electronic devices, such as cell phones, digital cameras, computers and DVD players, many of which may contain “conflict minerals,” as well for the oil, gas, and mineral sectors. As a result of the new law, many companies should consider reviewing current business, finance, and compliance practices and where necessary must satisfy SEC disclosure requirements on an annual basis in SEC reports. Failure to do so could lead to investigation and enforcement actions by the SEC and/or the US Department of Justice (DOJ), costly litigation and possible public relations problems.

¹ Pub. L. No. 111-203 (2010).

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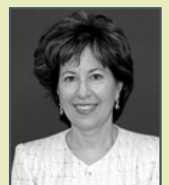
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Section 1502: Conflict Mineral Due Diligence

To help address the long-running international concern about the exploitation of certain minerals from the DRC and neighboring countries to help fund armed conflicts, Section 1502 of the Act amends the Securities Exchange Act of 1934 (Exchange Act) to require covered companies that use certain minerals in their products to disclose annually whether those minerals originate from the DRC or adjoining countries² if the use of the minerals is “necessary to the functionality of production of a product manufactured.”³ The “conflict minerals” that are covered under Section 1502 include columbite-tantalite (coltan), cassiterite (tin ore), gold, wolframite, or any of their derivatives, or any other mineral determined by the Secretary of State to be financing conflict in the DRC or adjoining countries.⁴ Minerals described in the Act are commonly found in electronic devices such as cell phones, computers, digital cameras, and DVD players, although not all minerals used in these devices come from this region of the world.

The SEC is required to issue regulations implementing Section 1502 no later than April 17, 2011 (within 270 days of enactment of the Act). The Act provides limited guidance as to the specific information that a company must disclose, and the SEC will therefore need to clarify the disclosure requirements in its regulations. The Act obligates covered companies to describe “products manufactured or contracted to be manufactured” that are not “DRC conflict free,”⁵ disclose the facilities used to process the conflict minerals, the country of origin of the conflict minerals, and efforts to determine the mine or location of origin with “the greatest possible specificity.”⁶ Moreover, it provides that when a covered company discloses that its products contain conflict minerals

that originate from the DRC or adjoining countries, it must disclose due diligence undertaken to discover the source and chain of custody of the mineral. Finally, the section mandates that the report submitted to the SEC must be reviewed by an independent private sector auditor.

Section 1504: Disclosure of Payments to Foreign Governments

Section 1504 amends the Exchange Act to require disclosure of payments to foreign governments by resource extraction issuers. The Act defines “resource extraction issuer” as an issuer required to file an annual report with the SEC that is engaged in commercial development of oil, natural gas, or minerals.⁷ A key Senate sponsor of the provision stated that Section 1504 supports international transparency in the oil, gas, and mineral sectors, and seeks to hold foreign governments accountable for payments received from foreign companies seeking to exploit resources, in an effort to reverse what has been commonly called the “resource curse”⁸ of corruption in countries that have significant natural resources. The provision is based on the Energy Security Through Transparency Act (ESTT)⁹ introduced by Senators Lugar and Cardin.

Under Section 1504, the SEC must issue final rules no later than April 17, 2011 (within 270 days of enactment of the Act). Thus, companies in the oil, natural gas, or minerals industries will have to wait for specific guidance as to whether Section 1504 is applicable to them and as

² Under Section 1502 of the Act, an adjoining country is any country that shares an internationally recognized border with the DRC. Therefore, a company must disclose to the SEC if the conflict mineral originated in the Central African Republic, Sudan, Uganda, Rwanda, Burundi, Zambia, or Angola.

³ *Id.*

⁴ *Id.*

⁵ “DRC conflict free” products are defined as those that do not contain minerals that “directly or indirectly finance or benefit armed groups” in the DRC or adjoining countries. *Id.*

⁶ *Id.*

⁷ Pub. L. No. 111-203, §1504. We anticipate that the SEC’s rules will also apply to foreign private issuers that file annual reports on Form 20-F or Form 40-F.

⁸ See 155 Cong. Rec. S9746 (daily ed. Sept. 23, 2009) (statement of Senator Lugar).

