



## Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30, 2010

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (“**the bill**”) will soon be the law of the land, assuming Senate passage. With the President’s signature, the bill will mark the greatest legislative change to financial supervision since the 1930’s. This legislation will affect every financial institution that operates in this country, many that operate from outside this country and will also have a significant effect on commercial companies. As a result, both financial institutions and commercial companies must now begin to deal with the historic shift in U.S. banking, securities, derivatives, executive compensation, consumer protection and corporate governance that will grow out of the general framework established by the bill. While the full weight of the bill falls more heavily on large, complex financial institutions, smaller institutions will also face a more complicated and expensive regulatory framework.

Following the bill’s passage, the regulatory implementation phase will begin. While few provisions of the bill are effective immediately and Congress has designed the bill to become effective in stages, regulators and market participants will need to begin responding to the legislation immediately after its passage. U.S. financial regulators will enter an intense period of rulemaking over the next 6 to 18 months, and market participants will need to make strategic decisions in an environment of regulatory uncertainty. The legislation is complicated and contains substantial ambiguities, many of which will not be resolved until regulations are adopted, and even then, many questions are likely to persist that will require consultation with the staffs of the various agencies involved. Agency rulemaking will, however, set the parameters of the new regulatory framework. The new regulatory framework will contain both new elements and elements drawn from the patchwork of current U.S. financial regulation. An understanding of the older layers of regulation will be indispensable for understanding the new law.

In addition, regulatory implementation will be a dynamic process. Market participants will change their behavior in response to the new regulations and to the rules issued by other regulators and by international bodies. The regulators will be challenged to conform the required regulations to a follow-on technical bill, as promised by Chairman Frank. We expect that there will be both severe challenges for financial institutions as well as significant market opportunities, both at home and abroad, and that regulators and market participants will be dealing with the bill’s consequences, both intended and unintended, for many years to come.

We hope you will find the attached summary of the bill useful. We apologize for its length, at over 120 pages. For those who would like to dip into only the sections relevant to them, the table of contents contains hyperlinks. We have also attached to the memorandum [the Davis Polk Regulatory Implementation Slides](#), which are designed to show the effectiveness and implementation time line of the major provisions of the bill.

By our count, the bill requires 243 rulemakings and 67 studies, as set forth on the table on the next page. To help our clients understand and participate in the regulatory process, we have created a dynamic, searchable, sortable web-based regulatory tool showing effectiveness dates, regulatory deadlines, required rulemakings and proposed and final rules that we will update to track the developing regulatory infrastructure. This internet tool, which we are making available to in-house lawyers as an online service, is designed by lawyers for lawyers and we are confident that it will help navigate the regulatory process during the coming months. If you are interested in finding out more about the Davis Polk Regulatory Tracker™, please contact [tracker@davispolk.com](mailto:tracker@davispolk.com).

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## Estimates of Rulemaking By Agency

| Agency          | All Rulemaking* | One-Time Reports / Studies | New Periodic Reports |
|-----------------|-----------------|----------------------------|----------------------|
| Bureau          | 24              | 4                          | 5                    |
| CFTC            | 61              | 6                          | 2                    |
| Council         | 56              | 8                          | 4                    |
| FDIC            | 31              | 3                          | 1                    |
| Federal Reserve | 54              | 3                          | 3                    |
| FTC             | 2               | 0                          | 0                    |
| GAO             | 0               | 23                         | 2                    |
| OCC             | 17              | 2                          | 2                    |
| OFR             | 4               | 1                          | 2                    |
| SEC             | 95              | 17                         | 5                    |
| Treasury        | 9               | 1                          | 1                    |
| Total**         | 243             | 67                         | 22                   |

\* This estimate only includes references to explicit rulemakings in the bill, and thus likely represents a significant underestimate.

\*\* The Total count eliminates double counting for joint rulemakings.

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## Systemic Risk Regulation

The bill creates the Financial Stability Oversight Council to serve as an early warning system identifying risks in firms and market activities, to enhance oversight of the financial system as a whole and to harmonize prudential standards across agencies. The new Office of Financial Research will serve as the information-gathering arm of the Council.

The Council is empowered to identify “systemically important” nonbank financial companies, thus bringing such companies under regulation by the Federal Reserve, and to recommend heightened prudential standards for the Federal Reserve to impose on these companies. The Council also has the power to recommend heightened prudential standards to primary financial regulators to apply to any activity that the Council identifies as contributing to systemic risk.

The vast majority of the systemic risk provisions require implementing regulation, and many give regulators discretion to modify the statutory standards or issue exemptions. In addition, the Financial Stability Oversight Council is not yet operational and has not yet put in place internal rules of procedure. As a result, on the eve of the Bill’s enactment, significant unknowns remain on the scope and content of systemic risk regulation, and the manner in which the Council will operate.

## Financial Stability Oversight Council

- **Membership.** The bill establishes the Financial Stability Oversight Council (the “**Council**”), consisting of 15 members: 10 voting and 5 nonvoting. The voting members are the Treasury Secretary, who serves as chairman, and the heads of the Federal Reserve, OCC, Bureau of Consumer Financial Protection (the “**Consumer Bureau**”), SEC, FDIC, CFTC, FHFA, NCUA and an independent member with insurance expertise. The nonvoting members are the Directors of the Office of Financial Research (the “**OFR**”) and the Federal Insurance Office (the “**FIO**”), a state insurance commissioner, a state banking supervisor and a state securities commissioner.
  - The Directors of the Consumer Bureau and the OFR and the independent member with insurance expertise must be appointed by the President and confirmed by the Senate.
  - The Director of the FIO will be appointed by the Treasury Secretary.
  - State commissioners and supervisors will develop the selection process for their nonvoting representatives.
  - Nonvoting members cannot be excluded from Council meetings, other than in certain cases involving confidential supervisory information upon an affirmative vote of the Council member agencies.
  - The independent member with insurance expertise will serve a 6-year term. The state insurance commissioner, state banking commissioner and state securities commissioner will serve 2-year terms.
- **Quarterly Meetings.** The Council will meet at the call of the Treasury Secretary or a majority of the members then serving, but not less frequently than quarterly.
- **Council Voting.** Council actions generally require a majority vote, although certain actions, including systemically important designations, require a 2/3 vote, including the affirmative vote of the Treasury Secretary.
- **Start Date.** The bill is silent as to whether the Council will begin its work and operations before the Senate confirms the Presidential appointees. Unlike other entities created by the bill, there is no



official start date. We believe the Council could legally begin operations at any time, even in advance of the Presidential appointees, but suspect that there will be an organizational start-up phase.

- **Financial Stability Powers and Duties.** The Council is charged with the goal of identifying risks to U.S. financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or risks that could arise outside the financial services marketplace. The Council is also supposed to promote market discipline and respond to emerging threats to U.S. financial markets.
  - To serve these purposes, the Council must engage in data gathering, information sharing, monitoring, and identification of gaps in regulation. The Council will also advise and make recommendations to Congress on regulatory developments.
  - Acting through the OFR, the Council can require reports from **any** financial company to assess threats to U.S. financial stability from an activity, market or the company itself. The Council can also require certified reports from systemically important nonbank financial companies and bank holding companies with assets of \$50 billion or more.
  - The Council is also required to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress and make recommendations in these areas that will enhance the integrity, efficiency, competitiveness and stability of the U.S. financial markets.
  - **International Consultation.** The Council must consult with the appropriate foreign regulatory authorities to the extent appropriate in exercising its systemic oversight authority with respect to foreign nonbank financial companies, foreign-based bank holding companies and cross-border activities and markets.
  - **Technical and Professional Advisory Committees.** The Council may appoint special advisory, technical or professional committees to assist in carrying out the functions of the Council, including an advisory committee consisting of State regulators. Council members are permitted to serve on these committees.
- **Systemic Designation Authority.** The Council is empowered to identify systemically important nonbank financial companies, financial activities or practices, financial market utilities and payment, clearance and settlement activities.
  - **Tailored Application.** Bank holding companies with \$50 billion or more in consolidated assets are treated as systemically important; no designation is required.
  - **Higher Thresholds** The bill refers to nonbank financial companies which are identified as systemically important as “nonbank financial companies supervised by the Federal Reserve.” In this memorandum, they are referred to as “**systemically important nonbank financial companies,**” and together with bank holding companies with \$50 billion or more in assets, as “**systemically important companies.**”
- **Recommending Standards.** The Council is authorized to make recommendations to the Federal Reserve concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to systemically important companies, to prevent or mitigate risk to U.S. financial stability that could arise from the material financial distress, failure or ongoing activities of these companies. The Federal Reserve must consider these recommendations in prescribing enhanced prudential standards. The Council may also issue recommendations to apply heightened standards and safeguards for financial activities and practices if the Council determines that the scope, size or interconnectedness of the activity could create or increase the risk of significant liquidity, credit or other problems. For further discussion on prudential standards for systemically important firms, see “Enhanced Prudential and Other Standards for Systemically Important Firms.”

- In making recommendations, the Council may differentiate among systemically important companies on an individual basis or by category, taking into consideration their capital structure, riskiness, the scope and complexity of their financial activities' riskiness and any other risk-related factors that the Council deems appropriate.
- For bank holding companies, the Council may recommend an asset threshold above \$50 billion, but only for the application of the following requirements: contingent capital, resolution plans, credit exposure reporting, concentration limits, enhanced public disclosures and short-term debt limits. The Council may not recommend a higher threshold for risk-based capital requirements, leverage limits, liquidity requirements and overall risk-management requirements.
- **Recommending Jurisdictional Dispute Resolution.** The Council must seek to resolve supervisory jurisdictional disputes among Council members if certain conditions are satisfied, including at the request of an agency involved. Recommendations by the Council, to be taken by 2/3 vote, are not binding.
- **Testimony Before Congress.** The Council must submit annual reports to Congress, and the Treasury Secretary must testify before Congress on the activities of the Council, significant financial market and regulatory developments, potential emerging threats to financial stability and determinations and recommendations made.
  - As part of the Council's annual report to Congress, each voting member must submit a signed statement attesting that all reasonable steps are being taken to ensure financial stability and mitigate systemic risk, or state what additional steps the voting member believes should be taken.
- **Council Subject to GAO Audit.** The GAO may audit the activities of the Council and any person or entity acting on behalf of or under the Council. The GAO may request and make copies of any records or other information under the control of or used by the Council or of a person or entity acting on behalf of or under the authority of the Council, and may have access to officers, directors and employees or agents of the Council.
- **Council Study on the Effects of Size and Complexity of Financial Institutions.** The bill calls for the Council to conduct an ongoing study on the economic impact of possible financial services regulatory limitations intended to reduce systemic risk. The study must estimate the costs and benefits on the efficiency of the capital markets, the financial sector and on national economic growth of imposing on large financial institutions limits on size, organizational complexity, interconnectedness or other limitations on activities or structure that may limit systemic risk.
  - The Council must report to Congress within 180 days after enactment and at least every 5 years thereafter on the results of the study.
- **Systemic Regulation Fees**
  - Beginning 2 years after enactment, the bill requires the Treasury Secretary and the Council to establish an assessment schedule applicable to systemically important companies sufficient to fund the expenses of the OFR, which include the Council's expenses.
    - The assessment schedule must take into account differences among systemically important nonbank financial companies and bank holding companies based on the considerations for establishing prudential standards, which include, among others, the nature, scope size, scale, concentration, interconnectedness and mix of the company's activities, the company's leverage, whether the company owns an insured depository institution and any other factor the Council deems appropriate.

- The bill also requires the Federal Reserve to impose fees on all systemically important companies in an amount the Federal Reserve estimates is “necessary or appropriate” to carry out its supervisory responsibilities.
  - The Federal Reserve does not currently assess fees for its examination or supervisory responsibilities.

## Systemic Risk

### Systemically Important Nonbank Financial Companies

- **Definition of “Nonbank Financial Company.”** A “nonbank financial company” is defined as any company, other than a bank holding company or a company that is treated as a bank holding company, that is “predominantly engaged in financial activities.”
  - To be “predominantly engaged in financial activities,” 85% or more of the company’s and its subsidiaries’ consolidated annual gross revenues or consolidated total assets must be attributable to activities that are financial in nature under Section 4(k) of the Bank Holding Company Act and, if applicable, attributable to the ownership or control of 1 or more insured depository institutions.<sup>1</sup>
  - Section 4(k) of the Bank Holding Company Act defines activities that are “financial in nature” to include, among others, securities underwriting, dealing and market-making, insurance activities, and merchant banking activities. Added by the Gramm-Leach-Bliley Act of 1999, Section 4(k) expanded the scope of permitted activities that could be conducted by a bank holding company that elects to be a financial holding company.
  - The Federal Reserve must issue regulations establishing the requirements for determining whether a company is “predominantly engaged” in financial activities.
  - For discussion regarding the treatment of foreign financial companies, see “[Foreign Financial Companies](#).”
- **Exclusions from the Definition of “Nonbank Financial Companies”**
  - The definition of U.S. nonbank financial company excludes U.S. national securities exchanges, clearing agencies, security-based swap execution facilities, registered security-based swap data repositories, boards of trade designated as a contract market, derivatives clearing organizations, swap execution facilities or registered swap data repositories, and for some of the foregoing, the parent thereof. Farm credit institutions are also excluded from the definition of nonbank financial company.
  - Earlier versions of the bill had excluded subsidiaries of bank holding companies from the definition of nonbank financial company. Because this exclusion was struck in the final bill, and replaced by the foregoing more specific list, subsidiaries of a bank holding company, including

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<sup>1</sup> The determination of whether a company is “predominantly engaged” in financial activities appears in several places in the bill. In some places, the test is on revenues or assets, and in others solely on revenues. Similarly, in some places the activities are limited to those that are “financial in nature” and in others they also include activities that are incidental financial activities. It is unclear whether these differences in definitions were intentional.

of a systemically important company, can be designated as systemically important in their own right unless they are expressly excluded.

- **Systemically Important Designation.** The Council is charged with identifying systemically important companies, which the bill identifies as those that could pose a threat to financial stability either due to the potential of material financial distress at the company or due to the company's ongoing activities. Consideration of the company's ongoing activities was added late in the conference process, thereby expanding the scope of companies potentially designated as systemically important.
  - **2/3 Council Vote.** Designation as systemically important requires approval of at least 2/3 of the voting members of the Council, including the affirmative vote of the Treasury Secretary.
  - **Factors to Consider.** In making the systemically important designation for U.S. entities, the Council must consider a series of open-ended criteria. Factors touch on leverage, assets and liabilities of the company, its degree of reliance on short-term funding, its activities, assets under management, interconnectedness with "significant" nonbank financial companies and "significant" bank holding companies, regulation by another regulator, and importance as a source of credit and liquidity, as well as any other risk-related factor the Council deems appropriate.
    - Similar factors apply for foreign nonbank financial companies, with a focus on U.S.-related assets, activities and operations. For information on these factors, see "[Foreign Financial Companies](#)."
    - The terms "significant" bank holding company and "significant" nonbank financial company will be defined by Federal Reserve rule, but entities excluded from the definition of U.S. nonbank financial company, including certain exchanges, clearing agencies and execution facilities, may not constitute significant entities for purposes of the interconnectedness factor.
  - **Information-Gathering for Financial Stability Purposes.** The Council, acting through the OFR, may require periodic and other reports from any nonbank financial company or bank holding company for the purpose of assessing whether the company itself, or any financial activity or market in which it participates, is systemically important.
    - If the Council is unable to determine whether the financial activities of a U.S. nonbank financial company pose a threat to U.S. financial stability based on such reports, the Council may direct the Board to examine the U.S. nonbank financial company for the sole purpose of determining whether the company should be deemed systemically important.
  - **No Dollar Threshold.** Unlike the \$50 billion threshold for bank holding companies, there is no minimum asset limit for nonbank financial companies to be considered systemically important. It is possible that the threshold above which bank holding companies are subject to enhanced standards will be used as a proxy.
- **Appeal and Review of Systemically Important Designation**
  - **Notice and Hearing.** Systemically important nonbank financial companies are entitled to written notice of a proposed designation and may request a hearing within 30 days of receiving such notice. The hearing must take place within 30 days of the request and the Council must make a final determination within 60 days of the hearing.
    - The right to notice and hearing is subject to an emergency exception that requires 2/3 vote of the Council. The company may request a hearing regarding the Council's decision to invoke the exception within 10 days of notice, and the decision is also subject to judicial review.

- For foreign nonbank financial companies, the Council must consult with the appropriate home country regulator during the appeal process.
- **Judicial Review.** Judicial review of designation is available within 30 days after notice of a final determination, and is conducted under the “arbitrary and capricious” standard.
- **Periodic Re-evaluation.** Re-evaluation of the systemically important designation must occur at least annually; rescission requires 2/3 vote, including the affirmative vote of the Treasury Secretary, the same as for designation.
- **Public Announcement of Designation.** The bill contains no express requirement that a designation be made public, although securities laws would likely require disclosure.
- **Consultation Regarding Designation.** The Council is required to consult with the primary financial regulatory agency, if any, before designating a nonbank financial company as systemically important or subjecting a company to enhanced standards under the anti-evasion provisions. The Council is not required to consult with the Federal Reserve.
  - The FIO may recommend any insurers, including their affiliates, that it believes should be designated.
  - With respect to foreign companies and cross-border activities and markets, the Council is required to consult with the “appropriate foreign regulatory authorities, to the extent appropriate.” For information regarding foreign regulator consultation, see “[Foreign Financial Companies](#).”
- **Financial Activities Designation for Anti-Evasion Purposes**
  - **Applicability of Anti-Evasion Regime.** The Council, on its own or at the Federal Reserve’s request, may determine that the financial activities of a company that is not a nonbank financial company should be supervised by the Federal Reserve and be subject to stricter standards. This requires a 2/3 vote of the Council, including the Treasury Secretary. The Council must find that:
    - Material financial distress related to the financial activities, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the financial activities, or, for foreign companies, the U.S. financial activities, would pose a threat to U.S. stability, based on factors considered in designating entities as systemically important; and
    - The company is organized or operates in such a manner as to evade application of the systemic risk regime.
  - **Procedure for Anti-Evasion Designation.** A company designated pursuant to the anti-evasion provision is entitled to the same notice, opportunity for hearing and judicial review as is a nonbank financial company that has been designated as systemically important.
    - As with other systemically important designations, the Council is required to consult with the primary financial regulatory agency, if any, before subjecting a company to enhanced standards pursuant to the anti-evasion provision.
    - The Council must submit a report to Congress detailing the reasons for the determination.
  - **Consequences of Application of Anti-Evasion Regime**
    - Financial activities, or for foreign companies, U.S. financial activities, are supervised by the Federal Reserve and subject to enhanced standards as if the company were a systemically important nonbank financial company.
      - In this context, “financial activities” are limited to activities that are financial in nature as defined in Section 4(k) of the Bank Holding Company Act, and include the

ownership or control of 1 or more insured depository institutions, but do not include internal financial activities conducted for the company or any affiliates, including internal treasury, investment and employee benefit functions.

- Prudential standards and supervision by the Federal Reserve do not apply to the nonfinancial activities of the company.
- To facilitate supervision of the financial activities of the company, the Federal Reserve may require, within 90 days of the Council's determination that the nonbank financial company is systemically important, that the company establish an intermediate holding company in which the financial activities of the company and its subsidiaries, other than internal financial activities as defined in the bill, will be conducted. The company may choose to establish such an intermediate holding company, even if not required by the Federal Reserve.
- **Safe Harbor Exemption.** The Federal Reserve, on behalf of and in consultation with the Council, is directed to establish criteria for exempting "types or classes" of nonbank financial companies from enhanced Federal Reserve supervision, taking into account the same criteria used in systemic importance designations. A report to Congress, due within 30 days of final regulations, must at a minimum contain the rationale for any exemption and the empirical evidence to support the criteria for exemption. Re-evaluation of the safe harbor exemption must occur at least every 5 years, and any revision must at least give a 2-year transition period.
  - The Senate Banking Committee report on the Senate bill indicated that the safe harbor provision is intended to take into account potential duplication between the requirements of Title I and the payment, clearing and settlement provisions in Title VIII for financial market utilities. Since this report, the definition of U.S. nonbank financial company was narrowed to expressly exclude a number of entities, including exchanges, clearing agencies, and other entities which could have fit under this stated intent.
  - The language itself is broad enough to capture other "types or classes" of entities.
- For more information on the implementation of the systemically important designation, see slide 1, "Nonbank Financial Companies: Path to Designation as Systemically Important."

### Systemically Important Bank Holding Companies

- **Automatic Systemic Designation.** Bank holding companies with \$50 billion or more in assets are automatically subject to enhanced prudential standards. No Federal Reserve action or Council determination is required.
- **\$50 Billion Threshold.** There is no authority to lower the \$50 billion threshold. The Federal Reserve has authority to raise the limit, and the Council may recommend such action, but only with respect to the application of the contingent capital requirement, resolution plans, credit exposure reporting, concentration limits, enhanced public disclosures and short-term debt limits. The Federal Reserve may not raise the threshold for risk-based capital requirements, leverage limits, liquidity requirements and overall risk-management requirements.
  - According to the [National Information Center](#), as of March 31, 2010, there were 36 domestic bank holding companies that exceeded the \$50 billion threshold.

### Enhanced Prudential and Other Standards for Systemically Important Firms

- **Enhanced Prudential Standards**
  - The Federal Reserve is required to establish enhanced risk-based capital, leverage and liquidity requirements, overall risk management requirements, resolution plans, credit exposure reporting,

concentration limits and prompt corrective action to apply to systemically important companies. Generally, rules implementing these requirements must be issued within 18 months after enactment.

- In setting enhanced risk-based and leverage capital standards, the Federal Reserve will need to take into account the floors and other requirements contained in the Collins Amendment. For discussion on such requirements, see [“Minimum Leverage and Risk-Based Capital Requirements.”](#)
- The Federal Reserve may, but is not required to, establish additional prudential standards, including: contingent capital requirements, enhanced public disclosure requirements, short-term debt limits and other prudential standards that it, on its own or pursuant to Council recommendations, deems appropriate.
  - The Federal Reserve, in consultation with the Council, may exempt a systemically important company from the risk-based capital requirements and leverage limits if such requirements are deemed inappropriate because of such company’s activities, such as investment company activities or assets under management, or structure, but must apply other standards that result in similarly stringent controls.
    - The extent to which this authority permits the Federal Reserve to exempt a systemically important company from the requirements of the Collins Amendment is unclear. For more information, see [“Minimum Leverage and Risk-Based Capital Requirements.”](#)
- **Consultation Regarding Heightened Standards.** The Federal Reserve must take into account recommendations of the Council in developing enhanced prudential standards. The report for the Senate bill indicates that Congress intends for the Federal Reserve to consult, to the extent appropriate, with foreign regulators.
  - Before imposing prudential standards or any other requirements that are likely to have a “significant impact” on a functionally regulated subsidiary or depository institution subsidiary of a systemically important company, the Federal Reserve must consult with each Council member that primarily supervises any such subsidiary with respect to such standards or requirements.
- **Guidelines for Designing Heightened Standards.** Standards must be more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States.
  - The Federal Reserve must design the standards to ensure, to the extent possible, that small changes in factors used to develop enhanced prudential standards do not result in sharp, discontinuous changes in the standards.
  - The Federal Reserve must take into account any recommendations by the Council.
- **Customizing Standards.** The systemic regime includes a number of provisions designed to tailor the application of stricter prudential standards to individual companies and take in account differences in the business models of financial companies.
  - **Standards to Increase in Stringency.** The standards must increase in stringency based on enumerated factors, including: the degree of leverage of the company, the amount and nature of financial assets of the company, the amount and types of liabilities of the company, including the degree of reliance on short-term funding, off-balance sheet exposure, certain other assessments imposed (e.g. FDIC Deposit Insurance Fund and state insolvency regimes) and any other risk-related factor the Federal Reserve deems appropriate.

- **Tailored Application.** The Federal Reserve is authorized, in prescribing enhanced prudential standards, to differentiate among companies on an individual basis or by category, taking into account their size, capital structure, riskiness, complexity, financial activities, including those of their subsidiaries and any other risk-related factors the Federal Reserve deems appropriate. The Federal Reserve must also take into account differences between systemically important nonbanks and bank holding companies.
  - The Federal Reserve must consider additional factors when applying standards to foreign nonbank financial companies and foreign-based bank holding companies. For information on these factors, see “[Foreign Financial Companies](#).”
- **Predominant Line of Business.** The Federal Reserve must adapt the required standards as appropriate in light of any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate. There is no numerical standard for the flexible adaption requirement.
- **Interaction with Requirements of the Collins Amendment.** It is unclear how the Federal Reserve will reconcile the Collins Amendment’s minimum leverage capital and risk-based capital requirements with the Federal Reserve’s obligation to customize leverage capital and risk-based capital requirements and differentiate between bank holding companies and nonbank financial companies. For discussion on the application of these requirements, see “[Application to Other Financial Institutions](#).”
- **Inclusion of Off-Balance Sheet Activities in Computing Capital Requirements.** For any bank holding company with \$50 billion or more in assets or any systemically important nonbank financial company, off-balance sheet activities must be taken into account for the purposes of meeting capital requirements.
  - The term “off-balance sheet activities” means an existing liability that is not on the balance sheet, but may move on-balance sheet upon the occurrence of some future event. The definition explicitly includes standby letters of credit, repos, interest rate swaps and credit swaps, among others.
- **Contingent Capital.** The Federal Reserve is permitted to require contingent capital, and the Council can make recommendations to that effect, but only after a Council study and subsequent report to Congress, which must be submitted within 2 years after enactment of the bill.
- **Concentration Limits**
  - **Limits on Credit Exposures to Non-Affiliates.** The Federal Reserve must prescribe standards to limit the risks posed by the failure of any individual company to a systemically important firm. The rules issued by the Federal Reserve must prohibit credit exposure of a systemically important company to any unaffiliated company that exceeds 25 percent of capital stock and surplus, or such lower amount as the Federal Reserve may prescribe by regulation, of the “company,” presumably the systemically important company.
    - Credit exposure is broadly defined to include derivatives, repos, securities loans and any transaction that the Federal Reserve determines to be similar. The Federal Reserve can exempt transactions from the credit exposure definition if in the public interest.
    - Transactions with a person are attributed to a company if its proceeds are used for the benefit of, or transferred to, that company.
    - Federal home loan banks are exempt from the limits.
    - The bill provides a transition period of 3 years from the date of enactment, subject to extension by the Federal Reserve for an additional 2 years to promote stability.



- **Concentration Limits on Large Financial Firms.** A separate provision prohibits any insured depository institution, depository institution holding company or systemically important nonbank financial company from merging with or acquiring substantially all of the assets or control of another company if the resulting company's total consolidated liabilities would exceed 10 percent of the aggregate consolidated liabilities of all financial companies at the end of the prior calendar year. The bill provides an exception for acquisitions where the target bank is in default or in danger of default. For more information regarding the concentration limits imposed by the bill, see "[Concentration Limits \(Liability Cap\)](#)".
- **Risk Committees at Public Companies.** The bill requires risk committees for systemically important, publicly traded nonbank financial companies, as well as any publicly traded bank holding companies with total consolidated assets of \$10 billion or more. The Federal Reserve may impose the requirement on publicly traded bank holding companies with less than \$10 billion in assets as necessary or appropriate to promote sound risk-management practices. Risk committees must have the number of independent directors as determined by the Federal Reserve, and include 1 risk management expert having experience in risk management at large complex companies.
  - The Federal Reserve must issue final rules to carry out this provision within 1 year after the transfer date, and such rules must take effect within 15 months after the transfer date.
  - The "**transfer date**" is the date when the OTS's power and duties are transferred to the Federal Reserve, OCC and FDIC, as applicable. It occurs one year after enactment, subject to an extension by up to 6 months by the Treasury Secretary. The Treasury Secretary must publish any extension of the transfer date in the Federal Register within 270 days after enactment.<sup>2</sup>
  - We believe it is likely that the Federal Reserve will not impose this requirement on foreign parent companies.
- **Resolution Plans ("Living Wills").** Systemically important nonbank financial companies and large, interconnected bank holding companies must prepare and maintain extensive rapid and orderly resolution plans, which must be approved by the Federal Reserve and the FDIC. Plans are nonbinding on bankruptcy courts, receivers or similar authorities. No private right of action may be based on any resolution plan.
  - The content of the "living wills" must include: (1) 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; (2) full descriptions of the company's ownership structure, assets, liabilities and contractual obligations; (3) identification of the 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 (4) any other information that the Federal Reserve and the FDIC jointly require by rule or order.
  - The FDIC and the Federal Reserve must review a company's living will to determine whether it is credible and whether it would facilitate an orderly resolution under the U.S. Bankruptcy Code. If the living will is found to be deficient, the company must resubmit the plan, including any proposed changes in business operations and corporate structure to facilitate implementation of the plan.

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<sup>2</sup> The transfer date is different than the designated transfer date for consumer protection.

- If a firm fails to adopt an acceptable plan, the FDIC and the Federal Reserve may impose more stringent capital, leverage, or liquidity requirements, or restrictions on growth, activities or operations. After having imposed other requirements, the FDIC and Federal Reserve may require a company to divest assets if the company's living will is deficient and a suitable, revised living will is not resubmitted within 2 years.
  - Separately, the FDIC has recently proposed a rule which would require insured depository institutions with more than \$10 billion in assets that are controlled by a holding company with greater than \$100 billion in assets to submit a living will, regardless of whether the parent company would be required to submit a living will under the legislation.
- **Credit Exposure Reports.** The Federal Reserve must require systemically important companies to submit periodic reports to the Federal Reserve, the Council and the FDIC on the nature and extent to which the company has credit exposure to other "significant" nonbank financial companies and "significant" bank holding companies and vice-versa.
- **Enhanced Public Disclosures.** The Federal Reserve may prescribe periodic public disclosures by systemically important companies in order to support market evaluation of the risk profile, capital adequacy and risk management capabilities of such companies.
- **Short-Term Debt Limits.** The Federal Reserve may prescribe short-term debt limits to mitigate the risks that an over-accumulation of short-term debt could pose to financial companies and financial stability. The limit may include off-balance sheet exposures.
  - Any short-term debt limits prescribed by the Federal Reserve must be based on short-term debt as a percentage of the capital stock and surplus of the company or on any other measure the Federal Reserve deems appropriate.
  - The definition of what constitutes "short-term debt" will be determined by Federal Reserve regulation, except that the term may not include insured deposits.
- **Stress Tests**
  - **Systemically Important Companies**
    - The Federal Reserve must conduct annual stress tests for all systemically important companies under at least 3 scenarios – baseline, adverse and severely adverse. The Federal Reserve must require each systemically important company to modify its living will based on the results of the analysis. The Federal Reserve will also publish a summary of the results of the stress tests.
    - Each systemically important company must also conduct semiannual internal stress tests and report the results of such stress tests to the Federal Reserve and its primary financial regulatory agency and publish a summary of the results as required by implementing regulations.
  - **Financial Companies with \$10 Billion or More in Assets.** All financial companies with \$10 billion or more in assets that are regulated by a primary Federal financial regulatory agency must conduct annual internal stress tests, also under at least 3 scenarios – baseline, adverse and severely adverse – and publish a summary of the results as required by implementing regulations.
  - The Federal Reserve may also require stress tests for non-systemically important companies.
- **Limitations on Nonbank Acquisitions.** Systemically important companies must provide prior notice to the Federal Reserve before acquiring control of voting shares of a company engaged in activities that are financial in nature or incidental thereto that has \$10 billion or more of consolidated assets.

- The bill states that the prior notice requirement does not apply to (1) an acquisition permitted under 4(c) of the Bank Holding Company, thus exempting less than 5% investments and investments in companies that are closely related to banking, and (2) an acquisition made in the course of a systemically important company's underwriting, dealing, or market-making activities.
- We presume that the Federal Reserve will be permitted to issue an order disapproving the transaction, and will establish procedures similar to those set forth in Regulation Y with respect to nonbanking acquisitions.
- **Elimination of Hart-Scott Exemption.** For the large nonbank acquisitions described above, the bill eliminates the statutory exemption from the Hart-Scott-Rodino Act filing requirements that is available in transactions for which prior Federal Reserve approval is required.
- **Reports and Examinations of Systemically Important Nonbank Financial Companies.** For information on such reports and examinations, see "[Regulation of Systemically Important Nonbank Financial Companies](#)".
- **Avoidance of Duplication.** The Federal Reserve must take any action it deems appropriate to avoid imposing requirements that duplicate existing requirements applicable to bank holding companies and nonbank financial companies under other provisions of law.
- **Rule of Construction with Respect to State Standards.** Regulations or standards under Title I may not be construed so as to lessen the stringency of requirements imposed by applicable primary financial regulatory agencies or other applicable agencies.
- For details on when systemic risk oversight provisions take effect, see slide 2, "Systemic Oversight of Bank Holding Companies" and slide 3, "Systemic Oversight of Nonbank Financial Companies."

### Remediation and Mitigatory Actions Upon Financial Distress or Grave Threat

- **Early Remediation.** The bill requires the Federal Reserve, in consultation with the Council and the FDIC, to establish requirements for early remediation of financial distress that must include:
  - For a company in the initial stages of financial decline, limits on capital distributions, acquisitions and asset growth; and
  - For a company in the later stages of financial decline, a capital restoration plan and capital-raising requirements, limits on transactions with affiliates, management changes, and asset sales.
- **Mitigatory Actions, Asset Sales and Breakup Powers.**
  - Upon a finding by the Federal Reserve, with approval of 2/3 vote of the Council, that a systemically important company poses a "grave threat" to financial stability, the Federal Reserve must take actions necessary to mitigate such risk, including:
    - limiting the ability of the company to merge with, acquire, consolidate with, or otherwise become affiliated with another company;
    - restricting the ability to offer a financial product or products;
    - ordering termination of activities;
    - imposing conditions on the manner in which the company conducts activities; and
    - if the Federal Reserve determines that such actions are inadequate to mitigate a threat to U.S. financial stability, requiring the company to sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities.

- **Penalty for Deficient Living Will.** Asset sales may also be applied as an ultimate sanction, after the Federal Reserve and FDIC have imposed other requirements, if a living will that was found lacking is not resubmitted within 2 years in revised form. For more information on living wills, see [“Resolution Plans.”](#)
- **Leverage Limit.** The Federal Reserve must require a systemically important company to maintain a debt-to-equity ratio of no more than 15-to-1 upon a determination by the Council that the company poses a grave threat to U.S. financial stability and imposition of the leverage limit is necessary to mitigate such threat. In making a determination, the Council must consider the same factors as applicable to the systemically important designation of nonbank financial companies.
- We expect that the “grave threat” authorities will be only rarely used, and as a last resort.

### Standards and Safeguards for Systemically Important Activities and Practices

- **Designating Activities and Setting Standards.** The Council may recommend heightened prudential standards or safeguards for particular financial activities or practices conducted by any company subject to regulation by a primary financial regulatory agency, including insurance companies, if it finds that the conduct, scope, nature, size, scale or interconnectedness of the 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 or the U.S. financial markets. The activity or practice, rather than the financial institution, would be considered significant.
  - **Recommending Heightened Prudential Standards with Respect to Designated Activities.** The bill permits the Council to recommend heightened standards, including prescribing the conduct of an activity in certain ways, or prohibiting the activity altogether. In setting such standards, the Council must consult with the primary financial regulatory agencies and provide for notice and comment. Furthermore, any such standards must take into account costs to long-term economic growth.
    - If the Council rescinds its recommendation that a particular financial activity requires such standards or safeguards, each primary financial regulatory agency may choose to maintain them but must establish an appeals process for entities subject to the agency’s jurisdiction.
  - **Implementation of Heightened Capital Standards.** The primary financial regulatory agency is required to either impose the standards recommended by the Council, impose similar standards that the Council deems acceptable, or provide a written explanation within 90 days after the recommendation explaining why the agency has not followed the Council’s recommendation.
    - Primary financial regulators may also require reports, examine for compliance and enforce standards for companies under their jurisdiction.
  - **Capital Requirements to Address Systemic Risks.** For information on such capital requirements, see [“Capital Requirements Must Address Systemic Risks.”](#)
  - **The Volcker Rule** prohibits proprietary trading and certain fund activities by bank holding companies and their affiliates and imposes enhanced capital and other quantitative limits on such activities by systemically important nonbank financial companies, including systemically important hedge funds. For information on the Volcker rule, see [“The Volcker Rule”](#).
- For details on the implementation of break-up provisions and limits to concentration and growth, see slide 4, “Break-Up, Concentration and Growth Limits.”

### Regulation of Systemically Important Nonbank Financial Companies

- **Registration.** Once designated, systemically important nonbank financial companies must register with the Federal Reserve within 180 days.

- For a discussion whether the registration requirement applies to foreign nonbank financial companies, or only their U.S. subsidiaries, see “[Foreign Financial Companies](#)”.
- **Intermediate Holding Companies.** The intermediate holding company regime is designed to create a company that will be under Federal Reserve supervision while keeping the parent separate from Federal Reserve supervision, except in limited circumstances.
  - **Mandatory Establishment.** The Federal Reserve must require a systemically important nonbank financial company to establish an intermediate holding company if it finds that such intermediate holding company is necessary for appropriate supervision or to ensure that Federal Reserve supervision does not extend to commercial activities.
  - **Board Authority to Require Establishment.** The Federal Reserve may require a systemically important nonbank financial company to set up an intermediate holding company no later than 90 days of the company’s designation as systemically important or such longer period as the Board of Governors may deem appropriate. If an intermediate holding company is required, the systemically important nonbank financial company must segregate all or a portion of activities that are financial in nature or incidental thereto under section 4(k) of the Bank Holding Company Act, other than internal financial activities, from its commercial activities.
    - The Federal Reserve may require certain companies to form intermediate holding companies under the bill’s anti-evasion provisions. For information on this requirement, see “[Anti-Evasion](#)”.
  - **Regulations.** The Federal Reserve must issue regulations to establish criteria for determining whether a nonbank financial company will be required to set up an intermediate holding company. The Federal Reserve may also issue regulations restricting or limiting transactions, other than transactions in connection with a *bona fide* acquisition or lease, between the intermediate holding company and its parent company or affiliates that are not subsidiaries of the same parent company as necessary to prevent unsafe and unsound practices.
  - **Source of Strength.** If an intermediate holding company is required, the direct or indirect parent must serve as a source of strength to the intermediate holding company.
  - **Enforcement Authority.** The bill permits the Federal Reserve to use powers granted under Section 8 of the Federal Deposit Insurance Act to enforce compliance with the intermediate holding company requirements against any company that controls an intermediate holding company.
- **Reports, Examinations and Enforcement Regarding Nonbank Companies.** Systemically important nonbank financial companies and their subsidiaries are subject to reporting requirements, examination by, and enforcement powers of the Federal Reserve. The Federal Reserve must consult with the primary financial regulators and avoid duplication to the fullest extent possible.
  - **Purpose of Reports and Examinations.** The Federal Reserve may require a systemically important nonbank financial company and its subsidiaries to produce reports and submit to examinations to keep the Federal Reserve informed as to the company’s and its subsidiaries’ financial condition, operational and other risks and systems for monitoring such risks and compliance by the company or its subsidiaries with the requirements of the systemic risk regime.
  - **Recommendations and Federal Reserve Back-up Authority for Certain Subsidiaries.** For depository institutions and functionally regulated subsidiaries of such companies, the Federal Reserve may recommend action or enforcement proceedings to the primary financial regulator. If the primary financial regulator does not take action within 60 days of the Federal Reserve’s recommendation, the Federal Reserve has back-up authority to take the recommended

supervisory or enforcement action as if the depository institution or functionally regulated subsidiary were a bank holding company.

- **FDIC Examinations and Back-up Authority.** The FDIC is authorized to make special examinations of any insured depository institution, systemically important nonbank financial company or bank holding company with \$50 billion or more total consolidated assets if necessary to implement its authority to provide for the orderly liquidation of the company under Title II of the bill, but the FDIC may not do so with respect to a company in “generally sound condition.” The FDIC is also granted back-up authority with respect to any depository institution holding company that engages in conduct or threatens conduct, including any acts or omissions, that pose a foreseeable and material risk to the Deposit Insurance Fund, but again, the FDIC may not exercise this authority with respect to a company that does not pose such a risk and is in “generally sound condition.”
- **Bank Holding Company Act Activities Restrictions and Acquisition Limits**
  - **No Activities Restrictions.** Systemically important nonbank financial companies are not required to conform to the activities restrictions in Section 4 of the Bank Holding Company Act.
  - **Bank Acquisitions.** Systemically important nonbank financial companies are subject to limits on bank acquisitions under Section 3 of the Bank Holding Company Act as if they were bank holding companies, meaning, among other things, that Federal Reserve approval is required before a systemically important nonbank financial company acquires direct or indirect control over more than 5% of the voting shares of a bank.
  - **Management Interlock Prohibition.** Systemically important nonbank companies are subject to a prohibition on management interlocks as if they were bank holding companies, and the Federal Reserve may not by regulation permit management interlocks between unaffiliated systemically important companies, other than on a temporary basis in the case of a merger, acquisition or consolidation.
- **“Hotel California” Provision (“De-banking”).** Any bank holding company with \$50 billion or more in assets as of January 1, 2010 which received assistance or participated in the capital purchase program under TARP automatically becomes a systemically important nonbank financial company if it subsequently ceases to be a bank holding company. Bank holding companies that were not TARP recipients, including foreign banking institutions treated as bank holding companies, are not subject to the “Hotel California” provision.
  - **Applicability of Bank Holding Company Act.** A former bank holding company subject to “Hotel California” would no longer be subject to the restrictions on nonbanking activities and investments in Section 4 of the Bank Holding Company Act, but it would continue to be subject to the prior approval requirements on bank acquisitions in Section 3 of the Bank Holding Company Act.
  - **Enhanced Prudential Standards.** A former bank holding company would continue to be subject to the enhanced prudential standards set forth above.
  - **Capital and Quantitative Limits in Volcker Rule.** A former bank holding company would also be subject to the portion of the Volcker Rule that requires the Federal Reserve to impose “additional” capital requirements and other quantitative limits with respect to its proprietary trading and its investing in or sponsoring of hedge funds or private equity funds. For more information on the additional capital requirements and other quantitative limits, see [“The Volcker Rule”](#).
  - **Appeal Procedure.** A former bank holding company may request an opportunity for a hearing before the Council to appeal its treatment as a systemically important nonbank financial

company. If the Council denies the appeal, it must review the decision at least annually. A Council decision to grant an appeal requires a vote of 2/3 of the Council, including the affirmative vote of the Treasury Secretary.