⁹ The ESTT, as introduced in the Senate, urges the administration to undertake to become an “implementing” country of the Extractive Industry Transparency Initiative (EITI). The EITI sets out a global framework for companies to disclose payments to foreign governments and for governments to disclose what they receive. See 155 Cong. Rec. S9746 (daily ed. Sept. 23, 2009) (statement of Senator Lugar). Currently, 36 countries have implemented or committed to implementing the EITI. See <http://eiti.org/implementingcountries>. There are also 50 oil and gas companies that support the Initiative and conduct international level self-assessments. See <http://eiti.org/supporters/companies>; see also Mara V.J. Senn and Rachel Frankel, “Firms Can Avoid EITI, FCPA Pitfalls,” Oil and Gas Journal, July 21, 2008.

to their detailed compliance obligations. Section 1504's requirement that companies that are required to file an annual report with the SEC make new disclosures about payments to foreign governments will at a minimum lead many companies to strengthen their record-keeping practices. The Act articulates some general guidance that should be taken into account immediately. The Act provides that a resource extraction issuer must include in an annual report (e.g., SEC Form 10-K) information relating to any payment made by it, any subsidiary, or any entity under its control to a "foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals...."¹⁰ Such information shall include the type and total amount of payments made for each project as well as the type and total amount of payments made to each government.¹¹

The Act defines "payments" as those made to further commercial development and that are not *de minimis*.¹² Payments that must be disclosed include, but are not limited to, taxes, royalties, fees, production entitlements, bonuses, and other material benefits as determined by the SEC to be part of the commonly recognized revenue stream.¹³ The Act requires disclosure of "any payment" without excluding payments that could be illegal under that country's anti-corruption laws as well as those of the United States and other jurisdictions. The term "foreign government" is defined as a "a department, an agency, or instrumentality...or a company owned by a foreign government," and "commercial development" is the "exploration, extraction, processing, export, and other significant actions relating to oil, natural gas, or minerals, or the acquisition of a license for any such activity, as determined by the [SEC]."¹⁴ A number of issues will need

to be resolved through the implementing regulations, including whether the SEC will require a company to disclose payments made to a foreign government if only a minor part of its business relates to commercial development of oil, gas, or minerals.

Implications

Sections 1502 and 1504 are important new statutory reporting requirements intended by Congress to address corporate social responsibility and could reflect a trend toward more such laws in the future. The new requirements will require many multinational companies to review their record-keeping and internal reporting procedures and make unprecedented disclosures to the SEC and the general public.

The SEC rules issued pursuant to Section 1502 will impose important new requirements on companies that may be using conflict minerals. The Act specifically targets disclosure of columbite-tantalite, cassiterite, and wolframite because these minerals are widely used in electronic devices such as cell phones, computers, and digital cameras. At a minimum, many covered companies will need to examine their due diligence processes and will have to devote resources to tracking the source and chain of custody of the minerals used in their products. Companies that use conflict minerals from the DRC or from surrounding countries in their products will have to bear the cost of hiring independent private sector auditors to ensure that the company exercised proper due diligence. Thus, if a company determines that its products contain conflict minerals, it may want to assess its business practices and may choose to avoid purchasing the covered minerals from the DRC and adjoining countries, or to ensure that it buys only from mines that do not finance or benefit armed groups in the region.

Section 1502 will allow investors to review whether a company's actions are contributing to armed violence and instability in the DRC or adjoining countries. Making the results of the due diligence process publicly available

¹⁰ Dodd-Frank Act, Pub. L. No. 111-203, §1504. This advisory focuses on the disclosure requirement as it relates to payments made to foreign governments.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* The SEC's regulations will presumably address whether the definition of "foreign government" includes foreign officials, political parties and candidates, as such terms are used in the Foreign Corrupt Practices Act.

could in some cases also expose a company to litigation under statutes such as the Alien Tort Statute, for example, if plaintiffs choose to claim that a company has “aided and abetted” a violation of international law in connection with use of conflict minerals in its products. A company’s disclosure that its products contain conflict minerals could also lead to a host of public relations problems both with investors and the general public.