## Foreign Financial Companies

- **Treated as a Bank Holding Company.** The systemic risk provisions of the bill cover foreign banks by including foreign banks that operate a branch, agency or commercial lending subsidiary in the U.S., treating them as though they were "bank holding companies." Many foreign banks also own U.S. banks, which means they themselves are bank holding companies.
  - **\$50 Billion Threshold.** The bill is silent on whether only U.S. assets would be considered when calculating the \$50 billion asset threshold.
  - **Extraterritorial Application Generally.** It is not yet known to what extent enhanced prudential standards or other systemic risk provisions will apply only to U.S. operations of foreign bank holding companies, and to what extent they will extend extraterritorially to the foreign parent.
    - The Supreme Court recently reiterated in *Morrison v. National Australia Bank*<sup>3</sup> the longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is presumed to apply only within the territorial jurisdiction of the United States. The court stated that, when a statute gives no clear indication of an extraterritorial application, it has none.
    - With respect to foreign bank holding companies, including foreign banking entities treated as bank holding companies, and foreign systemically important nonbank financial companies, a great deal of discretion is left to the regulators on what might apply and how. We describe some of the considerations below. The standards at times contemplate the possibility of extraterritorial application, sometimes they are silent, and in yet other provisions they seem to focus on the U.S. only. Ultimately, extraterritorial application will be determined during the regulatory implementation process in light of statutory language, the Federal Reserve's practices under the Bank Holding Company Act, the express terms of the statute, *Morrison v. National Australia Bank* and similar cases, developing standards elsewhere and home country rules. Some of the lines appear to be drawn by the bill, which seems to limit the extraterritorial reach expressly in the case of foreign nonbank financial companies, while similar language is largely absent for foreign bank holding companies. Ultimately, however, comity, mutual recognition and traditional rules will all play a role in establishing the lines of extraterritorial application.
  - **Recommendation and Application of Standards to Foreign Banking Entities.** In recommending and applying enhanced prudential standards to any foreign-based bank holding company, the Council and the Federal Reserve, respectively, must:
    - Take into account differences among systemically important companies, based in part on the factors used for the systemic importance determination for foreign nonbank financial companies, which, in turn, allow taking into account the amount and nature of U.S. financial assets, liabilities and off-balance sheet exposures, among other things; and

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<sup>3</sup> *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. \_\_\_\_, No. 08-1191, slip op. (June 24, 2010).

- Give due regard to the principles of national treatment and equality of competitive opportunity, and take into account the extent to which the foreign bank holding company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the U.S.
  - **Consultation with Foreign Regulators.** In practice, this may mean that the Council and the Federal Reserve will consult with foreign regulatory authorities before recommending or imposing any such standards, rather than attempting to impose U.S. standards without such prior negotiation.
  - **Traditionally Limited Extraterritorial Application.** The Federal Reserve traditionally has limited direct U.S. regulation of foreign banks to their U.S. activities and operations.
  - **U.S. Capital Standards.** Based on Federal Reserve precedent and previous versions of the House and Senate bills, it is likely that some form of U.S. capital standards will be applied, though the exact parameters are unclear. One area in particular, the Collins Amendment with its minimum risk-based and leverage capital requirements, appears to apply U.S. capital and leverage standards to intermediate bank and thrift holding companies of foreign bank holding companies regardless of the standards applicable to the foreign parent. The Collins Amendment in particular constitutes a major shift from traditional Federal Reserve practice, which generally applied only heightened risk-based capital standards following home country methodology in their application. For discussion on the application of these requirements to foreign banking entities, see [“Collins Amendment – Application to Other Financial Institutions”](#).
  - **GAO Study on Capital Requirements for U.S. Intermediate Holding Companies.** The future application of risk-based capital and leverage capital requirements in the foreign bank context could be influenced by the outcome of a study the bill mandates. The GAO, in consultation with the Federal banking agencies, is required to conduct a study of capital requirements applicable to U.S. intermediate holding companies of foreign banks that are bank or thrift holding companies, taking into account the principle of national treatment and equality of competitive opportunity. The GAO must submit a report to Congress; however, the report need not include recommendations on the capital requirements for foreign bank intermediate holding companies.
- **Termination / Establishment of U.S. Offices of a Foreign Bank and Broker-Dealer Registration in the U.S.** The Federal Reserve may terminate the activities of the U.S. branch, agency or commercial lending subsidiary of a foreign institution that presents a systemic risk to the U.S. if the Federal Reserve determines that the home country has not adopted, or made demonstrable progress toward adopting, an appropriate system of financial regulation to mitigate such systemic risk. The Federal Reserve may also take these criteria into account when deciding to approve a new branch, agency or commercial company lending application. The SEC may terminate U.S. broker-dealer registrations under the same circumstances. The bill does not define the circumstances under which a firm is deemed to present a systemic risk to the U.S.
- **Modification of Other Systemic Risk Provisions.** We expect that most systemic risk provisions will be modified to some degree when applied to foreign bank holding companies. Only a few provisions, however, including the following, are specific as to the way modifications might occur.



- **Mitigation of Reporting Burden.** Before requiring the submission of reports – as part of the Council’s data collection function - from a foreign-based bank holding company, the Council must, acting through the OFR, to the extent appropriate, consult with the appropriate foreign regulator of such company and, whenever possible, rely on information already being collected by such foreign regulator, “with English translation.” As regards certified reports that the Council, acting through the OFR, may require from systemically important companies, the Council must to the fullest extent possible use reports required to be provided to a relevant foreign supervisory authority.
    - **Asset Sale / Breakup Provision.** The Federal Reserve may prescribe rules regarding applicability of asset sale/breakup provisions to foreign-based financial companies posing a grave threat, but taking into account national treatment and equality of competitive opportunity; and must take into account the extent to which the company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States. We believe that these provisions, if invoked, would be limited to U.S. operations. For more information on breakup powers and asset sales, see [“Mitigatory Actions, Asset Sales and Breakup Powers”](#).
    - **Avoidance of Duplication.** The Federal Reserve must take any action it deems appropriate to avoid imposing requirements that duplicate existing requirements applicable to bank holding companies and nonbank financial companies under other provisions of law, but the scope of this provision is unknown.
  - **Treatment of Foreign Nonbank Financial Companies**
    - **Designation.** A foreign nonbank financial company may be designated as systemically important by the Council if it is “predominantly engaged in financial activities,” meaning that 85% or more of the consolidated annual gross revenues or consolidated total assets of the company and its subsidiaries are attributable to activities that are financial in nature under section 4(k) of the Bank Holding Company Act,<sup>4</sup> and, if applicable, attributable to the ownership or control of 1 or more insured depository institutions. We expect that most insurance companies, asset managers and hedge funds would meet this test.
    - Unlike in the House bill, a foreign company need not have “significant operations in the United States” in order to qualify as a nonbank financial company. For a designation as systemically important, however, the Council must consider factors including the company’s U.S.-related off-balance sheet exposure, U.S. financial assets and importance as a source of credit and liquidity in the U.S., among other things, achieving a similar effect.
    - In designating a foreign nonbank financial company under the emergency exception to providing notice and a hearing, the Council is required to consult with the appropriate home country supervisor, if any, of the foreign nonbank financial company that is being considered for such a determination.

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<sup>4</sup> Section 4(k) of the Bank Holding Company Act defines activities that are “financial in nature” to include, among others securities underwriting, dealing and market-making, insurance activities, and merchant banking activities. It was added by the Gramm-Leach-Bliley Act of 1999 to expand the scope of permitted activities for a bank holding company that elects to be a financial holding company.

- **Anti-Evasion Provision.** In addition, the U.S. financial activities of any foreign nonbank financial company may be made subject to supervision and enhanced prudential standards if the company is determined to be organized or operated in a manner as to evade the application of the systemic risk provisions, and such financial activities in the U.S. are determined to pose a threat to U.S. financial stability. The anti-evasion provision of the bill would apply only to financial activities in the U.S. For information on such application, see [“Financial Activities Designation for Anti-Evasion Purposes.”](#)
- **Re-evaluation and Rescission.** In deciding whether to waive or amend the provisions for review and potential rescission of a systemic importance determination, the Council must consult with the appropriate home country regulator.
- **Extraterritorial Application Generally.** As for foreign bank holding companies, it is not yet known to what extent enhanced prudential standards or other provisions will apply only to U.S. operations of systemically important foreign nonbank financial companies, and to what extent they will extend extraterritorially, either unilaterally or by agreement with home country regulators. As described below, an unclear provision of the bill applies systemic risk provisions generally only to U.S. activities and subsidiaries of foreign nonbank financial companies. In light of the *Morrison* decision, this provision should be presumed not to have extraterritorial application.
  - **General Application to U.S. Activities and Subsidiaries Only.** For foreign nonbank financial companies, the bill may significantly limit the extraterritorial applicability of the systemic risk provisions. It essentially states that, for purposes of the application of the systemic risk provisions, other than the designation clause itself, to foreign nonbank financial companies, references to “company” or “subsidiary” refer only to the U.S. activities and subsidiaries of a foreign company, “except as otherwise provided.” While this provision has been modified since the Senate bill, its precise impact is unknown, as “company” and “subsidiary” are rarely used in isolation. This language is both less clear and less helpful than the language in the Senate bill that pushed sharply in the direction of applying prudential standards only to U.S. operations. The precise meaning of this provision, however, will become clear only upon regulatory implementation.
- **Recommendation and Application of Enhanced Prudential Standards.** In recommending and applying enhanced prudential standards to any systemically important foreign nonbank financial company, the Council and the Federal Reserve, respectively, generally apply the same criteria as described above for foreign bank holding companies.
- **Mitigation of Reporting Burden; Asset Sale / Breakup Provision; Concentration Limit.** The provisions described above for foreign bank holding companies apply equally to systemically important foreign nonbank financial companies or, in the case of reports collected as part of the Council’s data collection function, to all foreign nonbank financial companies regardless of their systemic designation, subject only to the potential application to U.S. subsidiaries only.
- **Safe Harbor.** The Federal Reserve, on behalf of and in consultation with the Council, must set forth criteria for exempting “certain types or classes” of U.S. or foreign nonbank financial companies from enhanced Federal Reserve supervision, taking into account the same criteria used in systemic importance designations. It is unknown to what extent this will be used or how the “types and classes” will be drawn.
- **Avoidance of Duplication.** For information on the avoidance of regulatory duplication, see [“Avoidance of Duplication.”](#)

## International Policy Coordination

- **By the President.** The President of the United States may coordinate through all available international policy channels similar policies as found in domestic law relating to limiting systemic risk and protecting financial stability and the global economy.
- **By the Council.** The Treasury Secretary as Chairperson, in coordination with other members of the Council, must regularly consult with the financial regulatory entities and other appropriate organizations of foreign governments or international organizations on matters relating to systemic risk to the international financial system.
  - In addition, in exercising its duties under the systemic risk provisions with respect to foreign nonbank financial companies, foreign-based bank holding companies and cross-border activities and markets, the Council must consult with appropriate foreign regulatory authorities “to the extent appropriate.”
- **By the Federal Reserve and Treasury.** The Federal Reserve and Treasury must consult with their foreign counterparts, and through appropriate multilateral organizations, encourage comprehensive and robust prudential supervision and regulation for all highly leveraged and interconnected financial companies.

## The Office of Financial Research

In an unheralded section, the bill adds a new self-funded, largely independent Office of Financial Research with the power to gather vast amounts of information from financial market participants and to required standardization of financial information to be reported to the OFR and other regulators.

The OFR has broad information gathering authority backed by subpoena power, and all data it collects is subject to the Freedom of Information Act. Several of the OFR provisions appear to overlap and even conflict in some places, meaning the scope of the OFR’s powers will not be known until developed through rulemaking and practice.

- **Institutional Structure.** The OFR is located inside of the Treasury Department, but its Director is appointed to a 6-year term by the President, with the advice and consent of the Senate. The Director has a nonvoting seat on the Council.
- **Funding.** The OFR sets its own budget and funds it with fees on large banks and non-bank financial companies supervised by the Federal Reserve.
- **Purpose and Duties.** The OFR’s purpose is to support the member agencies by, among others:
  - Collecting data on behalf of the Council and providing data to the Council and Council-member agencies;
  - Standardizing the types and formats of data reported and collected;
  - Performing applied research and essential long-term research;
  - Developing tools for risk measurement and monitoring;
  - Making the results of the activities of the OFR available to financial regulatory agencies; and
  - Assisting Council-member agencies in determining the types and formats of data they are authorized by the bill to collect.
- **Jurisdictional Authority.** The OFR is empowered to collect data from all financial companies, not just those subject to the systemic risk regime. Furthermore, for the purposes of the OFR subtitle, “financial companies” is defined broadly to have the same meaning as in the orderly liquidation regime in Title II, plus insured depository institutions and insurance companies.

- **Subpoena Power.** The OFR's data collection efforts are backed by the power to issue a subpoena to any financial company.
- **Rulemaking Authority.** The OFR has authority to issue regulations and collect reports, data and information after consultation with the Treasury Secretary. OFR is required to issue, and Council-member agencies are required to implement, regulations that standardize the scope and format of data collected by Council-member agencies on behalf of the Council. The OFR has back-up authority to implement the regulations if member agencies fail to do so within 3 years of issuance.
  - However, the bill clarifies that the OFR's authority does not supersede or interfere with the independent authority of a member agency under other law to collect data, in such format and manner as the member agency requires.
- **Independent Powers.** The OFR appears to have independent authority to issue regulations and collect reports, data and information without approval from the Council. It is required to make data available to the Council and Council-member agencies only as necessary to support their regulatory responsibilities.
- **Data Standardization.** An important role of the OFR is standardizing financial data. The OFR is required to issue regulations that standardize the scope and format of data collected by Council-member agencies on behalf of the Council, which include financial transaction data and position data. Furthermore, Council-member agencies are obligated to implement these standardization regulations—to the extent that they do not, the OFR has authority to implement these regulations with respect to the financial entities under the jurisdiction of that member agency, in consultation with the Treasury Secretary.
- **Data and Information Sharing.** The OFR is authorized to share data and information with the Council, Council-member agencies and the Bureau of Economic Analysis. Any information so shared must be maintained with at least the same level of security as used by the OFR and may not be shared with any individual or entity without the permission of the Council.
- **Data Center.** The bill calls for the creation of a Data Center within the OFR, which will collect and publish financial data.
  - **The Power to "Validate" Data.** The Data Center, on behalf of the Council, has the power to "collect, validate and maintain" all data necessary to carry out the duties of the OFR.
  - **Data Collection for Financial Stability Purposes.** The OFR may, as determined by the Council or by the Director in consultation with the Council, require the submission of periodic and other reports from any financial company for the purpose of assessing the extent to which the company, a company's financial activity or a financial market in which the company participates poses a threat to U.S. financial stability.
  - **Data Publication and Confidentiality.** The extent to which information submitted to the OFR would be kept confidential, made public or subject to the Freedom of Information Act is complex, and the bill is internally inconsistent. Confidential supervisory information is meant to be kept confidential, we believe, as are financial positions. Confidentiality concerns remain mainly because of the following:
    - The OFR is required to "maintain the confidentiality" of all data collected under its authority; however, such data is also subject to the Freedom of Information Act, which contains confidentiality carve-outs that are likely to be more narrow than comfortable for many regulators or market participants in many factual situations.
    - The OFR is required to publish, in a manner that is easily accessible to the public, databases on financial companies and financial instruments and formats and standards for OFR data, which may include standards for reporting financial transaction and position

- data to the OFR. While the OFR may not publish “confidential data,” the term is not defined.
- By contrast, information gathered under the new SEC registration and reporting obligations applicable to investment advisers is expressly carved out from Freedom of Information Act requirements. For more information, see “[Information Sharing and Confidentiality](#)”.
  - **Catalog of Financial Entities and Instruments.** The Data Center must maintain a catalog of the financial entities and instruments reported to the OFR.
  - **Financial Transaction and Position Data.** The OFR is required to collect, on a schedule determined by the Director, in consultation with the Council, financial transaction and position data from financial companies.
    - Financial transaction data includes the structure and legal description of a financial contract, with sufficient detail to describe the rights and obligations between counterparties and make possible an independent valuation.
    - Position data includes data on financial assets or liabilities held on the balance sheet of a financial company and includes **information that identifies counterparties**, the valuation by the financial company of the position, and information that makes possible an independent valuation of the position.
  - **Requirements to Use Existing Data.** Before requiring the submission of reports from any financial company that is regulated by a Council-member agency, a primary financial regulatory agency or a foreign supervisory authority, the Council, acting through the OFR, must consult with the appropriate regulator of such company, and “whenever possible,” rely on information already being collected by such regulator.
  - **Data Sharing in Support of Regulatory Responsibilities.** The OFR is required to share with the Council and Council-member agencies data collected and maintained by the Data Center as necessary to support their regulatory responsibilities.
  - **Research and Analysis Center.** The bill also calls for the creation of a Research and Analysis Center within the OFR to develop and maintain independent analytical capabilities to, among other things: promote best practices for financial risk management; monitor and report on changes in system-wide risk; and to evaluate and report on stress tests.
  - **Certified Reports from Systemically Important Companies.** The Council, acting through the OFR, may require certified reports from systemically important companies to keep the Council informed as to the financial condition of the company, its systems for monitoring and controlling risks, transactions with any depository institution subsidiary and the extent to which the activities and operations of the company and any subsidiary could have the potential to disrupt financial markets or affect U.S. financial stability.
    - **Use of Existing Reports.** The Council, acting through the OFR, must, to the “fullest extent possible,” use reports that the company has already provided other Federal, State or foreign supervisory authorities; public information; and externally audited financial statements.
  - **Required Reports to Congress.** The OFR is required to submit to Congress a report on the state of the U.S. financial system not later than 2 years after the date of enactment, and annually thereafter. The Director is required to testify annually to Congress on the activities of the OFR and its assessment of systemic risk, and no government officer or agency has the right to review the Director’s testimony prior to its submission.

- **Revolving Door Restrictions for OFR Employees.** The bill prohibits OFR employees from being employed by or providing consulting services to any financial company for 1 year after having access to the OFR's transaction or position data or confidential business information.

## Orderly Liquidation Authority

The bill includes a new orderly liquidation authority that will replace the Bankruptcy Code and other applicable insolvency laws for liquidating financial companies and certain of their subsidiaries under certain circumstances. Under the new liquidation authority, the Treasury Secretary would have the authority to appoint the FDIC as receiver of any financial company if certain conditions are satisfied. The new authority is modeled largely on Sections 11 and 13 of the Federal Deposit Insurance Act, but with several important differences. These differences were designed to harmonize the rules defining creditors' rights with those contained in the Bankruptcy Code, discourage bailouts, ensure due process, protect customer property and reduce the moral hazard that could result if shareholders, unsecured creditors or management are insulated from the consequences they would have suffered in a liquidation under the Bankruptcy Code or other applicable insolvency law.

The result is a law that attempts to balance the goals of the bankruptcy and customer protection laws with the goals of preserving or restoring financial stability, public confidence and reasonable risk-taking that may have been disrupted as a result of a financial panic.