Section 1504 could in some cases implicate the DOJ and SEC’s oversight and regulation of companies pursuant to the Foreign Corrupt Practices Act (FCPA). Generally, the FCPA’s anti-bribery provisions prohibit corruptly providing anything of value to government officials in order to obtain or retain business. The FCPA also contains a books and records provision that requires companies to maintain accurate books and records and devise and maintain a system of internal accounting records. A resource extraction issuer that discloses payments to foreign governments may become subject to enhanced scrutiny that could result in a time-consuming and costly FCPA investigation or enforcement action. For example, a discrepancy between the company’s disclosure and the foreign government’s disclosure could raise red flags, drawing attention from the DOJ and/or SEC. Affected companies are urged to participate in the SEC rulemaking process during the comment period, and to the extent necessary, should seek the advice of counsel.

The disclosure requirement could raise another FCPA issue. The DOJ and SEC both have consistently encouraged companies to voluntarily disclose illegal payments, often rewarding companies that voluntarily disclose potentially covered payments with deferred prosecution agreements or mitigation of civil and criminal penalties.¹⁵ If a company fails to disclose information required by the Act, and the DOJ and/or SEC subsequently

learn about a resource extraction issuer’s FCPA violations through cooperation with foreign governmental authorities or a whistleblower, the SEC and/or DOJ may take a harder line toward prosecution and enforcement under the FCPA, in addition to the SEC opening an investigation and bringing suit for failure to make such disclosures pursuant to Section 1504.¹⁶ In addition, any violations of Section 1504, when ultimately disclosed to investors, could provide a new basis for shareholder class action or derivative lawsuits, including actions for fraud brought pursuant to Section 10(b) of the Exchange Act.

In some cases, companies that are subject to Section 1504 because they are required to file annual reports with the SEC may be at a competitive disadvantage to companies that are not subject to this requirement. Some foreign governments may be more likely to award bids and contracts to companies not required to file annual reports with the SEC, and thus not obligated to disclose payments, as a way to circumvent public scrutiny of payments they receive. Another concern for companies affected by the new law will be the public disclosure of otherwise confidential bids, as well as public disclosure of otherwise confidential information, such as the terms of a particular arrangement for a company to purchase oil or gas from a foreign government.

As noted above, the SEC is required to issue implementing regulations for each of these two provisions no later than April 17, 2011. The disclosure requirements under the two sections are not immediately effective. Section 1502 disclosures will need to be made by a covered company in a report submitted annually to the SEC, and made publicly available on the company’s website, beginning with the company’s first full fiscal year that begins after SEC regulations are issued. Section 1504 disclosures will need to be included in a covered company’s annual report, submitted to the SEC in an interactive data format with

¹⁵ See, e.g., *Securities & Exchange Commission Division of Enforcement, Enforcement Manual* § 6.1.2 (2010); Memorandum from Deputy Attorney General Mark R. Filip, Principles of Federal Prosecution of Business Organizations §§ 9-28.700, 9-28.750 available at <http://www.justice.gov/opa/documents/corp-charging-guidelines.pdf>.

¹⁶ An issuer, as well as any officer, director, employee or agent of the issuer, may be subject to criminal and/or civil monetary penalties (and/or imprisonment for natural persons) for FCPA violations or violations of Section 13 of the Exchange Act.

electronic tags identifying certain information, commencing with the first fiscal year that ends not earlier than one year after the SEC issues final rules.

Because of the various implications discussed above, a company that believes it is or may become subject to one or both of these provisions should consider submitting comments on the rules that the SEC ultimately proposes and should consider evaluating relevant policies, practices, and record-keeping, to ensure compliance with the new requirements. In particular, companies subject to Section 1504 may want to begin investigating ways to easily track all payments to governments, including the type and amount of each payment, to avoid having to reconstruct information for each payment after the fact.

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

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

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

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

Title I. Financial Stability

Title I, which became generally effective upon enactment of the Act, creates a Financial Stability Oversight Council (FSOC) to address systemic risk in the financial system and an Office of Financial Research (OFR) to support the FSOC in carrying out its duties. Title I sets forth the following required and permissive rulemakings, which, unless specified otherwise, either have no specific timeframe or must be issued within 18 months of the Transfer Date:¹

¹ The Transfer Date refers to the date that is one year after enactment of the Act, extendable to 18 months after enactment (i.e., July 21, 2011 extendable to January 21, 2012). On the Transfer Date, pursuant to Title III of the Act, the Board of Governors of the Federal Reserve System assumes responsibility for supervision of savings and loan holding companies and their nonbank subsidiaries, while federal savings associations and state savings associations become the responsibility of the Office of the Comptroller

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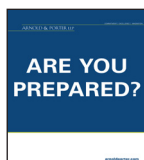
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- The FSOC must adopt rules necessary for the FSOC's conduct of business, including rules of organization, procedure, or practice.
- The FSOC may recommend to the federal banking agencies that they apply new or heightened standards and safeguards for a financial activity or practice, and it must provide notice to the public and an opportunity to comment on any such recommendation. In turn, the federal banking agencies must impose the recommendations or explain in writing why they will not. No timeframe is specified either for the FSOC to recommend or for the federal banking agencies to impose the recommendations, but if the federal banking agencies choose to reject the recommendations they must do so within 90 days.
- The Board of Governors of the Federal Reserve System (Federal Reserve) must issue, no later than 18 months after the Transfer Date, rules establishing prudential standards applicable to nonbank financial companies supervised by the Federal Reserve and bank holding companies with total consolidated assets equal to or greater than \$50 billion in order to prevent or mitigate risks to financial stability.
- The Federal Reserve must promulgate, no later than 18 months after the Transfer Date, rules regarding resolution plans and credit exposure reports, leverage limitations, early remediation of financial distress, the establishment of intermediate holding companies, and exemptions from its supervision.
- The Federal Reserve must prescribe limits on credit exposures of nonbank financial companies supervised by the Federal Reserve or a bank holding company with total consolidated assets of \$50 billion or more. This rulemaking must occur no later than 18 months after the Transfer Date, but the regulations may not take effect until three years after the Transfer Date, which restriction is extendable an additional two years by the Federal Reserve.
- The Federal Reserve must promulgate rules regarding

the establishment of risk committees no later than one year after the Transfer Date, to take effect no later than three months after that.

- The Federal Reserve may issue, no later than 18 months after the Transfer Date, regulations regarding contingent capital, periodic public disclosures, short-term debt limits, and transactions between an intermediate holding company or a nonbank financial company supervised by the Federal Reserve and its affiliates.
- The federal banking agencies must promulgate regulations regarding stress tests and establishing leverage and risk-based capital requirements for certain financial institutions. No timeframe is specified for this rulemaking.
- The OFR, in consultation with the Chairperson of the FSOC (the Treasury Secretary), must issue rules, regulations, and orders to the extent necessary to collect and provide data to the FSOC and member agencies, standardize the types and formats of data reported and collected, and assist member agencies in determining the types and formats of data authorized by the Act to be collected by member agencies.

Title II. Orderly Liquidation Authority

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

The FDIC, in consultation with the FSOC, is required to issue regulations that govern the rights of creditors and counterparties of a company placed into receivership. The FDIC is also required to enact rules that:

of the Currency and the Federal Deposit Insurance Corporation, respectively.

- Prohibit the sale of assets in liquidation to individuals who have defaulted on obligations to covered financial companies;
- Regulate compensation paid to and activities undertaken by senior executives and directors of a company placed into receivership;
- Establish interest rates for payments of post-insolvency interest to creditors of a covered financial company;
- Govern record retention by covered financial companies; and
- Charge risk-based assessments on large financial companies to recover costs incurred in connection with the liquidation of a financial company.

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

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

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

Title III splits the rulemaking authority of the abolished OTS prospectively between the Federal Reserve and the OCC. The Federal Reserve is required under this title to issue regulations applicable to savings and loan holding companies and their nonbank subsidiaries, including regulations governing transactions between savings and loan holding companies and their affiliates, as well as regulations supervising tying arrangements and credit extensions to executives, directors, and principal shareholders under the Home Owners' Loan Act. The OCC is required under this title to issue regulations applicable to savings associations, and must also amend the term "assessment base" with respect

to insured depository institutions under the Federal Deposit Insurance Act. No deadlines for the rulemakings required under this title have been specified.