## Designation as a Covered Financial Company

### Which Companies Are Covered

- **No Fixed Category.** Unlike almost any other statute, the orderly liquidation authority is not limited to a fixed category of persons, determinable in advance, such as all systemically important financial companies. Instead, it could apply to any financial company if certain determinations are made. The required determinations depend as much on general market conditions as they do on the systemic importance of a particular firm in a vacuum. The conditions for coverage are more likely to be found during a financial panic. They are less likely to be found during periods of relative calm.
- **Presumption Against Applicability.** The process for designating a financial company as a "covered financial company" subject to the orderly liquidation regime contains high procedural hurdles. As a result, the statute effectively contains a presumption against applicability, and instead includes a presumption in favor of applying the Bankruptcy Code or other applicable insolvency law to liquidate or reorganize an insolvent financial company, even a systemically important one. The orderly liquidation authority is designed for extreme cases during severe financial conditions.
- **Before or After a Bankruptcy Filing.** If the required determinations are made, however, the orderly liquidation authority will apply whether or not the determinations are made before or after the commencement of proceedings under the Bankruptcy Code. If a bankruptcy case has commenced, a receivership under the orderly liquidation authority will replace the bankruptcy proceedings.
- **Limited to Financial Companies.** The orderly liquidation authority is limited to financial companies; it does not apply to non-financial companies. As a result, the definition of the term "financial company" is critical to the scope of the statute.
- **Definition of Financial Company.** Subject to the exclusions and qualifications summarized below, the term "financial company" is defined as follows:

- **Domestic Companies.** Any company that is incorporated or organized under U.S. Federal or State law that is:
  - a bank holding company, as defined by the Bank Holding Company Act;
  - a nonbank financial company, including an insurance company or a securities broker-dealer, that has been determined by the Council to be systemically important and therefore subject to supervision by the Federal Reserve;
  - any company that is predominantly engaged in activities that are financial in nature or incidental thereto under Section 4(k)<sup>5</sup> of the Bank Holding Company Act, including an insurance company or securities broker-dealer; or
  - any subsidiary of any of the foregoing that is predominantly engaged in activities that are financial in nature or incidental to a financial activity under Section 4(k) of the Bank Holding Company Act, other than a subsidiary that is an insured depository institution or an insurance company.
    - **Exclusions.** The following companies are excluded from the term financial company for purposes of the orderly liquidation authority: Fannie Mae, Freddie Mac, any Federal Home Loan Bank, any Farm Credit System institution and any government entity.
      - **Government Entity.** The term “government entity” is not defined, but the term “company” is defined in the orderly resolution provisions to include companies that are majority owned by the United States or any State.
    - **Qualifications.** No company may be deemed to be predominantly engaged in activities that are financial in nature or incidental to a financial activity unless the consolidated revenues of such company from such activities constitute at least 85% of the total consolidated revenues of such company, including any revenues attributable to a depository institution investment or subsidiary.

### Process for Designating Covered Financial Companies

- **Designation as a Covered Financial Company: The “Three Keys.”** Subject to the exceptions described below for broker-dealers or insurance companies, a financial company will be designated as a covered financial company, and the FDIC will be appointed as its receiver, if at any time, including on the eve of bankruptcy, the Treasury Secretary makes the following determinations, upon the recommendation of 2/3 of the Federal Reserve Board and 2/3 of the FDIC Board, and in consultation with the President:
  - **Required Determinations**
    - the financial company is “in default or in danger of default;”

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<sup>5</sup> Section 4(k) of the Bank Holding Company Act defines activities that are “financial in nature” to include, among others, securities underwriting, dealing and market-making, insurance activities, and merchant banking activities. Added by the Gramm-Leach-Bliley Act of 1999, Section 4(k) expanded the scope of permitted activities that could be conducted by a bank holding company that elects to be a financial holding company.

- the failure of the financial company and its resolution under otherwise applicable insolvency law would have serious adverse effects on financial stability in the United States;
- no viable private sector alternative is available to prevent the default of the financial company;
- any effect of using the orderly liquidation authority on the claims or interests of creditors, counterparties and shareholders of the financial company and other market participants would be appropriate given the beneficial impact of using the orderly liquidation authority on U.S. financial stability;
- the use of the orderly liquidation authority would avoid or mitigate the adverse effects that would result from resolving the financial company under otherwise applicable insolvency law;
- a Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to being converted by regulatory order; and
- the company satisfies the definition of “financial company” contained in the statute.
- **Exceptions for Broker-Dealers and Insurance Companies**
  - **Broker-Dealers.** If the financial company is a securities broker-dealer or its largest U.S. subsidiary is a securities broker-dealer, the designation must be approved by 2/3 of the Securities and Exchange Commission and 2/3 of the Federal Reserve Board, provided that the FDIC is consulted.
  - **Insurance Companies.** If the financial company is an insurance company or its largest U.S. subsidiary is an insurance company, the designation must be approved by the Director of the new Federal Insurance Office and 2/3 of the Federal Reserve Board, provided that the FDIC is consulted.
- **In Default or Danger of Default.** The Treasury Secretary could find the financial company to be in default or danger of default if:
  - a case has been, or likely will promptly be, commenced with respect to the company under the Bankruptcy Code;
  - the company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion;
  - the assets of the company are, or are likely to be, less than its obligations to creditors and others; or
  - the company is, or is likely to be, unable to pay its obligations, other than those subject to a *bona fide* dispute, in the normal course of business.
- **Covered Subsidiaries.** If the FDIC is appointed as receiver of a covered financial company, it may appoint itself receiver of any subsidiary of the covered financial company, other than an insured depository institution, insurance company or covered broker-dealer, if the FDIC and the Treasury Secretary jointly determine that:
  - the subsidiary is in default or danger of default;
  - such action would avoid or mitigate serious adverse effects on the financial stability or economic conditions of the U.S.; and
  - such action would facilitate the orderly liquidation of the covered financial company.



- Once the FDIC appoints itself as receiver over a designated subsidiary, the designated subsidiary will be treated as a “covered financial company” for purposes of the bill.
- For timing highlights of the FDIC’s appointment as receiver, see slide 5, “Appointment of a Receiver for Orderly Liquidation.”

### Judicial Review of the Designation and Appointment Process

- **Judicial Review.** Subject to the exception described below, the Treasury Secretary must obtain an order from the U.S. District Court for the District of Columbia before appointing the FDIC as receiver of any covered financial company.
  - **Limited Review.** The court’s review is limited to whether the Treasury Secretary’s determination that the financial company is in default or danger of default and the Treasury Secretary’s determination that the entity satisfies the statutory definition of “financial company” are “arbitrary and capricious.” If the court does not make these findings, it must issue the requested order.
  - **Confidential.** The proceeding would be confidential, backed by criminal penalties for “reckless,” but not merely negligent, disclosures.
  - **Expedited.** The court would be required to rule within 24 hours of receiving a petition from the Treasury Secretary, or else the petition will be deemed granted by operation of law.
  - **Due Process.** The affected company would be given notice of the hearing and an opportunity to oppose the determination.
  - **Appellate Review; No Stay.** Either party may appeal decision to the U.S. Court of Appeals for the D.C. Circuit and then to the U.S. Supreme Court on an expedited basis, but the decision may not be stayed or enjoined pending appeal.
- **Exception for Board Acquiescence or Consent.** The Treasury Secretary is not required to obtain court authorization if the financial company’s board of directors, or body performing similar functions, “acquiesces or consents” to the FDIC’s appointment as receiver. Because the statute protects directors against any liability for acquiescing or consenting to the FDIC’s appointment in “good faith,” it is likely that the Treasury Secretary will put intense pressure on boards to acquiesce or consent in order to avoid judicial review of the appointment decision.

### Applicable Insolvency Laws upon Appointment of FDIC as Receiver

- **Generally.** Except for covered broker-dealers or covered insurance companies, the FDIC will apply the provisions of the orderly liquidation authority instead of the Bankruptcy Code or other applicable insolvency law.
- **Covered Broker-dealers.** In the case of a covered financial company that is an SEC-registered broker-dealer and a member of the Securities Investor Protection Corporation (“**SIPC**”), the FDIC must appoint SIPC as trustee for the liquidation of the covered broker-dealer under the Securities Investor Protection Act (“**SIPA**”). Effectively, the FDIC will have control over the orderly liquidation of any assets or liabilities, including customer accounts and related customer name securities or customer property, transferred to a bridge financial company pursuant to the statute, and SIPC will have control over the liquidation of any assets or liabilities, including any customer accounts and related customer name securities or customer property, left behind at the covered broker-dealer. The orderly liquidation authority will govern the orderly liquidation of any bridge financial company, and SIPA will generally govern the liquidation of the left-behind assets and liabilities, including customer accounts and related customer name securities and customer property, except as otherwise provided in the orderly liquidation authority.

- **Covered Insurance Companies.** The liquidation or rehabilitation of any insurance company that itself is, or is the subsidiary of, a covered financial company would be carried out by the appropriate state regulator under applicable state law, rather than the FDIC under the orderly liquidation authority.
  - **Back-up Authority.** If the appropriate state regulator does not file the appropriate judicial action under state law within 60 days after an insurance company or its parent has been designated as a covered financial company, the FDIC will have the authority to stand in the place of the appropriate state regulator and file the appropriate judicial action in the appropriate state court to place the insurance company in liquidation under applicable state law.

## Orderly Liquidation Authority Rules

### Effect of the FDIC's Appointment

- **Effect of Appointment.** If the FDIC is appointed receiver of a covered financial company, it succeeds by operation of law to all of the rights, titles, powers and privileges of the covered financial company and its stockholders, members, officers and directors, subject to the provisions of the orderly liquidation authority including the exceptions for insurance companies and broker-dealers. This would effectively place the FDIC in the shoes of the covered financial company to work out the company's claims under applicable state and other law, except where some provision of the orderly liquidation authority provides otherwise.

### Scope of the FDIC's Powers

- **Modeled on the Federal Deposit Insurance Act.** The FDIC's powers are largely modeled on its powers to resolve insured depository institutions under Sections 11 and 13 of the Federal Deposit Insurance Act, with certain differences designed to harmonize the rules defining creditors' rights with those contained in the Bankruptcy Code. Subject to the special provisions for covered insurance companies, as discussed above, and covered broker-dealers, as discussed above and below, the FDIC would have both its core resolution powers and the authority to administer the claims process, with very limited judicial review.
- **Core Resolution Powers.** The FDIC's core resolution powers authorize it to transfer all or any portion of the assets or liabilities of the financial company to a third party at fair value. If a third-party buyer cannot be found at fair value, the FDIC would have the authority to establish a temporary bridge financial company to hold any part of the business worth preserving until it could be sold to a third party at fair value or otherwise liquidated in an orderly fashion.
  - **Cherry-Picking Power.** A key tool in the FDIC's core resolution powers is the power to cherry-pick the assets or liabilities of a covered financial company and transfer them to a third party or bridge financial company without the need to obtain any creditors' consent or prior court review. Subject to the minimum recovery right described below, this authority includes the power to differentiate between creditors within the same class or treat junior creditors better than senior creditors.
- **Claims Process for Left-Behind Assets.** The FDIC would also have the authority to administer the process of deciding which creditors receive what, and in what order, from the liquidation of any left-behind assets, including any value received from the sale of any portion of the business.
  - **Minimum Recovery Right.** The FDIC's power to cherry-pick assets and liabilities for transfer to a third party or bridge financial company is subject to each creditor's right to receive at least the same amount as it would have received in satisfaction of its claim in a liquidation of the company under Chapter 7 of the Bankruptcy Code, as if the FDIC had not been appointed as

receiver and no transfer of any assets or liabilities under the orderly liquidation authority had taken place.

- **Financial Assistance.** The FDIC may provide a wide range of financial assistance for the resolution of a covered financial company, including making loans to, or purchasing debt, purchasing assets, assuming or guaranteeing obligations, taking liens on assets, and selling or transferring assets or liabilities of, the covered financial company. The new statute imposes some mandatory conditions on the exercise of these powers, including:
  - **Unsecured Creditors.** Unsecured creditors must bear losses, up to the amount they would have suffered in a liquidation under Chapter 7 of the Bankruptcy Code; and
  - **Removal of Management and Board.** Any management or board members of the covered financial company responsible for the failed condition must be removed.
- **Tempered Version of the FDIC's "Super Powers."** Under the Federal Deposit Insurance Act, the FDIC has a variety of "super powers" that allow it to avoid, set aside or otherwise limit the claims of creditors and other stakeholders. These "super powers" have been tempered in the orderly liquidation authority through harmonization with the rules governing creditors' rights in the Bankruptcy Code. To the extent any remnants of these "super powers" remain, however, they could change the rules of the game on the eve of bankruptcy and disrupt an otherwise effective credit risk management program for any creditor of a covered financial company that is resolved under the orderly liquidation authority instead of the Bankruptcy Code.
  - **Priority of Claims.** Unlike the Federal Deposit Insurance Act, the orderly liquidation authority does not include a priority for any deposit claims over the claims of other general creditors because the universe of financial companies eligible to be "covered financial companies" does not include insured depository institutions or other companies eligible to take deposits. The priority scheme in the orderly liquidation authority does, however, include a priority for amounts owed to the United States over the claims of general creditors, unless the United States otherwise agrees or consents.
  - **Contingent Claims.** The FDIC has long taken the position that claims against an insured depository institution for contingent obligations are not provable in a conservatorship or receivership under the Federal Deposit Insurance Act. Thus, the beneficiary of an undrawn line of credit, letter of credit or guarantee has no provable claim to draw down additional amounts or to exercise its indemnification or guarantee rights once the FDIC has been appointed receiver or conservator over an insured depository institution. Alternatively, the FDIC has taken the position that contracts for contingent obligations can be repudiated as "burdensome" and that damages for such repudiation will be zero. In contrast, contingent claims are provable in a bankruptcy proceeding and the allowable amount of such claim is the estimated value of the claim, in some cases the face amount, on the date of bankruptcy.
    - **Bankruptcy Rule Adopted.** The orderly liquidation authority has harmonized the treatment of contingent claims with the Bankruptcy Code. It defines the term "claim" to include contingent claims, provided that no creditor may receive less in a receivership proceeding than it would have received in a liquidation proceeding under Chapter 7 of the Bankruptcy Code and specifically provides that the measure of damages for repudiation of a contingent obligation shall be no less than the estimated value of the claim as of the date the FDIC is appointed as receiver, if the FDIC so prescribes by rule or regulation.
  - **Special Enforceability Requirements.** Under the Federal Deposit Insurance Act, an agreement with an insured depository institution is not enforceable against the institution or the FDIC in a receivership proceeding unless it is in writing, was contemporaneously approved by the board of directors of the institution, has been a continuous record of the institution since its

execution and satisfies certain other requirements. In contrast, the Bankruptcy Code relies on applicable state or other noninsolvency law to determine the enforceability of agreements, and will even recognize the enforceability of oral agreements if applicable state or other noninsolvency law requirements are satisfied.

- **Almost the Same as Bankruptcy Rule.** The orderly liquidation authority retains the flat prohibition on oral contracts, but will treat any written agreement as enforceable so long as it was duly executed or confirmed in the ordinary course of business as demonstrated by the counterparty to the satisfaction of the receiver.
- **Enforceability of *Ipsso Facto* Clauses.** The Federal Deposit Insurance Act provides that so-called *ipso facto* clauses are not enforceable, except in the case of qualified financial contracts (“QFCs”), director or officer liability insurance contracts and depository institution bonds. *Ipsso facto* clauses are provisions that purport to authorize a counterparty to terminate or accelerate performance on a contract solely by reason of the FDIC’s appointment as receiver or the insolvency of the institution. Counterparties are, however, generally permitted to terminate or accelerate performance on account of other defaults. In contrast, under the Bankruptcy Code, an automatic stay applies to the exercise of all rights under any contract, other than QFCs.
  - **FDIA Rule Retained.** The orderly liquidation authority retains the approach contained in the Federal Deposit Insurance Act.
- **Repudiation of Contracts.** The Federal Deposit Insurance Act also empowers the FDIC to disaffirm or repudiate any contract or lease, including a QFC, to which an insured depository institution is a party if the FDIC determines within a “reasonable period of time” that the contract would be “burdensome” and repudiation of the contract would promote the orderly administration of the institution’s affairs. If the FDIC disaffirms or repudiates a contract, it must pay the counterparty damages. Rather than measure damages as the lost benefit of the counterparty’s bargain, however, the Federal Deposit Insurance Act provides that, except in the case of QFCs, the damages are limited to “actual direct compensatory damages” determined as of the date the FDIC was appointed as receiver. In contrast, under the Bankruptcy Code, only executory contracts and unexpired leases may be rejected, and only with the approval of the bankruptcy court. Damages are generally calculated as breach of contract damages as measured in accordance with applicable noninsolvency law.
  - **FDIA Rule Retained, with Two Important Exceptions.** The orderly liquidation authority retains the repudiation power and the methods of calculating damages contained in the Federal Deposit Insurance Act, with 2 notable exceptions:
    - **Exception for Debt Obligations.** In the case of debt for borrowed money or evidenced by a security, the damages are required to be no less than the amount lent plus accrued interest and any accreted original issue discount as of the date of the FDIC’s appointment
    - **Post-Appointment Interest.** Moreover, to the extent such an allowed claim is secured by property having a value in excess of the amount of such claim and any accrued interest through the date of repudiation, the claim may include such accrued interest.
  - **Bankruptcy Rule for Contingent Claims.** As described above, the Bankruptcy Code rule for measuring damages is effectively adopted for contingent claims.
- **Special Treatment for QFCs.** QFCs are a special class of contracts that receives virtually identical treatment under both the Federal Deposit Insurance Act and the new orderly liquidation authority. QFCs include securities contracts, commodity contracts, forward contracts,

repurchase agreements, swap agreements and master agreements for any of the foregoing. They are basically the same as the list of protected contracts under the Bankruptcy Code.

- **Exception from the Prohibition on Enforcing *Ipsa Facto* Clauses.** The prohibition on the enforceability of *ipso facto* clauses does not apply to QFCs, subject to a 1-business day stay period.
- **Transfer of QFCs.** During the 1-business day stay, the FDIC has the option to transfer all, but not less than all, of the QFCs with a particular counterparty and its affiliates to a single third-party financial institution. If the FDIC exercises this option, the counterparty is not permitted to terminate, accelerate or otherwise exercise its rights to close out the contract solely by virtue of the FDIC's appointment as receiver, the insolvency of the covered financial company or the transfer to the third party or bridge financial company. However, the counterparty may exercise such close-out rights upon the occurrence of another default.
- **Damages for Repudiated QFCs.** If the FDIC repudiates a QFC, damages are calculated as of the date of repudiation, rather than the earlier date of the FDIC's appointment, in light of industry practices, and may include the cost of cover.
- **Secured QFCs.** An otherwise enforceable and perfected security interest that collateralizes a QFC obligation may not be set aside unless the security interest was taken with actual intent to defraud.
- **Compare to Bankruptcy Code Treatment.** The Bankruptcy Code contains a blanket exception to the automatic stay for QFCs. There is no 1-business-day stay on the exercise of close-out rights.
- **Security Interests / Preferential or Fraudulent Transfers.** The FDIC has long taken the position that, except in the case of a secured QFC, an otherwise perfected security interest may be set aside as unenforceable if it was taken in contemplation of the institution's insolvency. The FDIC makes no distinction between security interests taken to secure pre-existing debt and those to secure new debt. Applicable case law has tempered the effect of the FDIC's position by requiring the security interest to have been taken within days of the institution's insolvency, but the reasoning of that case law would not automatically apply to nonbank financial companies. In contrast, the Bankruptcy Code only permits a security interest or other transfer of property to be set aside if it amounts to a preferential or fraudulent transfer on account of pre-existing debt that improves the position of the creditor. Security interests taken in return for new value cannot be set aside, even if taken on the eve of insolvency.
  - **Bankruptcy Rules Adopted.** The orderly liquidation authority effectively replaces this traditional position under the Federal Deposit Insurance Act with the substance of the preferential and fraudulent transfer rules in Sections 546, 547 and 548 of the Bankruptcy Code.
- **Setoff Rights.** The FDIC generally gives effect to setoff rights arising under applicable noninsolvency law because there is nothing in the Federal Deposit Insurance Act that limits such rights, although if the FDIC were to transfer liabilities to a third party or bridge bank without transferring the corresponding assets, it could destroy mutuality of the offsetting claims. In contrast, the Bankruptcy Code expressly recognizes the enforceability of setoff rights, subject to certain conditions.
  - **Bankruptcy Rule Adopted, With Important Modification.** The orderly liquidation authority effectively incorporates the setoff rules from Section 553 of the Bankruptcy Code, with some qualifications to permit the FDIC to transfer liabilities to a third party or bridge financial company even if the transfer destroys the mutuality of offsetting claims. As a

compromise for permitting a creditor's setoff rights to be destroyed in this manner, the creditor's affected claim is given priority over the claims of other general creditors.

- **Power to Temporarily Stay of Litigation.** Similar to its power under the Federal Deposit Insurance Act, the FDIC may request a stay for up to 90 days of any judicial action or proceeding to which such covered company is or becomes a party, and the relevant court is required to grant the stay.
- **Liquidation of "Stockbrokers" and "Commodity Brokers."** The FDIC, as receiver under the orderly liquidation authority, would be required to use the applicable liquidation provisions of the Bankruptcy Code in liquidating "stockbrokers" that are not members of SIPC and "commodity brokers," as such terms are defined in subchapters III and IV, respectively, of Chapter 7 of the Bankruptcy Code.
- **Maximum and Minimum Entitlements.** Under the Federal Deposit Insurance Act, each creditor is entitled to receive no more than it would have received in a liquidation. The maximum entitlement is designed to protect the FDIC against claims for equal treatment if the FDIC exercises its cherry-picking powers in a way that results in certain creditors receiving more than they would have received in a liquidation. This maximum entitlement has also effectively functioned as a minimum entitlement for creditors who are not the beneficiaries of such FDIC action from having to bear the costs of such actions beyond the amount of any losses they would have suffered in a liquidation proceeding. These concepts were made express in the orderly liquidation authority, except that the benchmark for both the maximum and minimum entitlements is a liquidation proceeding under Chapter 7 of the Bankruptcy Code instead of just a liquidation.
- **Mandatory Rulemaking.** As a further way to reduce the gap between the rules governing creditors' rights in the Federal Deposit Insurance Act and those in the Bankruptcy Code, the orderly liquidation authority requires the FDIC to promulgate rules to implement the statute in a manner that increases legal certainty and further reduces the gap between how creditors are treated in a liquidation under the Bankruptcy Code and how they are treated under the orderly liquidation authority. No deadline is given for issuing such rules and regulations.
- For information detailing implementation of the FDIC's orderly liquidation authority, see slide 6, "Creation of the Orderly Liquidation Authority."

### Priority of Claims Among Unsecured Creditors

- **General List of Priorities.** Subject to the supplemental priorities discussed below, unsecured claims that are proved to the satisfaction of the receiver will be given priority in the following order:
  - Administrative expenses of the receiver;
  - Amounts owed to the United States, unless the United States agrees or consents otherwise;
  - Wages, salaries or commissions owed to employees other than senior executives and directors, up to \$11,725 each, as indexed for inflation;
  - Contributions owed to certain employee benefit plans to the extent of the number of covered employees multiplied by \$11,725 (as indexed for inflation), less the aggregate amount paid to such employees as wages, salaries or commissions, plus the aggregate amount paid by the receivership on behalf of such employees to another employee benefit fund;
  - Any other general or senior liabilities of the company not described below;
  - Claims subordinated to general unsecured creditors;
  - Wages, salaries or commissions to senior executives and directors; and

- Equity claims of shareholders, members, general partners, limited partners or other persons with interests in equity.
- **Supplemental Priorities.** In addition to the general list of priorities, the orderly liquidation authority includes the following supplements to the priority list:
  - **Setoff.** Claims of creditors with otherwise enforceable setoff rights will rank senior to general unsecured claims to the extent the FDIC destroys the mutuality of any offsetting claims by transferring one of the otherwise offsetting claims to a third party or bridge financial company.
  - **Post-Receivership Financing.** Post-receivership financing incurred by the FDIC on behalf of a covered financial company will rank senior to administrative expenses.
  - **Covered Broker-Dealers.** In the case of the receivership of a covered broker-dealer:
    - SIPC's administrative expenses will rank equally with the FDIC's administrative expenses;
    - The FDIC will be entitled to recover any amounts paid to customers or to SIPC under the special broker-dealer provisions of the orderly liquidation authority on an equal basis with amounts owed to the United States.; and
    - SIPC will be entitled to recover any amounts paid out of the SIPC Fund to meet its obligations under the special broker-dealer provisions of the orderly liquidation authority or SIPA on a basis that is junior to amounts owed to the United States, but senior to all other claims.

#### Time Limits on a Receivership

- **General Time Limit.** The bill imposes a 3-year time limit on the duration of the FDIC's role as receiver, with the possibility of 2 one-year extensions.
- **Extensions.** Such extensions are permitted only upon a written certification by the FDIC Chairperson that continuation of the receivership is necessary to maximize the net present value return or minimize the amount of loss, and to protect the stability of the financial system. For the second extension, a report to Congress is also required.
- **Further Litigation Extension.** The bill permits further extension solely for the purpose of completing ongoing litigation in which the FDIC as receiver is a party upon certain determinations by the Council and an FDIC report to Congress. In such a case, the appointment of FDIC as receiver must end within 90 days after the completion of the litigation.
- **No Liability after Expiration of Receivership.** The bill provides that neither the FDIC nor the Deposit Insurance Fund will be liable for unresolved claims arising from the receivership after the termination of the receivership. The reference to the Deposit Insurance Fund is presumably a technical drafting error, and Congress meant the Orderly Liquidation Fund.

#### Protections for Customer Property

- **Covered Broker-Dealers.** The orderly liquidation authority includes special provisions for covered broker-dealers. It seems likely that the principal intent behind these provisions is to provide the customers of covered broker-dealers with the same degree of protection as they would enjoy in a normal SIPC liquidation proceeding. It appears that these special provisions are supposed to work as follows, subject to clarification by joint SEC-FDIC rulemaking, in consultation with SIPC:
  - **Exercise of Core Resolution Powers.** If the FDIC is appointed as receiver of a covered broker-dealer, the FDIC will have the core resolution powers to establish 1 or more bridge financial companies and to transfer all or any portion of the covered broker-dealer's assets and

liabilities, including customer accounts and related customer name securities and customer property, to the bridge financial company.

- **SIPC as Trustee for Left-Behind Claims.** At the same time, the FDIC is required to appoint SIPC as the trustee to liquidate the covered broker-dealer and any of its assets or liabilities, including customer accounts and related customer name securities and customer property, that are left behind in a liquidation proceeding under SIPA, except as otherwise provided in the orderly liquidation authority.
  - **SIPC's Powers and Duties.** Except as described below or as otherwise provided in the orderly liquidation authority, SIPC would have the same powers and duties it would otherwise have under SIPA, except with respect to any assets or liabilities transferred by the FDIC to any bridge financial company.
  - **Limits on SIPC's Powers**
    - **Interference with the FDIC's Core Resolution Powers.** SIPC would not be permitted to exercise its powers under SIPA in a manner that impeded or impaired the FDIC's powers to take any actions to:
      - make any funds available to the receivership;
      - organize, establish, operate or terminate any bridge financial company;
      - transfer assets and liabilities between the covered broker-dealer and any bridge financial company or between bridge financial companies;
      - enforce or repudiate any contracts;
      - take any other action relating to any bridge financial company; or
      - determine any claims under the orderly liquidation authority.
    - **Rules for Qualified Financial Contracts.** The rules governing counterparty rights on QFCs with the covered broker-dealer would be governed by the QFC provisions in the orderly liquidation authority and not in SIPA.
  - **Limits on the FDIC's Powers**
    - **Customer Protection Rules.** The FDIC's authority would be subject to a prohibition on exercising any of its powers with respect to a covered broker-dealer in a manner that would:
      - adversely affect the rights of a customer to customer property or customer name securities;
      - diminish the amount or timely payment of net equity claims of customers; or
      - otherwise impair the recoveries provided to a customer under SIPA.
    - **Use of Net Proceeds.** The FDIC would be required to use the net proceeds from any transfer, sale or disposition of assets of the covered broker-dealer for the benefit of the estate of the covered broker-dealer.
  - **Satisfaction of Customer Claims.** SIPC, the FDIC or the bridge financial company, as applicable, would be required to promptly discharge all obligations of a covered broker-dealer or any bridge financial company to a customer relating to, or net equity claims based on, customer property or customer name securities by the delivery of securities or the making of payments to or for the account of such customer as would have been the case if the actual proceeds realized from the liquidation of the covered broker-dealer under



the orderly liquidation authority had been distributed in a proceeding under SIPA, without the appointment of the FDIC as receiver and without any transfer of assets or liabilities to a bridge financial company.

- **Priorities**
  - **Customer Property.** As trustee for a covered broker-dealer, SIPC would be required to allocate customer property and deliver customer name securities in accordance with Section 8(c) of SIPA.
  - **Other Claims.** SIPC would be required to pay all other claims in accordance with the priority rules in the orderly liquidation authority.

## Orderly Liquidation Fund

- **Orderly Liquidation Fund.** The term “Orderly Liquidation Fund” refers to a fund established within the Treasury, which is not required to be pre-funded by the private sector, from which the FDIC may borrow funds to carry out its mission under the orderly liquidation authority.
- **Costs Funded by Borrowings from Treasury.** The FDIC would have the authority to fund the costs of resolving any particular covered financial company by issuing debt securities to Treasury, up to a maximum amount for each covered financial company equal to:
  - during the 30-day period immediately following the appointment of the receiver, 10% of the book value of the covered financial company’s total consolidated assets, based on its most recent financial statements available; and
  - after such 30-day period, 90% of the fair value of such company’s total consolidated assets that are available for repayment.
- **Post-Event Assessments to Repay Borrowings from Treasury.** The FDIC would be required to repay its borrowings from Treasury within 60 months or such longer period as approved by Treasury by, if necessary, imposing assessments:
  - **Claimants that Received Excess Benefits.** “As soon as practicable” on any “claimant that received additional payments or amounts from the [FDIC] pursuant to [the minimum or maximum recovery right provisions in] subsection (b)(4), (d)(4) or (h)(5)(E), except for payments or amounts necessary to initiate and continue operations essential to implementation of the receivership or any bridge financial company, to recover on a cumulative basis” any excess benefits that such claimant received in the receivership over what such claimant was entitled to receive in a liquidation under Chapter 7 of the Bankruptcy Code or in a SIPC proceeding.
  - **Large Financial Companies.** If the amounts to be recovered on a cumulative basis from such claimants are insufficient to allow the FDIC to repay its obligations to Treasury within 60 months or such longer period as approved by Treasury, the FDIC would be required to recover the shortfall from assessments on eligible financial companies and other financial companies with total consolidated assets of \$50 billion or more.
    - **Eligible Financial Companies.** Any bank holding company with total assets of \$50 billion or more and any nonbank financial company designated as systemically important by the Council.
    - **Graduated Assessments Based on Assets, Risks and Other Factors.** In imposing any assessments, the FDIC must use a risk matrix as recommended by the Council. In establishing such risk matrix, the Council and the FDIC must take the following factors into account in determining the size of assessments:

- **General Conditions.** Economic conditions generally at the time;
  - **Other Guarantee Arrangements.** Any assessments imposed on the financial company or an affiliate of such financial company that is an insured depository institution to fund deposit insurance, a broker-dealer to fund SIPC insurance, an insured credit union assessed pursuant to the Federal Credit Union Act or an insurance company for a state insurance guarantee fund;
  - **Risk to the System.** Risk presented by the financial company to U.S. financial stability;
  - **Beneficiary of Orderly Liquidation.** The extent to which the company received benefitted, or likely would benefit, from the orderly liquidation of a covered financial company, compared, for example, to a liquidation under Chapter 7 of the Bankruptcy Code;
  - **Risks Contributing to the Failure.** Any risks presented by the financial company during the 10-year period immediately prior to the appointment of the FDIC as receiver that contributed to the failure of the covered financial company; and
  - **Other Factors.** Other factors that the FDIC or the Council deems appropriate.
- **Rulemaking.** The FDIC would be required, in consultation with the Treasury Secretary, to issue rules and regulations to govern the assessment process.
  - **Acceptable Orderly Liquidation Plan and Mandatory Repayment Plan.** The FDIC may not use any of its funding as receiver for any covered financial company unless and until it shall have submitted an orderly liquidation plan for such company that is acceptable to the Treasury Secretary. The FDIC and the Treasury Secretary must reach an agreement that provides a specific plan and schedule for the repayment of the borrowings from Treasury.

## Other Important Provisions

- **Choice of Law Rules.** Noninsolvency choice of law rules would determine applicable noninsolvency law governing the perfection of security interests and the creation and enforcement of security entitlements.
- **Coordination with Foreign Financial Authorities.** The FDIC is required to coordinate with the appropriate foreign financial authorities regarding the orderly liquidation of a covered financial company that has assets or operations in a country other than the United States.
- **Guaranteed Subsidiary Contracts.** The FDIC would have the power to enforce subsidiary contracts, including QFCs, that are guaranteed by a covered financial company in receivership notwithstanding any cross-default in the underlying contract based solely on the insolvency of the guarantor, if the guarantee and all related assets/liabilities are transferred to a bridge financial company or a third party.
- **Clearing Organization.** The FDIC as receiver would be required to use its best efforts to meet all margin, collateral and settlement obligations of a covered financial company with a clearing organization with respect to QFCs; if the receiver defaults on such obligations, the clearing organization would have the right to exercise its rights and remedies immediately with respect to such QFCs despite any otherwise applicable stay on the exercise of close-out or other rights.
- **Required Study on Secured Credit Haircuts.** The Council would be required to complete a study within 1 year of enactment on whether a haircut, of various degrees, on secured creditors of a covered financial company “could improve market discipline and protect taxpayers” and make recommendations to Congress on whether and how to implement any such haircuts.

- **Prohibition on Taxpayer Funding of Bailouts.** The orderly liquidation authority prohibits taxpayer funds from being used to prevent liquidation of a firm. All funds expended must be recovered either through disposition of assets of a covered financial company or assessments on the financial sector in order to ensure no taxpayer losses.
- **Directors and Officers**
  - **Personal Liability.** Directors and officers of a covered financial company may be held personally liable for monetary damages in any civil actions by the FDIC with respect to gross negligence or a greater disregard of a duty of care under applicable state law. Federal courts are required to expedite the consideration of any case brought by the FDIC against directors and officers of a covered financial company.
  - **Recoupment of Compensation from Senior Executives and Directors.** The FDIC is permitted to recover from any current or former senior executive or director substantially responsible for the failed condition of a covered financial company any compensation received during the 2 year period prior to the date the FDIC is appointed as receiver. In the case of fraud, no such time limit will apply. In seeking to recover any such compensation, the FDIC is required to weigh the financial and deterrent benefits of such recovery against the cost of executing the recovery.
  - **Ban on Senior Executives and Directors.** The Federal Reserve, or if the covered financial company was not supervised by the Federal Reserve, the FDIC, is permitted to prohibit a senior executive or director of a covered financial company from participating in the conduct of the affairs of **any** financial company for a period of time of not less than 2 years if the Federal Reserve or FDIC determines that the senior executive or director:
    - violated any law, regulation, final cease-and-desist order, written condition in an application, notice or request, or written agreement;
    - engaged or participated in an unsafe or unsound practice in connection with any financial company; or
    - committed or engaged in any act, omission, or practice which constitutes a breach of the fiduciary duty of such executive or director;

**and**

  - by reason of such violation, practice or breach received financial gain or other benefit and such violation, practice or breach contributed to the failure of the company;

**and**

- such violation, practice or breach involves personal dishonesty or demonstrates a willful or “continuing” disregard for the safety and soundness of such company.

## Monitoring and Other Studies

- **Inspector General Reviews.** The bill provides the Inspector General of the FDIC, Treasury Inspector General, and the Inspectors General of primary financial regulatory agencies with authority to conduct, supervise, and coordinate audits and investigations in connection with the liquidation of a covered financial corporation.
- **Report to Congress and the Public.** No later than 60 days after appointment of the FDIC as receiver, the FDIC is required to file a report with Congress setting forth enumerated information, including information on the covered financial company’s financial condition, description of the plan to wind down the covered company and the expected costs of the liquidation.

- **Report on Judicial and Bankruptcy Processes.** The bill requires the GAO and Administrative Office of the United States Courts to monitor the activities of the U.S. District Court for the District of Columbia and conduct separate studies on the bankruptcy and orderly liquidation process for financial companies under the Bankruptcy Code.
- **Report on Bankruptcy Process for Financial Companies.** The bill requires the Federal Reserve, in consultation with the Administrative Office of the United States Courts, to conduct a study on the resolution of financial companies under Chapters 7 or 11 of the Bankruptcy Code.
- **Reports on International Coordination.** The bill requires a GAO study on international coordination of orderly liquidation of financial companies. The bill also requires the Federal Reserve, in consultation with the Administrative Office of the United States Courts, to conduct a study on international coordination relating to the resolution of systemically important financial companies under the Bankruptcy Code and applicable foreign law.
- **Report on Implementation of Prompt Corrective Action Measures.** The bill requires that the GAO study of the prompt corrective action implementation by federal banking agencies and report to Congress within 1 year after the date of enactment. The Council is required to submit a report to Congress within 6 months on actions taken in response to the report.

## The Volcker Rule

Subject to certain exceptions and a transition period, the Volcker Rule prohibits any “banking entity” from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund. It also requires systemically important **nonbank** financial companies to carry additional capital and comply with certain other quantitative limits on such activities, although it does not expressly prohibit them. The Volcker Rule is not effective until 2 years after enactment, at which point a 2-year transition period begins, with the possibility of additional extensions thereafter. For more detail regarding the implementation of the Volcker Rule’s proprietary trading and sponsoring provisions, see slide 7, “Volcker Rule: Proprietary Trading” and slide 8, “Volcker Rule: Sponsoring and Investing in Hedge Funds and Private Equity Funds.”

## Proprietary Trading

### General Prohibition

- The Volcker Rule prohibits any “banking entity” from engaging in proprietary trading, subject to certain exceptions and a transition period.
- **“Banking entity”** is defined as any insured bank or thrift, any company that controls an insured bank or thrift, any company that is treated as a bank holding company under Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of such an entity.
- **“Proprietary trading”** is defined as engaging as a principal for the “trading account” of a banking entity or systemically important nonbank financial company in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, derivative, contract of sale of a commodity for future delivery, option on any such security, derivative, or contract, or other security or financial instrument that the appropriate Federal banking agencies, the SEC, and the CFTC (the “regulators”) may, by rule, determine.
  - **“Trading account”** is defined as any account used for acquiring or taking positions in securities or other instruments principally for the purpose of selling in the near term, or otherwise with the intent to resell in order to profit from short-term price movements, and any other accounts as the regulators may, by rule, determine.

**Permitted Activities**

- Subject to certain limitations described below, including the absence of any material conflict of interest, and any additional restrictions or limitations that the regulators may impose, the following types of transactions are excluded from the general ban on proprietary trading:
  - Purchases, sales, acquisitions or dispositions of the following instruments:
    - U.S. government or agency obligations;
    - obligations, participations or other instruments of or issued by Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution; or
    - state or municipal obligations.
  - Purchases, sales, acquisitions or dispositions of any security or other instrument “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.”
  - Risk-mitigating hedging activities “in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts, or other holdings.”
  - Purchases, sales, acquisitions or dispositions of any security or other instrument “on behalf of customers.”
  - Investments in small business investment companies and certain “public welfare” investments.
  - Purchases, sales, acquisitions or dispositions of any security or other instrument by a 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), if:
    - conducted in compliance with insurance company investment laws, regulations and guidance of the jurisdiction in which such insurance company is domiciled; and
    - the appropriate Federal banking agencies, after consulting with the new systemic risk council of regulators and relevant state insurance commissioners, have not jointly determined that a particular law, regulation or item of guidance is insufficient to protect the safety and soundness of the banking entity (e.g., the parent of the insurance company) or of U.S. financial stability.
  - Proprietary trading conducted 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, unless the banking entity is directly or indirectly controlled by a banking entity organized in the United States.
  - Such other activity as the regulators determine, by rule, would “promote and protect” the safety and soundness of the banking entity and U.S. financial stability.

**Limitations on Permitted Activities**

- No transaction, class of transactions or activity may be deemed to be a “permitted activity” under the Volcker Rule if it would:

- Involve or result in a “material” conflict of interest, to be defined by rule, between the banking entity and its clients, customers, or counterparties;
  - Result, directly or indirectly, in a “material” exposure to high risk assets or high risk trading strategies, to be defined by rule;
  - Pose a threat to the safety and soundness of such banking entity; or
  - Pose a threat to U.S. financial stability.
- The regulators are required to issue regulations implementing these limitations with respect to otherwise permitted activities.

## Hedge Funds and Private Equity Funds

### General Prohibition

- The Volcker Rule also prohibits a banking entity from acquiring or retaining any equity, partnership or other ownership interest in, or sponsoring, any hedge fund or private equity fund, subject to certain exceptions and a transition period.
  - **Covered persons.** Same as under the proprietary trading ban: any banking entity.
  - **“Hedge fund” and “private equity fund”** are defined as any issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that act, or “such similar funds” as the regulators may, by rule, determine. Potentially broader than typical definition of hedge funds and private equity funds, particularly in light of regulators’ authority to determine that other funds are “similar” to 3(c)(1) or 3(c)(7) funds.<sup>6</sup>
  - **“Sponsoring”** is defined as
    - Serving as a general partner, managing member, or trustee of a fund;
    - In any manner selecting or controlling, or having employees, officers, directors or agents who constitute, a majority of the directors, trustees or management of a fund; or
    - Sharing with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variant of the same name.