Title IV. Regulation of Advisers to Hedge Funds and Others

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

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

- The SEC may issue rules prescribing steps that registered investment advisers must take to safeguard client assets over which they have custody;
- The SEC and the Commodity Futures Trading Commission (CFTC) must jointly issue rules, no later than July 21, 2011, to establish the form and content of reports required to be filed by private fund advisers registered under both the Advisers Act and the Commodity Exchange Act;
- The SEC must adjust the net-worth standard required to qualify as an “accredited investor” so that the individual net worth of any natural person (or joint net worth with spouse) is more than \$1 million, excluding the value of the primary residence, except that during the four-year period that begins July 21, 2010, any net worth standard must be \$1 million, excluding the value of the primary residence;
- The SEC may undertake an initial review of the definition of an “accredited investor” as it applies to natural persons, and adjust the definition following notice and comment rulemaking, except as to the net worth standard described above;
- The SEC must, no earlier than July 21, 2014 and at least once every four years thereafter, undertake a review of the “accredited investor” definition in its entirety for purposes of Rule 215 of the Securities Act of 1933 as the term applies to natural persons, and the SEC may make adjustments as it deems appropriate after notice and comment rulemaking; and
- The SEC must make inflation adjustments to the “qualified client” standard in any SEC rule under Section 205(e) of the Advisers Act not later than July 21, 2011, and every five years thereafter.

Title V. Insurance

Title V establishes a Federal Insurance Office (FIO), and gives the Treasury Secretary the authority to issue orders, regulations, policies, and procedures to carry out the functions of the FIO, to facilitate the collection of information from insurers and affiliates, and to preempt certain state insurance measures. Title V also provides that the states

adopt nationwide uniform requirements regarding the payment and allocation of premium taxes. We note that, generally, many of the provisions in Title V became effective on July 22, 2010, while some of the Title V provisions will become effective July 22, 2011.

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

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

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

Title VI sets forth, for example, the following required rulemakings:

- The appropriate federal banking agencies may establish capital regulations applicable to bank holding companies, savings and loan holding companies, and insured depository institutions (there is no specific timeframe for this rulemaking, but the rulemaking may not be effective any earlier than the Transfer Date);
 - The Federal Reserve must prescribe capital adequacy and other risk management standards applicable to supervised securities holding companies and nonbank financial companies supervised by the Federal Reserve (there is no specific timeframe for this rulemaking);
 - The Federal Reserve must enact other rules regulating supervised securities holding companies, which may include substantive areas such as registration requirements, recordkeeping and reporting requirements, and compliance with applicable provisions of law (there is no specific timeframe for this rulemaking);
 - The Federal Reserve must issue rules implementing the conformance period for divestiture and for transition for illiquid funds (this rulemaking must be issued no later than January 21, 2011), and concentration limits on large financial firms (this rulemaking must be issued no later than October 21, 2011), as well as establish criteria for determining whether to require a grandfathered unitary savings and loan holding company to establish an intermediate holding company (there is no specific timeframe for this rulemaking);
 - The appropriate federal banking agencies must jointly issue rules that require a bank holding company or a savings and loan holding company to serve as a source of financial strength for any subsidiary that is a depository institution (additionally, if the insured depository institution is not a subsidiary of a bank holding company or a savings and loan company, then the jointly issued rules must require that any company that directly or indirectly controls the insured depository institution serve as the source of financial strength) (this rulemaking must be issued between the Transfer Date and one year after the Transfer Date);
 - The appropriate federal banking agencies, along with the SEC and the CFTC, must issue rules implementing the Volcker Rule and coordinate to ensure comparable regulations to the extent possible (this rulemaking must be issued no later than October 21, 2011; however, depending on when issued, the final rule will become effective no earlier than August 2011 and no later than July 21, 2012);
 - The appropriate federal banking agencies, along with the SEC and the CFTC, must issue regulations regarding internal controls and recordkeeping in order to ensure compliance with the Volcker Rule (this rulemaking must be published for notice and comment no later than October 21, 2011; however, depending on when issued, the final rule will become effective no earlier than August 2011 and no later than July 21, 2012); and
 - The SEC must issue rules prohibiting, for a designated period of time, an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security from engaging in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity (exceptions to this prohibition would include, however, certain risk-mitigating hedging activities, and purchases or sales consistent with commitments to provide liquidity for the asset-backed security or *bona fide* market-making in the asset-backed security) (this rulemaking must be issued no later than April 17, 2011).
- In addition, Title VI sets forth, for example, the following permissive rulemakings:
- The Federal Reserve may issue regulations or interpretations concerning the manner in which a netting agreement between a member bank or a subsidiary and an affiliate may be taken into account in determining the amount of an inter-affiliate “covered transaction” under Section 23A of the Federal Reserve Act, including the extent to which a netting agreement may be taken into account in determining whether a covered transaction is fully secured under Section 23A (there is no specific timeframe for this rulemaking, but the rulemaking may not be effective any earlier than one year after the Transfer Date);