### Permitted Activities

- Subject to the same limitations on permitted activities described above under proprietary trading (e.g., the absence of any material conflict of interest), and any additional restrictions or limitations that the regulators may impose, the following activities are excluded from the ban on sponsoring or investing in hedge funds or private equity funds:
  - All of the permitted activities listed above under proprietary trading, except for the ones that relate solely to proprietary trading;

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<sup>6</sup>Rep. Frank (D-MA) and Rep. Himes (D-CT) sought in a colloquy during the reopened House debate to clarify that the Volcker Rule is intended to prohibit investments in “traditional” hedge funds and private equity funds, and not “subsidiaries or joint ventures that are used to hold other investments.”

- “Organizing and offering” a private equity or hedge fund, including **sponsoring** such a fund (except that the same name or a variant of the name may not be shared), if **all** of the following conditions are met:
  - The banking entity provides *bona fide* trust, fiduciary or investment advisory services; and
  - The fund is organized and offered only in connection with the provision of such services, and only to persons who are customers of such services of the banking entity; and
  - The banking entity does not acquire or retain an equity interest, partnership interest or other ownership interest in the fund other than the following investments:
    - Seed investments – *i.e.*, any investment made or retained in any amount of the total ownership of a fund (including 100%) for the purpose of establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, and
    - Other *de minimis* investments – *i.e.*, any other investment in a hedge fund or private equity fund, **provided** that in the case of both seed investments and other *de minimis* investments:
      - the banking entity “actively” seeks unaffiliated investors to reduce or dilute its investment;
      - the banking entity’s investment is reduced to not more than 3% of the total ownership of the fund within 1 year after the fund’s establishment (with the possibility of a 2-year extension) and thereafter is maintained at not more than 3%; and
      - the investment is “immaterial” to the banking entity, as defined by the regulators pursuant to rulemaking, but in no case may the aggregate of all of the banking entity’s permitted seed and other *de minimis* investments exceed 3% of the banking entity’s Tier 1 capital; and
  - The banking entity and its affiliates comply with the 23A and 23B restrictions on transactions with such funds, as described below; and
  - The banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations or performance of the fund, or any fund in which such fund invests (anti-bailout provision); and
  - The banking entity does not share with the fund, for corporate, marketing, promotional or other purposes, the same name or a variant of the same name; and
  - No director or employee of the banking entity takes or retains an equity interest, partnership interest or other ownership interest in the fund, except for any director or employee who is “directly engaged in providing investment advisory or other services” to the fund; and
  - The banking entity discloses to prospective and actual investors in the fund, in writing, that any losses in such fund are borne solely by investors in the fund and not by the banking entity, and otherwise complies with any additional rules that the regulators may issue that are designed to ensure that losses are so borne.
- 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, unless the banking

entity is directly or indirectly controlled by a banking entity organized in the United States, and provided that no ownership interest in such fund is offered for sale or sold to a U.S. resident.

### Limitations on Permitted Activities

- The bill applies the same limitations on permitted activities as are described above under proprietary trading. For more information, see "[Limitations on Permitted Activities](#)" above.

### No Prohibition on Certain Securitization Activities

- The Volcker Rule provides that "[n]othing in this section shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law."
- **Credit Retention Requirements.** The bill's credit retention provisions separately require the federal banking agencies and the SEC to prescribe regulations that require securitizers of asset-backed securities, by default, to maintain 5% of the credit risk in assets transferred, sold or conveyed through the issuance of asset-backed securities. For more information, see "[Credit Retention Requirements](#)."
- **Securitizer.** The bill's credit retention provisions define the term "securitizer" as "(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer."

### Additional Limitations

#### Additional Capital and Other Quantitative Limits on Permitted Activities

- **Generally.** If the regulators determine that additional capital requirements or quantitative limits, including diversification requirements, would be appropriate to protect the safety and soundness of any banking entities engaged in permitted proprietary trading or permitted sponsoring or investing in hedge funds or private equity funds, the regulators are required to impose such additional capital requirements and quantitative limits.
  - **Deductions.** For purposes of determining compliance with any of these additional capital requirements, the aggregate amount of outstanding investments by a banking entity under the exceptions for seed or other *de minimis* investments, including retained earnings, must be deducted from the assets and tangible equity of the banking entity, and the amount of the deduction must increase commensurate with the leverage of the hedge fund or private equity fund invested in.

#### 23A and 23B Limitations on Transactions with Advised or Managed Funds

- **General Prohibition on 23A Covered Transactions.** Prohibits any banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor of a hedge fund or private equity fund, or that organizes and offers such a fund as a permitted activity, **and any affiliate** of such banking entity, from entering into a covered transaction as defined by Section 23A of the Federal Reserve Act with any such fund, or any hedge fund or private equity fund controlled by such fund, as if the banking entity or an affiliate, other than the fund, were a member bank and the fund were its affiliate.
- **Compliance with 23B.** In addition, any banking entity that serves, directly or indirectly, as the investment manager, investment adviser or sponsor of a fund, or that organizes and offers a fund as



a permitted activity, will be subject to Section 23B of the Federal Reserve Act as if the banking entity were a member bank and the fund were its affiliate.

- **Exception for prime brokerage transactions with hedge funds or private equity funds.** The Federal Reserve may grant an exemption from the prohibition on 23A covered transactions for purposes of permitting a banking entity to enter into any “prime brokerage transaction,” which is undefined in the bill, but presumably to be defined by regulation, with any hedge fund or private equity fund that it manages, sponsors or advises or in which it has taken an equity, partnership or other ownership interest, if:
  - The banking entity is in compliance with each of the conditions set forth in the permitted activity exception for sponsoring hedge funds or private equity funds described above;
  - The CEO or equivalent officer certifies in writing annually that the anti-bailout condition of that permitted activity exception is satisfied; and
  - The Federal Reserve has determined that such transaction is consistent with the safe and sound operation and condition of the banking entity.

### Anti-Evasion

- **Internal Controls and Recordkeeping.** The regulators must issue rules regarding internal controls and recordkeeping to insure compliance with the Volcker Rule.
- **Termination of Activities.** Whenever the appropriate federal regulator has “reasonable cause” to believe that a banking entity or systemically important nonbank financial company has made an investment or engaged in an activity “in a manner than functions as an evasion” of the requirements of the Volcker Rule, including through abuse of a permitted activity, or otherwise violates the Volcker Rule’s restrictions, the regulator must order termination of such activity or disposal of such investment.

### Systemically Important Nonbank Financial Companies.

- **Additional Capital Requirements and Quantitative Limitations.** Although systemically important nonbank financial companies are not subject to the prohibitions on proprietary trading or sponsoring or investing in hedge funds or private equity funds, the Federal Reserve is required to impose additional capital requirements and other quantitative limits on such activities.
- **23A and 23B Type Limits.** Although systemically important nonbank financial companies are not subject to the 23A and 23B limits described above, the regulators are required to adopt rules imposing additional capital charges or other restrictions to address the same types of risks and conflicts of interest addressed by the 23A and 23B limits applicable to banking entities.

### Effective Date and Transition Period

- **Effective date.** None of the prohibitions, requirements or limitations of the Volcker Rule are effective until the earlier of:
  - 12 months after the issuance of final rules implementing the Volcker Rule; and
  - 2 years after the date of enactment of the Volcker Rule.
- **Transition period begins after effective date.**
  - **Initial 2-year period.** Within 2 years after the effective date of the Volcker Rule, banking entities and systemically important nonbank financial companies must conform their activities and investments to be in compliance with the Volcker Rule, as applicable.

- **3 one-year extensions possible.** The Federal Reserve may grant up to three 1-year extensions of the transition period, if “consistent with the purposes of this section” and “not detrimental to the public interest.”
- **Extended transition period for illiquid funds.** The Federal Reserve may, upon application by any banking entity, extend the transition period for up to a **maximum of 5 years** “to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010” to take or retain any equity, partnership, or other ownership interest in, or otherwise provide additional capital to, an illiquid fund.
  - **Illiquid fund defined.** Subject to rulemaking by the Federal Reserve, an illiquid fund is a hedge fund or private equity fund that:
    - as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets (undefined) “such as portfolio companies, real estate investments and venture capital investments”; and
    - makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.<sup>7</sup>
- **Rulemaking.** The Federal Reserve must issue rules to implement the 2-year initial transition period and the extended transition period for illiquid funds within 6 months of enactment, *i.e.*, before all other Volcker Rule rulemaking and at the same time as the scheduled completion of the Council study.

## Council Study and Rulemaking

- **Study and Timing.** The Financial Stability Oversight Council must conduct a study and issue recommendations on implementation of the Volcker Rule’s provisions within 6 months of enactment.
- **Rulemaking and Timing.** The regulators are required to issue rules implementing the Volcker Rule within 9 months after completion of the study. They are also required to issue rules implementing the transition rules within 6 months of the Volcker Rule’s enactment.
- **Rulemaking Authority.** Rulemaking authority is granted to the following regulators, who must consider the findings of the Council study in their rulemaking, with respect to the entities indicated:
  - The appropriate Federal banking agencies (the Federal Reserve, the FDIC, the OCC and the OTS), **jointly**, with respect to insured banks and thrifts;
  - The Federal Reserve, with respect to any company that controls an insured bank or thrift or is treated as a bank holding company under section 8 of the International Banking Act of 1978 or any systemically important nonbank financial company and any subsidiary of any of the foregoing, other than a subsidiary for which a different regulator is its primary financial regulatory agency;
  - The CFTC, with respect to any entity for which it is the primary financial regulatory agency; and
  - The SEC, with respect to any entity for which it is the primary financial regulatory agency.

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<sup>7</sup> The definition of “illiquid fund” purports to distinguish between a “hedge fund” and a “private equity fund, as such term is used in section 203(m) of the Investment Advisers Act of 1940.” However, section 203(m) of the Advisers Act as it appears in the final version of the Dodd-Frank Bill no longer includes a reference to “private equity fund.”

- **Coordination.** The regulators must consult with each other and coordinate their rulemaking, but rules need not be issued jointly, except among the banking appropriate Federal banking agencies in certain instances. The Chair of the Financial Stability Oversight Council will be responsible for coordination of regulations issued under this section.

## Related Studies

- **Banking Activities.** Within 18 months of enactment, the appropriate Federal banking agencies must jointly review and report on the activities that a banking entity may engage in under federal and state law, including activities authorized by statute, order, interpretation and guidance.
  - In the report, the agencies must include recommendations regarding the potential negative effect of such activities on safety and soundness of banking entities and the U.S. financial system, the “appropriateness” of the conduct of such activities or type of investment and such additional restrictions as may be necessary to address risks to safety and soundness arising from such activities or investments.
- **Proprietary Trading.** The GAO is required to conduct a study of proprietary trading, including risks (both systemic and to particular institutions), conflicts, disclosure and control systems associated with proprietary trading by and within covered entities and to produce a report within 15 months of enactment.
  - **Considerations of Study.** The GAO must consider the current practice and the advisability of a complete ban on the activity, limitations on scope of activities, additional capital requirements, enhanced restrictions on intra-affiliate transactions, enhanced public accounting or disclosure requirements, and any other option deemed appropriate.
  - **Broad Access to Records.** The bill provides the GAO with access to a broad range of information and data and access to officers, directors, employees, independent public accountants and representatives. The Comptroller General is able to make and retain copies of books, records, and accounts.
  - **Confidentiality Limits.** The bill requires confidentiality of reports, but permits the GAO to disclose information obtained to a department, agency or official of the federal government for official use, a Congressional committee upon request and to a court, upon a court order.

## Swaps Pushout Rule

At the heart of the so-called “**Swaps Pushout Rule**” is a prohibition on the provision of certain types of “Federal assistance” to certain swap dealers and major swap participants referred to as “swaps entities.”<sup>8</sup>

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<sup>8</sup> For ease of presentation, the term “swap” will be used in this memorandum to refer to both “swaps” and “security-based swaps,” the term “swap dealers” will be used in this memorandum to refer to both “swap dealers” and “security-based swap dealers,” and the term “major swaps participants” will be used in this memorandum to refer to both “major swap participants” and “major security-based swap participants.”

## Prohibition on Federal Assistance

### ■ **Meaning of “Federal Assistance”**

- Federal assistance means “the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act [or] Federal Deposit Insurance Corporation insurance or guarantees for the purpose of:
  - making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;
  - purchasing the assets of any swaps entity;
  - guaranteeing any loan or debt issuance of any swaps entity; or
  - entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity.”

### ■ **Definition of “Swaps Entity”**

- The term “swaps entity” means any swap dealer or major swap participant that is registered under the Commodity Exchange Act or Securities Act.
  - “Swap dealer” is a newly defined category that includes any person that “regularly enters into swaps with counterparties as an ordinary course of business for its own account,” in addition to persons that hold themselves out as dealers or who make a market in swaps.
    - Significantly, however, in the final hours of the conference, a proviso was added to the definition of “swap dealer,” but not to the definition of “security-based swap dealer,” that “in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.” Based on the placement of this proviso, it is unclear whether it is a carve-out from all definitional prongs of the definition of “swap dealer” or only the definitional prong including as a swap dealer a person who is commonly known in the trade as a dealer or market maker in swaps.
    - Depending on its interpretation, the foregoing carve-out has the potential to exempt certain banks and thrifts that have a traditional lending function and limited swap activities from becoming “swap dealers,” allowing them to receive “Federal assistance” without pushing out their swaps activities.
  - “Major swap participant” is a newly defined category generally meant to encompass entities that are not swaps dealers but have significant positions in swaps that could pose systemic danger. The SEC and CFTC are mandated under the Act to clarify the scope and reach of these definitions through regulation.
  - For details on when the SEC and CFTC is required to promulgate rules and regulations affecting swap dealers and major swap participants, and when these swaps entities must comply with such rules and regulations, see slide 13, “Swap Dealers and Major Swap Participants.”
- ***Exclusions from the Definition of “Swaps Entity”***
  - Insured depository institutions that are major swap participants but not swap dealers are excluded from the definition of the term “swaps entity”. As a result, an insured depository institution would be a swaps entity only if it is a swap dealer.

- In addition, the term “swaps entity” does not include insured depository institutions or covered financial companies that are in conservatorship or receivership or have had their businesses transferred to a bridge bank or other bridge financial company under the Federal Deposit Insurance Act or Title II of the Act.

## Exemptions from the Prohibition on Providing Federal Assistance

- Insured depository institutions are not subject to the prohibition on Federal assistance if they limit their swaps activities to the following:
  - hedging or similar risk mitigation directly related to its activities; or
  - swaps involving rates or reference assets that are permissible for investment by a national bank under the portion of the National Bank Act contained in 12 U.S.C. §24(Seventh), other than uncleared credit default swaps, including those referencing the credit risk of asset-backed securities.
    - The National Bank Act permits national banks to invest in a wide range of assets, including loans; promissory notes; drafts; bills of exchange; other extensions of credit; foreign currency; coins; bullion, which includes gold, silver and certain other precious metals; U.S. government and agency securities; certain investment shares in investment companies as long as the assets held by the investment companies are themselves bank permissible; and debt securities that are considered investment securities, generally marketable investment grade debt securities, but also including, to a limited degree, non-investment grade debt securities that the bank reasonably believes will be repaid as to principal and interest and to be reasonably liquid. In addition, the OCC has the power to interpret the National Bank Act to allow other instruments to be permissible investments.
    - 12 U.S.C. 24(Seventh) expressly prohibits national banks from dealing in equity securities.

## Pushing Out to a Swaps Entity Affiliate

- The Swaps Pushout Rule specifically provides that an insured depository institution that is part of a bank holding company or savings and loan holding company supervised by the Federal Reserve may have a swaps entity affiliate and still receive Federal assistance, so long as Sections 23A and 23B of the Federal Reserve Act are complied with, subject to any additional requirements that the SEC or CFTC, depending on the type of swap, **and** the Federal Reserve may determine to be necessary and appropriate are complied with.
  - Elsewhere in the bill, Sections 23A and 23B of the Federal Reserve Act are modified to include derivatives with affiliates as “covered transactions” to the extent they create bank or thrift credit exposure to the affiliate, and, as a result, such derivatives will be subject to quantitative limits and collateral requirements under these sections, when they become effective.
  - In addition, the authority given to the SEC or CFTC and the Federal Reserve to make rules governing the relationship of insured depository institutions to swap entity affiliates is quite broad and could allow the regulators to impose limitations and restrictions that are more severe than those resulting from Sections 23A and 23B.
    - The Council has the discretion to prohibit Federal assistance to swaps entities, regardless of the exemptions in the statute, if necessary to mitigate systemic risk and protect taxpayers as determined by 2/3 of the Council, including the approvals of the Treasury Secretary, the Federal Reserve Chairman and the FDIC Chairperson.
    - This exception does not expressly apply to the U.S. branches of foreign banks.

## Prohibition of Use of Taxpayer Funds to Prevent Receivership

- The Swaps Pushout Rule precludes the use of taxpayer funds to prevent the receivership of any swap entity resulting from that entity's swap activity if the entity is FDIC-insured or has been designated as systemically important.
  - If, nonetheless, such an FDIC-insured or systemically important institution is put into receivership or declared insolvent because of swap activity, then its swap activity will be subject to termination or transfer in accordance with applicable law.
  - No taxpayer resources may be used for the orderly liquidation of any swaps entity that is not FDIC insured or systemically important.
  - All funds expended on the termination or transfer of swap activity of a swaps entity must be recovered, either through the disposition of assets of the swap entity or by assessments, including on the financial sector.
  - In addition, the Swaps Pushout Rule contains the following remarkably broad provision: "Taxpayers shall bear no losses from the exercise of any authority under [the derivatives title of the Bill]." The provision does not define the terms "loss" or "taxpayer" or specify any remedies for the breach of the provision.

## Interaction with the Volcker Rule

- The Swaps Pushout Rule explicitly provides that insured depository institutions are subject to the Volcker Rule with respect to their proprietary activity in derivatives, including swaps.

## Effective Date and Transition Rule

- **Effective Date.** The Swaps Pushout Rule will become effective 2 years after the derivatives title of the Bill becomes effective, which is 360 days after the date of enactment.
  - For more information on when the pushout provisions take effect, see slide 10, "Section 716: Swaps Pushout Rule."
- **Transition Rule for Insured Depository Institutions.** In addition, the Swaps Pushout Rule requires the appropriate Federal banking agency, in consultation with the SEC and CFTC, to permit insured depository institutions up to 24 months after the effective date to divest the swaps entity or cease the activities that require registration as a swaps entity. The regulators must take various factors into account in determining the appropriate transition period, which could be less than 24 months. The transition period may also be extended by the appropriate Federal banking agency, after consultation with the SEC and CFTC, for an additional 1-year period.
  - **Other Swaps Entities.** There does not appear to be a similar transition period for swaps entities that are not insured depository institutions.

## Bank Capital (Collins Amendment)

- The Collins Amendment, originally drafted by the FDIC staff and reflecting [views held by Chairwoman Bair](#), imposes, over time, the risk-based and leverage capital standards currently applicable to U.S. insured depository institutions on U.S. bank holding companies, including U.S. intermediate holding companies of foreign banking organizations, thrift holding companies and systemically important nonbank financial companies. One of the effects of the Collins Amendment is to eliminate trust preferred securities as an element of Tier 1 capital. Implementing regulations must be issued no later

than 18 months from the bill's effective date and there are highly negotiated transition periods and grandfathering exemptions. For information regarding the issuance of rules and effective dates of such risk-based and leverage capital standards, see slide 11, "Collins Amendment Timeline."

- The Collins Amendment echoes changes that have been proposed but not yet been adopted by the Basel Committee on Banking Supervision in the "Basel III" process and those that are contemplated in the new U.S. systemic risk regulatory regime.