- The Federal Reserve may also issue rules prohibiting an insured depository institution from purchasing or selling assets to insiders, unless certain conditions have been met (i.e., the transaction is on market terms and, if it represents more than 10 percent of the capital stock and surplus of the insured depository institution, it has been approved in advance by a majority of disinterested directors) (there is no specific timeframe for this rulemaking, but the rulemaking may not be effective any earlier than the Transfer Date); and
- The Federal Reserve may issue regulations that establish restrictions or limitations on transactions between an intermediate holding company or a parent of such company (there is no specific timeframe for this rulemaking).

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

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

permissible rulemakings:

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

capital and margin requirements for swaps dealers and security-based swap dealers, as well as major swap participants and major security-based swap participants. The federal banking regulators, in consultation with the SEC and CFTC, are required to impose such capital and margin requirements on both swap dealers and security-based swap dealers, as well as major swap participants that are depository institutions.

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

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

Title VIII. Payment, Clearing, and Settlement Supervision

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

The Federal Reserve is authorized to prescribe rules that:

- Authorize a Federal Reserve Bank to establish an

account for and provide assistance (including discount and borrowing privileges) to a designated institution similar to the assistance provided to depository institutions under the Federal Reserve Act; and

- Impose recordkeeping requirements, upon majority vote by the FSOC, on systemically important clearing entities or on financial institutions engaged in designated activities that are subject to risk management standards prescribed by the Federal Reserve pursuant to this title.

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

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

Rulemakings required or authorized under Title IX, which generally became effective on July 22, 2010, include various measures centered around securitizations and the protection of retail investors. New regulations issued pursuant to this title would:

- Require securitizers of mortgage-backed and other asset-backed securities to retain credit risk in such securities. The federal banking agencies must jointly prescribe these regulations by April 17, 2011.
- Create new disclosure obligations, including new requirements relating to pre-sale disclosures and disclosures relating to short sales. Broker-dealers and investment advisors could also face new rules designed to address gaps or overlaps in regulations that apply to their relationships with retail customers. Such regulations could include a new “best interests” fiduciary standard. Rules that address relationships with retail customers would be proposed after an SEC study and report to Congress, due in January 2011.
- Substantially rewrite regulations that apply to credit rating agencies, also known as nationally registered statistical rating organizations (NRSROs), enhancing

public disclosure of their procedures and methodologies. The SEC would even be authorized, after a study, to establish a system for the assignment of NRSROs to perform initial credit ratings of asset-backed securities such that issuers, sponsors, or underwriters would not be able to select the rating agency. The majority of the rulemakings relating to NRSROs would be required by July 21, 2011.

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

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

Title X. Bureau of Consumer Financial Protection

Title X establishes the Bureau of Consumer Financial Protection (CFPB) within the Federal Reserve. The CFPB will regulate consumer financial products and services to ensure compliance with federal consumer financial laws and has the authority to prescribe rules to this effect, including rules supervising market participants and mandating certain disclosures to consumers. No timeframe is specified for rules issued pursuant to this general rulemaking authority. However, by September

19, 2010, the Treasury Secretary, in consultation with a number of other agencies, must determine a “Designated Transfer Date” for the transfer of specified functions and powers from the agencies to the CFPB. The Designated Transfer Date may be no earlier than January 17, 2011 nor later than July 21, 2011 (although this may be extended up to January 21, 2012).

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

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

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

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

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

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

- The Equal Credit Opportunity Act;
- The Electronic Fund Transfer Act;

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

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

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

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

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

Title XII. Improving Access to Mainstream Financial Institutions

Title XII is designed to provide access to mainstream financial institutions to Americans who are normally

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

Title XIV. Mortgage Reform and Anti-Predatory Lending Act

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

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

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

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

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

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

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

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