## Minimum Leverage and Risk-Based Capital Requirements

- The appropriate Federal banking agencies must establish minimum leverage and risk-based capital requirements to apply to insured depository institutions, depository institution holding companies and systemically important nonbank financial companies.
  - **Two Floors.** The minimum leverage and risk-based capital requirements applicable to these institutions are subject to 2 floors. They must be:
    - Not "less than" the "generally applicable risk-based capital requirements" and the "generally applicable leverage capital requirements."
    - Not "quantitatively lower than" the above requirements that were in effect for insured depository institutions as of the date of enactment of the bill.
  - **Generally Applicable Risk-Based and Leverage Capital Requirements.** The Collins Amendment defines "generally applicable risk-based capital requirements" and "generally applicable leverage capital requirements" to mean the risk-based capital requirements and minimum ratios of Tier 1 capital to average total assets, respectively, established by the appropriate Federal banking agencies to apply to insured depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act, regardless of total consolidated asset size or foreign financial exposure.
    - The formula for "generally applicable risk-based capital requirements" must include the required ratio of regulatory capital components (numerator) over risk-weighted assets (denominator).
    - The formula for "generally applicable leverage capital requirements" must include the required ratio of regulatory capital components (numerator) over average total assets (denominator).
  - **Financial Subsidiary Deductions.** The Collins Amendment clarifies that the requirement applicable to national banks to deduct investments in subsidiaries that are engaged in financial activities does not apply at the holding company level or to systemically important nonbank financial companies, except, in the latter case, if so required by the Federal Reserve or primary financial regulator.
  - **Basel III.** The Collins Amendment does not expressly permit the U.S. banking supervisors to amend capital adequacy guidelines in accordance with the standards that will be applied internationally when the Basel III process, which currently contemplates the publication of final standards by the end of 2010 and their effectiveness by the end of 2012, is completed. As a result, the Collins Amendment will create a statutory floor and U.S. banking regulators would be able to implement Basel III only to the extent it is consistent with the Collins Amendment floor.
    - It appears that regulators would generally be able to impose more stringent Basel III capital rules on insured depository institutions and bank holding companies than those that have applied historically to banks but would not be able to apply less stringent rules, with the

possible exception of giving effect to any countercyclical requirements contemplated by Basel III and the bill.

- **Effects of the Application of the Collins Amendment.** The current leverage and risk-based capital requirements applicable to insured depository institutions – not those currently applicable to bank holding companies – will set the new minimum standard for leverage and risk-based capital requirements for insured depository institutions, depository institution holding companies and systemically important nonbank financial companies. Consequently:
  - After the transition periods described below, hybrid securities may be included only in Tier 2 capital, whereas the Federal Reserve currently allows bank holding companies to include some hybrid securities, subject to quantitative limits and other restrictions, in Tier 1 capital.
  - The current leverage and risk-based capital requirements for banks are as follows:

|                                   |                      | To be considered “well capitalized” | To be considered “adequately capitalized” |
|-----------------------------------|----------------------|-------------------------------------|---|
| Minimum risk-based capital ratios | Tier 1 capital ratio | 6%                                  | 4%  |
|                                   | Total capital ratio  | 10%                                 | 8%  |
| Minimum leverage ratio*           |                      | 5%                                  | 4%  |

\* A 3% minimum leverage ratio applies for institutions if the FDIC determines that the institution is not anticipating or experiencing significant growth, has well-diversified risk, among other factors, and is rated composite “1” under the CAMELS rating system.

## Transition Periods and Permanent Exemptions

- **General Rule.** For bank holding companies and systemically important nonbank financial companies, any “regulatory capital deductions” for debt or equity issued before May 19, 2010 will be phased in incrementally from January 1, 2013 to January 1, 2016. Exceptions are set forth below.
  - The term “regulatory capital deductions” presumably refers to the exclusion of hybrid capital, such as trust preferred securities, from Tier 1 capital.
  - The Basel Committee has proposed that countries aim to implement Basel III by the end of 2012, which coincides with the beginning of the phase-in period. As currently drafted, the Basel III rules would also exclude the forms of hybrid capital typically issued in the U.S. from Tier 1 capital, although some Basel III grandfathering and/or phase-in provisions are expected.
- **Bank and Thrift Holding Companies With Less than \$15 Billion in Assets.** The bill does not require any “capital deductions” for debt or equity instruments issued before May 19, 2010 by a depository institution holding company with total consolidated assets of less than \$15 billion as of December 31, 2009.
  - The bill would permanently grandfather hybrid capital for the purposes of application of the Collins Amendment to these institutions.
- **TARP Preferred.** Debt or equity instruments issued to the Federal government or any agency before the end of the Treasury’s authority to invest via TARP on October 4, 2010, are exempt from the Collins Amendment.
  - The bill explicitly and permanently grandfathers all TARP preferred issuances, regardless of the size of the institution.
- **Thrift Holding Companies.** For thrift holding companies, other than those in mutual form on May 19, 2010, any “regulatory capital deductions” required by the Collins Amendment for debt or equity issued



before May 19, 2010 will be phased in from January 1, 2013 to January 1, 2016. Exceptions are noted below. All other requirements under the Collins Amendment, the minimum leverage and risk-based capital ratios, are effective 5 years after enactment.

- **Intermediate U.S. Holding Companies of Foreign Banks.** For domestic bank holding company subsidiaries of foreign banking organizations that have relied on the exemption from the Federal Reserve's capital adequacy guidelines under Supervision and Regulation Letter SR-01-1, the U.S. risk-based capital and leverage capital requirements and the other requirements of the Collins Amendment for debt or equity issued before May 19, 2010 will take effect 5 years after enactment.
- **Mutual Holding Companies.** The bill does not require any "capital deductions" for debt or equity instruments issued before May 19, 2010 by an organization that was a mutual holding company on May 19, 2010.
- **Newly Issued.** For all institutions, the Collins Amendment is retroactively effective with respect to debt or equity issued on or after May 19, 2010 except, as noted above, TARP preferred issued by the Treasury.
- **Application to Other Financial Institutions**
  - **Nonbank Financial Companies.** While systemically important nonbank financial companies are subject to the Collins Amendment, another part of Title I grants the Federal Reserve the authority to exempt systemically important nonbank financial companies from application of the risk-based capital requirements and leverage requirements. In order to do so, the Federal Reserve must determine, in consultation with the Council, that the requirements are not appropriate for a company because of the company's activities or structure, and must apply other standards that result in similarly stringent controls.
    - If the Federal Reserve makes this determination, it appears that the Collins Amendment would not apply to a systemically important nonbank financial company, but the interaction of the 2 portions of the bill is not as clear as one would hope. Assuming the better reading applies, then hedge funds, asset managers and systemically important insurance companies would have tailored, rather than bank-centric, capital standards apply to them as the new regime is implemented.
    - The Federal Reserve does not have the authority to exempt thrift holding companies that are not systemically important from the Collins Amendment. As a result, insurance companies and their holding companies that control thrifts but are not systemically important will be subject to the Collins Amendment requirements.
  - **Foreign Parents.** The requirements of the Collins Amendment would not apply to foreign parents of bank and thrift holding companies, but would apply to any U.S. bank or thrift holding company, as those terms are defined in Section 3 of the Federal Deposit Insurance Act, including any intermediate holding company, that is owned or controlled by a foreign organization.
    - While not expressly stated, systemically important foreign nonbank financial companies presumably will not be subject to the Collins Amendment at the foreign parent level. For more information, see "Foreign Financial Companies."
  - **Other Depository Institution Holding Companies.** Depository institution holding companies that are not bank or thrift holding companies, such as holding companies of industrial banks, credit card banks, or trust banks, are not subject to the Collins Amendment.
  - **FHLBs.** Federal home loan banks are exempt.

- **Small BHCs.** The bill does not change the treatment of small bank holding companies with less than \$500 million in assets under the Federal Reserve's [Small Bank Holding Company Policy Statement](#).
- The following table summarizes the applicability of the Collins Amendment's risk-based and leverage capital requirements, as well as of the exclusion for certain hybrid instruments from Tier 1 capital:

|   | General risk-based capital and leverage capital requirements  | Exclusion from Tier 1 capital for hybrid debt or equity instruments issued before May 19, 2010* |
|---|---|---|
| <b>Bank holding companies</b>   |   |   |
| Large bank holding companies – more than \$15 billion in assets as of December 31, 2009             | Effective upon implementing regulation required within 18 months  | Phase-in of exclusion incrementally from January 1, 2013 to January 1, 2016                     |
| Medium-size bank holding companies – less than \$15 billion in assets as of December 31, 2009       | Effective upon implementing regulation required within 18 months  | Permanent grandfather   |
| Small bank holding companies – less than \$ 500 million in assets                                   | Exempt  | Exempt  |
| <b>Thrift holding companies</b>   |   |   |
| Large thrift holding companies – more than \$15 billion in assets as of December 31, 2009           | Effective 5 years after enactment   | Phase-in of exclusion incrementally from January 1, 2013 to January 1, 2016                     |
| Medium to small thrift holding companies – less than \$15 billion in assets as of December 31, 2009 | Effective 5 years after enactment   | Permanent grandfather   |
| <b>Mutual holding companies</b>   | If thrift holding companies, effective 5 years after enactment. Otherwise, for bank holding companies, effective upon implementing regulation required within 18 months | Permanent grandfather   |
| <b>Holding companies of industrial banks, credit card banks and trust banks</b>                     | Not subject   | Not subject   |
| <b>Systemically important nonbank financial companies</b>   | Federal Reserve may exempt. Effective upon implementing regulation required within 18 months  | Phase-in of exclusion incrementally from January 1, 2013 to January 1, 2016                     |
| <b>Foreign parents</b>  | Not subject   | Not subject   |
| <b>Intermediate U.S. holding companies of foreign banks</b> relying on SR 01-1                      | Effective 5 years after enactment   | Effective 5 years after enactment   |
| <b>Federal home loan banks</b>  | Exempt  | Exempt  |

\* All institutions, except those identified above as “exempt” or “not subject,” must exclude hybrid securities issued on or after May 19, 2010 from Tier 1 capital. TARP preferred issuances issued until the end of the Treasury’s authority to invest via TARP are also exempt from this requirement.

## GAO Studies and Reports

- The GAO, in consultation with the federal banking agencies, is required to conduct 3 studies and submit the reports to Congress within 18 months of enactment. The reports may include specific recommendations for legislative or regulatory action regarding the treatment of hybrid capital and access to credit by small depository institutions, indicating that there may be some flexibility in the Collins Amendment requirements, although such studies will be published after the Basel III standards are scheduled to be finalized.
  - **Study on Holding Company Capital Requirements.** The GAO, in consultation with the Federal banking agencies, is required to conduct a study on the use of hybrid capital instruments as a component of Tier 1 capital for banking institutions and bank holding companies. The study must consider, among other things, whether disqualifying trust preferred instruments could lead to the failure or undercapitalization of existing banking organizations and the international competitive implications prohibiting hybrid capital for Tier 1 capital.
  - **Study on Foreign Bank Intermediate Holding Company Capital Requirements.** The GAO, in consultation with the Federal banking agencies, is required to conduct a study of capital requirements applicable to U.S. intermediate holding companies of foreign banks that are bank or thrift holding companies, taking into account the principle of national treatment and equality of competitive opportunity.
  - **Small Banks Study.** The GAO, after consultation with the Federal banking agencies, must conduct a study on the access to capital by insured depository institutions with total consolidated assets of \$5 billion or less.

## Capital Requirements Must Address Systemic Risks

- The Collins Amendment also requires the appropriate federal banking agencies, subject to Council recommendations, to impose capital requirements on insured depository institutions, depository institution holding companies and systemically important nonbank financial companies to address the risks arising out of certain activities to “other public and private stakeholders.” At a minimum, the requirements must address risks that relate to:
  - significant volumes of activity in derivatives, securitized products, financial guarantees, securities borrowing and lending, and repos;
  - concentrations in assets for which reported values are model-based; and
  - concentration in market share for any activity that would substantially disrupt financial markets if unexpectedly discontinued by the institution.
- The Council also has authority to recommend heightened prudential standards to apply to certain activities and practices whether or not the institution in which they take place is systemically important. For discussion on this authority, see [“Standards and Safeguards for Systemically Important Activities and Practices.”](#) Banking supervisors are likely to coordinate these recommendations with the capital charges for systemically risky activities required by the Collins Amendment.

## Derivatives

The bill comprehensively regulates most derivatives transactions formerly deregulated by the Commodity Futures Modernization Act of 2000. Largely following the historical jurisdictional divisions between the CFTC and the SEC, the bill categorizes the derivatives transactions within its scope as either “swaps,”

which are subject to primary regulation by the CFTC, “security-based swaps,” which are subject to primary regulation by the SEC, or “mixed swaps,” which are subject to joint regulation by the CFTC and SEC. Because many of the requirements of the bill are nearly identical for both swaps and security-based swaps, for ease of presentation, unless otherwise indicated, the term “swaps” will be used in this memorandum to refer to both “swaps” and “security-based swaps,” the term “swap dealers” will be used in this memorandum to refer to both “swap dealers” and “security-based swap dealers,” and the term “major swap participants” will be used in this memorandum to refer to both “major swap participants” and “major security-based swap participants.”

The most significant aspects of the derivatives section are (1) mandatory clearing through regulated central clearing organizations and mandatory trading through either regulated exchanges or swap execution facilities, in each case, subject to certain key exceptions, (2) new categories of regulated market participants, including swap dealers and major swap participants and (3) the push-out from banks into bank affiliates of many swap activities.

As with other parts of the bill, many of the details of the new regulatory regime relating to swaps are left to the regulators to determine through rulemaking, which in most cases will occur during the first 360 days following the bill’s enactment.

## Jurisdictional Allocations: Swaps, Security-based Swaps and Mixed Swaps

- **Jurisdictional Allocation.** The bill generally grants the CFTC jurisdiction over swaps and swap market participants and the SEC jurisdiction over security-based swaps and security-based swap market participants. The two commissions share jurisdiction over mixed swaps.
- **Swaps.** The bill regulates, among other things, credit default swaps, interest rate swaps, and total return swaps on a broad range of asset categories. Swaps based on a single security or a narrow-based index of securities are generally regulated by the SEC, while swaps based on broad-based securities indices, government securities and most other reference assets are regulated by the CFTC. Options on equities and other securities, certain forward contracts and futures contracts are excluded from the definition of “swap” and their current regulatory status is generally not affected by the bill.
  - The definition of “swap” also excludes, among other transactions, sales of a nonfinancial commodity or security for deferred shipment or delivery that are intended to be physically settled and any transaction providing for the purchase or sale of 1 or more securities on a fixed basis that is subject to the Securities Act and the Securities Exchange Act of 1934 (“**Exchange Act**”).
  - **Foreign Exchange Swaps and Forwards.** The bill provides that foreign exchange swaps and forwards will be considered to be swaps, and subject to CFTC jurisdiction, unless Treasury makes a written determination that either or both types of transactions (1) should not be regulated as swaps and (2) are not structured to evade the bill. The status of foreign exchange swaps and forwards was subject to controversy during the legislative phase, with the House and Senate taking opposite views of whether these transactions should be within the bill. The resulting compromise leaves to the Treasury the final determination, based upon a consideration of specified criteria.
    - Even if the Treasury ultimately determines to exclude foreign exchange swaps and forwards, the bill provides that parties to such transactions are subject to certain business conduct standards, and requires these transactions to be reported to a swap data repository or, if no swap data repository will accept reporting of such swaps or forwards, to the CFTC.
    - Similarly, the bill prohibits foreign exchange swaps and forwards that are cleared or traded on an exchange or swap execution facility from being exempted from prohibitions on fraud and manipulation.

- The Treasury's determination regarding foreign exchange transactions will not affect the CFTC's jurisdiction over retail foreign exchange transactions.
- **Security-based Swaps.** The bill defines "security-based swap" as a swap that is based on (1) a narrow-based security index, (2) a single security or loan, including any interest therein or on the value thereof or (3) the occurrence, nonoccurrence or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition or financial obligations of the issuer.
  - The definition excludes agreements, contracts or transactions that only meet the definition of security-based swap due to referencing or being based on government securities and certain other "exempted securities" (not including municipal securities). As noted above, the effect of this is to allocate jurisdiction of swaps on government securities to the CFTC. Options and physically-settled forwards on such securities are not swaps or security-based swaps and therefore are not subject to most provisions of the bill.
- **Mixed Swaps.** The bill grants the CFTC and the SEC, in consultation with the Federal Reserve, joint rulemaking authority over "mixed swaps" that contain both swap and security-based swap characteristics.
- **Exclusion of Identified Banking Products.** The bill excludes from CFTC and SEC jurisdiction, and from the definitions of "security-based swap" and "security-based swap agreement," the following "identified banking products" that are effected by a bank under the jurisdiction of an appropriate Federal banking agency: (1) a deposit account, savings account, certificate of deposit or other deposit instrument issued by a bank, (2) a banker's acceptance, (3) a letter of credit issued or loan made by a bank, (4) a debit account at a bank arising from a credit card or similar arrangement and (5) a participation, sold to certain persons, in a loan that the bank or affiliate of the bank, other than a broker or dealer, has funded and participates in or owns.
  - The bill eliminates certain legal certainty protections, contained in the Legal Certainty for Bank Products Act, for swap agreements sold by banks.
  - The bill authorizes the appropriate Federal banking agency to except an identified banking product from the exclusion above if it determines, in consultation with the CFTC and SEC, that the product has been structured to evade the Commodity Exchange Act or the Exchange Act.
- **Other Jurisdictional Allocations**
  - The bill grants the CFTC jurisdiction over puts, calls and options on securities exempted by the SEC under Section 36(a)(1) of the Exchange Act and the SEC jurisdiction over products exempted by the CFTC under Section 4(c)(1) of the Commodity Exchange Act. The two commissions may also cede authority to each other without giving up antifraud authority in cases where jurisdiction may not be clear. FINRA and the National Futures Association are generally prohibited from regulating swaps and security-based swaps, respectively.
  - The bill provides for specific procedures to be followed in the case of a proposal to list or trade a novel derivative product that may have elements of both securities and futures. Importantly, however, the exclusion from the Commodity Exchange Act for qualifying hybrid instruments remains intact. Accordingly, many structured products that contain elements of both commodities contracts and securities will continue to be regulated as securities and will not be treated as swaps or security-based swaps under the bill.
- **State Law Preemption.** The bill prohibits (1) States from considering or regulating swaps and security-based swaps as insurance under State law and (2) State gaming or bucket shop laws from invalidating security-based swaps between eligible contract participants or effected on a registered

national securities exchange. Interestingly, the preemption from State gaming and bucket shop laws is only provided with respect to security-based swaps and not for other swaps. In fact, the provision of the Commodity Exchange Act that formerly provided a preemption for over-the-counter derivatives previously excluded from the purview of the Commodity Exchange Act has been deleted in the bill.

- For a depiction of SEC and CFTC jurisdictional allocations and rulemaking guidelines, see slide 12, “Derivatives Jurisdictional Division and Rulemaking.”

## New and Amended Definitions

### New Categories of Market Participants: Swap Dealer and Major Swap Participant

- **Swap Dealer.** The bill defines “swap dealer” as any person that holds itself out as a dealer in swaps; makes a market in swaps; 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 in the trade as a dealer or market maker in swaps. The definition excludes a person that enters into swaps for such person’s own account, individually or in a fiduciary capacity, “but not as part of a regular business.”
  - The bill provides that an insured depository institution will not be considered a “swap dealer” to the extent it offers to enter into a swap with a customer in connection with originating a loan to that customer. This exception does not apply to the definition of “security-based swap dealer.”
  - The bill exempts from designation as a swap dealer an entity that engages in *de minimis* swap dealing in connection with transactions with or for customers, as determined on the basis of factors to be established through CFTC and SEC rulemaking.
  - The bill alters the Exchange Act definition of “security” to include security-based swaps, but modifies the definition of “dealer” in the Exchange Act to clarify that a dealer in security-based swaps with eligible contract participants is not required to register as a broker-dealer. However, there is no similar exemption specified for persons who act as “brokers” of security-based swaps.
- **Major Swap Participant.** The bill defines “major swap participant” as any non-dealer:
  - that maintains a substantial position in swaps for any of the major swap categories as determined by the CFTC and SEC, excluding both positions (1) held for hedging or mitigating commercial risk and (2) maintained by an employee benefit plan under ERISA for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;
  - whose outstanding 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
  - that is a financial entity that maintains a substantial position in outstanding swaps in any major swap category as determined by the CFTC and SEC, is highly leveraged relative to the amount of capital it holds and is not subject to capital requirements established by an appropriate Federal banking agency.
  - **Substantial Position.** The bill requires the CFTC and SEC each to provide a definition of “substantial position” that is “prudent for the effective monitoring, management and oversight” of entities that are systemically important or can significantly impact the financial system of the United States.
  - **Financing Subsidiary Exclusion.** The bill excludes from the definition of major swap participant, but not from the definition of major security-based swap participant, an entity with a primary business of providing financing for an affiliate’s manufactured products, that uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and

foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or an affiliate.

- The bill authorizes the CFTC and SEC to designate a person as a swap dealer or major swap participant for a single type, class or category of swap and not others.
- For details on when the SEC and CFTC is required to promulgate rules and regulations affecting swap dealers and major swap participants, and when these swaps entities must comply with such rules and regulations, see slide 13, "Swap Dealers and Major Swap Participants."

## Revisions to Existing Definitions of Certain Market Participants

- **Expanded Definitions of CPOs and FCMs.** The bill also significantly expands the definitions in the Commodity Exchange Act of "futures commission merchant," "introducing broker," "commodity pool" and "commodity pool operator," which may result in many more entities, including some swaps market participants that are otherwise treated as swap dealers or major swap participants, being required to register with the CFTC in these categories.
  - **Futures Commission Merchant.** The bill defines "futures commission merchant" to include any individual, association, partnership, corporation or trust that in connection with a swap, solicits or accepts orders or accepts any money, securities or property, or extends credit in lieu thereof, to margin, guarantee or secure any trades or contracts or retail commodity agreements, contracts or transactions.
  - The bill grants the CFTC additional authority to include or exclude persons from the definition of "futures commission merchant."
- **Eligible Contract Participants.** The bill raises the standard slightly for certain categories of eligible contract participants, which term is relevant to the business conduct and exchange trading requirements described below, by requiring:
  - government entities, political subdivisions, multinational or supranational government entities and any instrumentality, agency or department thereof to own or invest at least \$50 million on a discretionary basis in order to qualify as an eligible contract participant, and
  - individuals to invest at least \$10 million on a discretionary basis in order to qualify as an eligible contract participant, or at least \$5 million if the contract is entered into to manage a risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual.

## Clearing, Trading and Reporting Swaps

### New Mandatory Clearing of Swaps

- The bill requires the clearing of all swaps that the CFTC or SEC has determined should be cleared. If no clearing house will accept such a contract for clearing, the bill directs and authorizes the regulators to take specified actions.
  - The bill requires the CFTC and SEC, on an ongoing basis, to review swaps to determine if they should be required to be cleared, and to provide a public comment period.
  - The bill requires clearing organizations to submit to the CFTC or SEC any swaps it plans to accept for clearing and to provide notice to its members of the submission. The CFTC and SEC are required to publish the submissions for comment and, in general, make a determination within 90 days of receipt of the submission.

- The bill requires the CFTC and SEC, in reviewing swaps, to take into account, among other factors: notional exposures, trading liquidity and pricing data; the availability of operational expertise and relevant infrastructure; the effect on the mitigation of systemic risk and on competition; and the existence of reasonable legal certainty, in the event of the insolvency of the relevant clearing house or its clearing members, with regard to the treatment of customer and swap counterparty positions, funds and property.
- Swaps entered into before the application of the clearing requirement will not need to be cleared if they are reported within specified timeframes.
- For more information on the implementation of clearing requirements, see slide 15, “Clearing, Exchange Trading and Reporting of Swaps.”
- **The Commercial End-User Exemption to Clearing**
  - The bill provides an optional exemption from clearing to any swap counterparty that (1) is not a financial entity, (2) is using the swap to hedge or mitigate commercial risk and (3) notifies the CFTC or SEC how it generally meets its financial obligations associated with entering into uncleared swaps.
  - **Financial Entity.** For the purpose of the optional exemption, the term “financial entity” means a swap dealer, a major swap participant, a commodity pool, a private fund, an employee benefit plan or a person predominantly engaged in the business of banking, or in activities that are financial in nature. The definition of financial entity excludes certain captive finance companies, as does the swap dealer definition. The CFTC and SEC are authorized to exempt small banks and certain other entities from the definition of financial entity.
  - **Affiliates.** The bill allows affiliates of persons exempt from the clearing requirement to hedge or mitigate the commercial risk of the exempt person using uncleared swaps. However, the affiliate must not be a swap dealer, a major swap participant, a commodity pool, a bank holding company with over \$50 billion in consolidated assets, an issuer or certain private investment companies.
  - **Board Committee Review.** The bill requires any issuer of securities registered under the Securities Act or reporting under the Exchange Act to obtain approval to enter into swaps that are subject to an exemption from the clearing requirement from an appropriate committee of its board of directors.
  - **Election to Clear.** The bill authorizes a counterparty to an uncleared swap to elect to clear the swap and choose the clearing organization at which the swap is cleared.
- **Non-Discrimination in Swap Clearing.** Although the bill does not require fungible clearing of swaps across clearing organizations, the bill requires clearing organizations to (1) clear swaps executed bilaterally or on an unaffiliated market on a nondiscriminatory basis and (2) offset all swaps with the same terms and conditions on an economically equivalent basis within the clearing organization. The bill prohibits the CFTC from compelling a derivatives clearing organization to accept the counterparty credit risk of another clearing organization.

### New Mandatory Trade Execution Requirements for Swaps

- The bill requires that all swaps that are subject to the clearing requirement be traded on a board of trade designated as a contract market or a securities exchange or through a swap execution facility, unless no such entity accepts the swap for trading. Trades may be executed other than on an exchange or through a swap execution facility if the clearing requirement does not apply, e.g., trades with a non-financial entity that are exempt from clearing.



- **Swap Execution Facility.** The bill defines “swap execution facility” as a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that (1) facilitates the execution of swaps between persons; and (2) is not a designated contract market or national securities exchange.
  - The bill does not provide any exemption for swap execution facilities from registration as futures commission merchants, brokers or exchanges.
- All swaps with a counterparty that is not an eligible contract participant must be exchange-traded.

## Public Reporting of Swap Transaction Data

- The bill requires the CFTC and SEC to promulgate rules for real-time public data reporting of swap transactions, including price and volume.
- Both cleared and uncleared swaps must be reported to a registered swap data repository.
- The responsibility for reporting is allocated primarily to swap dealers.

## Other New Requirements Concerning Swaps

### New Business Conduct Requirements

- The bill requires registered swap dealers and major swap participants to conform with any business conduct standards the CFTC and SEC may prescribe relating to fraud, diligent supervision of the business of the swap dealer or major swap participant, adherence to position limits and any other matter that the Commissions determine to be appropriate.
- The CFTC and SEC must adopt business conduct standards for swap dealers and major swap participants that:
  - establish a duty to verify that any counterparty meets the eligibility standards for an eligible contract participant;
  - require disclosure, to any counterparty that is not a swap dealer or major swap participant, of the material risks of a swap, any material incentives or conflicts of interest the swap dealer or major swap participant may have and the daily mark for each swap; and
  - establish a duty to communicate in a fair and balanced manner based on principles of fair dealing and good faith.
- **Special Entities.** The bill imposes stringent business conduct requirements on swap dealers and major swap participants in their dealings with “special entities,” which include pension funds, endowments, retirement plans and government agencies and entities, including municipalities.
  - When acting as an advisor to a special entity, the bill (1) prohibits a swap dealer or major swap participant from engaging in fraud, deception or manipulation and (2) requires a swap dealer, but not a major swap participant, to act in the best interest of the special entity and make reasonable efforts to obtain information about the special entity as is necessary to make a reasonable determination as to whether any swap recommended by the swap dealer is in the best interests of the special entity.
  - When offering to enter or entering into a swap with a special entity, the bill requires:
    - a swap dealer or major swap participant to comply with any duty prescribed by the CFTC or SEC that requires a reasonable basis to believe that certain special entity eligible

contract participant counterparties have an “independent representative” that (1) has sufficient knowledge to evaluate the transaction and risks, (2) is not subject to a statutory disqualification, (3) is independent of the swap dealer or major swap participant, (4) undertakes a duty to act in the best interests of the counterparty, (5) makes appropriate disclosures and (6) will provide written representations to the special entity regarding fair pricing and the appropriateness of the transaction; and

- a swap dealer to disclose to the special entity in writing the capacity in which the swap dealer is acting before the initiation of the transaction.
- The bill excludes from the application of these business conduct standards any transaction that is (1) initiated by a special entity on an exchange or swap execution facility and (2) one in which the swap dealer or major swap participant does not know the identity of the counterparty.

### Capital and Margin Requirements

- **General Requirements.** The bill imposes capital and, for uncleared swaps, initial and variation margin requirements on dealers and major swap participants.
  - The capital and uncleared swap margin requirements will be set for banking entities by the prudential regulators in consultation with the CFTC and SEC. For other entities, the capital and uncleared swap margin requirements will be set by the CFTC and SEC.
  - The bill requires the capital and margin requirements to (1) help ensure the safety and soundness of the swap dealer or major swap participant and (2) be appropriate for the risk associated with the entity's uncleared swaps.
- **Use of Non-cash Collateral.** The bill requires regulators to permit the use of non-cash collateral to meet margin requirements if doing so is consistent with preserving the financial integrity of markets trading swaps and the stability of the United States financial system.
- **No Express Grandfathering for Margin.** The bill does not expressly provide for grandfathering with respect to capital or margin requirements for existing swaps. This has been a point of great sensitivity for a number of market participants.
- **Applicability of Margining to Commercial End Users.** Although the bill does not expressly exempt from the margining requirements those swaps counterparties that are exempt from the clearing requirement, a June 30, 2010 letter from Sen. Dodd (D-CT) and Sen. Lincoln (D-AR) to Rep. Frank (D-MA) and Rep. Peterson (D-MN) have stated that it is not the intent that such non-financial swaps counterparties be subject to the margin requirements.

### Protection of Counterparty Funds and Property

- **FCM / Broker-Dealer Registration.** The bill requires any entity accepting a swap customer's money, securities or property, or extending credit in lieu of money, securities or property to margin, guarantee or secure a swap cleared by or through a clearing house to be a registered futures commission merchant if the contract is a CFTC-regulated swap, or a registered broker, dealer or security-based swap dealer if the contract is a security-based swap.
- **Segregation of Funds and Property.** The bill, subject to limited exceptions, requires futures commission merchants, brokers, dealers and security-based swap dealers to treat and deal with money, securities and property of swaps customers received to margin, guarantee or secure cleared swaps as belonging to the swap customer and to account for and not commingle such property of swaps customers with their own funds or use that property to margin, secure or guarantee trades or contracts of other persons. The bill also prohibits clearing houses and depository institutions from

holding, disposing of or using property required to be segregated as described above as belonging to the futures commission merchant, broker, dealer or security-based swap dealer or any person other than the swaps customer.

- **Segregation of Margin at Third-Party Custodian.** The bill requires swap dealers and major swap participants, at the option of a counterparty to an uncleared swap, to segregate initial margin for the counterparty's benefit at a third-party custodian. The bill requires a swap dealer or major swap participant to report on a quarterly basis to a counterparty that does not choose to require segregation regarding the swap dealer or major swap participant's back office compliance with margin and collateral requirements.
- **Commodity Contract.** The bill expands the definitions in the Bankruptcy Code of "commodity contract" to include a cleared CFTC-regulated swap and "customer" to include an entity that holds a claim against a futures commission merchant arising out the futures commission merchant's business for the commodity contract account of such entity.

### Position Limits and Large Swap Trader Reporting

- **Positions in Individual Instruments.** The bill requires the CFTC, with respect to physical commodities other than excluded commodities as defined by the CFTC, to establish limits on the amount of positions, other than bona fide hedge positions, that may be held by any person in futures contracts, options on futures contracts or on commodities traded on or subject to the rules of a designated contract market, or any swaps that are economically equivalent to such contracts or options. The bill requires the CFTC, in establishing such position limits, to strive to prevent the limits from causing price discovery in the commodity to shift to foreign boards of trade.
- **Aggregate Positions.** The bill requires the CFTC to establish limits for each month, including related hedge exemption provisions, on the aggregate number or amount of positions in contracts based upon the same underlying commodity, as defined by the CFTC, that may be held by any person, including any group or class of traders.
- **Position Limits on Size.** The bill requires the SEC to establish limits, including related hedge exemption provisions, on the size of positions in any security-based swap that may be held by any person. The SEC is authorized to aggregate positions in any security-based swap and (1) any security or loan or group of securities or loans on which the security-based swap is based or references or (2) any security or group or index of securities, the price, yield, value or volatility of which, or of which any interest therein, is the basis for a material term of such security-based swap and any other instrument relating to such security or group or index of securities.
- **Exemptions from Position Limits.** The CFTC and SEC may exempt, conditionally or unconditionally, any person or class of persons, any swap or class of swaps or any transaction or class of transactions from the prescribed position limits.
- **Enforcement.** In addition to limits that may be established by the CFTC and SEC, the bill also requires designated contract markets and swap execution facilities to establish and enforce position limits or position accountability requirements on their own markets or facilities.
- **Reporting.** The bill requires traders who exceed CFTC or SEC-prescribed thresholds in (1) CFTC-regulated swaps performing a significant price discovery function or (2) security-based swaps and related instruments to file reports to the CFTC or SEC.
  - The bill requires such large swap traders in CFTC-regulated swaps to keep specified books and records.
- **Preexisting Positions.** The bill excepts preexisting positions from the new position limit requirements.

## Extraterritoriality

- The provisions of the bill relating to CFTC-regulated swaps do not apply to activities outside the United States unless those activities (1) have a direct and significant connection with activities in, or effect on, commerce of the United States or (2) contravene the rules and regulations promulgated by the CFTC as necessary or appropriate to prevent evasion of the bill.
- The provisions of the bill relating to SEC-regulated swaps do not apply to any person insofar as such person transacts a business in security-based swaps without jurisdiction of the United States, unless such person transacts a business in security-based swaps in contravention of the rules and regulations that may be promulgated by the SEC to prevent evasion of the bill. This provision is modeled on the existing Exchange Act jurisdictional provision.

## Exchange Act Beneficial Ownership Reporting

- The bill amends Sections 13(d), 13(f) and 13(g) of the Exchange Act to include within their beneficial ownership reporting requirements a market participant who becomes or is deemed to become a beneficial owner of a security upon the purchase or sale of a security-based swap under SEC rules.
- The bill amends Sections 13 and 16 of the Exchange Act to preclude security-based swap contracts from being deemed as beneficial ownership positions in the underlying securities unless the SEC, by rule, determines after consultation with the prudential regulators and the Treasury, 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 relevant section of the bill that the purchase or sale of the security-based swaps be deemed the acquisition of beneficial ownership of the equity security.

## Rulemaking, Effectiveness and Exemptive Authority

- **Rulemaking.** The bill requires the CFTC and SEC to individually promulgate required rules within 360 days of enactment of the bill, unless specified otherwise in the bill.
  - The bill requires the CFTC and SEC to issue interim final rules providing for the reporting of uncleared swaps entered into before the date of enactment within 90 days of the date of enactment.
  - The bill requires the CFTC to issue rules providing for the registration of swap dealers and major swap participants within 1 year of the date of enactment.
  - The bill requires the SEC, not later than 1 year after the date of enactment, to issue rules providing for the registration of security-based swap dealers and major security-swap participants.
- **Effective Dates.** The effective date for each subtitle of Title VII is the later of (1) 360 days after the date of the enactment of Title VII (2) or, to the extent a provision requires rulemaking, no less than 60 days after publication of a final rule or regulation implementing such provision.
  - The bill provides that certain reporting provisions for uncleared swaps and security-based swaps, as described above, take effect upon enactment. Uncleared swaps entered into before the date of enactment, if their terms have not expired as of the date of enactment, must be reported to a trade repository or to the CFTC or SEC, as appropriate, within 30 days or such other period as the CFTC or SEC determines to be appropriate, following the adoption of an interim final rule—which must take place within 90 days of the date of enactment—or such other period as the CFTC or SEC determines to be appropriate.
  - The bill provides that the position limits provisions are effective on the date of enactment.

- **Effect on Current Swaps.** The bill provides that, unless specifically reserved in the applicable swap agreement, no requirement under the bill or an amendment made by the bill shall constitute a termination event, *force majeure*, illegality, increased costs, regulatory change or similar event, that would permit a party to terminate, renegotiate, modify, amend or supplement 1 or more transactions under a swap.
- **Exemptive Authority.** The bill prohibits the CFTC and SEC from granting exemptions from many of the key provisions their respective subtitles of the bill, except as expressly authorized. The CFTC and SEC have authority by rule to further define terms.

## Conflicts of Interest

- The bill requires the CFTC and SEC to promulgate rules to mitigate conflicts of interest, which may include numerical limits on the control of, or the voting rights with respect to, any swap clearing house or exchange by a bank holding company with consolidated assets of \$50 billion or more, a nonbank financial company supervised by the Federal Reserve, an affiliate of such a bank holding company or nonbank financial company, a swap dealer, a major swap participant or an associated person of a swap dealer or major swap participant.

## Enforcement Authority, Insider Trading, Disruptive Practices and Whistleblowers

- The bill grants the CFTC, SEC and prudential regulators increased enforcement authority related to swaps.
- The bill grants the CFTC increased insider trading authority regarding information emanating from Federal government departments and agencies that may affect or tend to affect the price of any commodity in interstate commerce and persons who receive and trade in this information.
- The bill prohibits any trading, practice or conduct on or subject to the rules of a registered entity that (1) violates bids or offers; (2) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or (3) is of the character of bidding or offering with the intent to cancel the bid or offer before execution.
- The bill prohibits entering into a swap transaction knowing, or acting in reckless disregard of the fact, that the counterparty will use the swap as part of a device, scheme or artifice to defraud any third party.
- The bill requires the CFTC, at its discretion, to pay an award to whistleblowers who voluntarily provide "original information" that leads to the successful enforcement of a judicial or administrative action or related action brought under the Commodity Exchange Act and results in monetary sanctions exceeding \$1 million.

## "Swaps" Are Not 1256 Contracts

- The bill provides that "swaps," including interest rate, currency, basis, commodity, equity, equity index and credit default swaps, as well as any "similar agreement," will not be subject to Section 1256 of the Internal Revenue Code, for years beginning after the date of enactment. If Section 1256 applies to a position, the taxpayer must in general recognize gain or loss at the end of each tax year as if the position had been sold at that time, and treat that gain or loss as 60% long-term capital and 40% short-term capital gain or loss. The provision clearly contemplates that certain instruments, even if "traded on or subject to the rules of a qualified board or exchange," would not be considered "regulated futures contracts" within the meaning of Section 1256, notwithstanding some uncertainty regarding the scope of that term under current law.

- It is our understanding that the provision is intended to ensure that instruments that were not subject to Section 1256 prior to enactment will not become so by reason of the bill, and also that the provision is not intended to affect the current application of Section 1256 to certain “foreign currency contracts.” These intentions may be clarified by legislative history.
- The term “swap” is not defined in the Internal Revenue Code, although the language of the provision closely parallels the definition in a Treasury regulation of a “notional principal contract” (generally, a contract that among other things requires periodic payments by 1 party to the other at least annually). The term “swap” is generally defined for purposes of the bill, by reference to Section 1a(47) of the Commodity Exchange Act as proposed to be codified by the bill, which would appear to encompass a wide universe of derivative instruments, including for example certain forward contracts and “bullet swaps.” It thus may be difficult in some cases to determine whether a particular instrument constitutes a “regulated futures contract” that is subject to the application of Section 1256 or an excluded “swap” or “similar agreement.”
- This provision would in general have no impact on dealers or electing traders in “securities” (including among other things interest rate, currency and equity notional principal contracts) or electing dealers or traders in actively traded commodities (including notional principal contracts with respect thereto), which are generally subject to an all-ordinary mark-to-market regime under Section 475 of the Internal Revenue Code.

## Other Provisions

- **General Changes to CFTC Regulation of Contract Markets and Clearing houses.** In addition to new swap-related regulation and oversight of boards of trade designated as contract markets and designated clearing organizations, the bill makes a number of changes to the existing CFTC framework for regulation of these entities. Contract markets and clearing organizations will each, under the bill, become subject to a significantly larger set of “core principles” than under the Commodity Exchange Act prior to passage of the bill. Notably, the new core principles for derivatives clearing organizations include requirements related to governance, financial stability and limitation of credit exposure, among other things. In addition, the bill amends the rule process by which CFTC-regulated boards of trade and clearing houses may introduce new products and otherwise amend their rules.
- **Foreign Boards of Trade.** The bill provides the CFTC the authority to adopt rules and regulations requiring registration of foreign boards of trade that provide direct access to United States persons. In formulating these rules and regulations, the CFYC is directed to consider whether comparable regulation exists in the foreign board of trade's home country. Specific limitations apply where the foreign board of trade proposes to provide direct access to United States persons with respect to contracts that settle against prices of contracts listed on a U.S. futures exchange.
- **Portfolio Margining.** The bill amends the Exchange Act and Commodity Exchange Act to facilitate portfolio margining by allowing cash and securities to be held in a futures account and futures and options on futures and related collateral to be held in a securities account by a dual-registered broker-dealer/futures commission merchant pursuant to an approved portfolio margin program, subject to certain requirements, including regulatory action by the SEC and CFTC. In addition, the CFTC is directed to ensure that securities held in a portfolio margin account that is carried as a futures account are “customer property” and owners of such accounts are “customers” for purposes of relevant provisions of the Bankruptcy Code.

## Swaps Pushout Rule

- For more information, see [“Swaps Pushout Rule.”](#)

## Regulation of Advisers to Hedge Funds and Others

The bill reflects the fact that, although private funds and their advisers generally are not considered to have been the primary cause of the financial crisis, their increasing importance to, and impact on, the global financial system have generated considerable discussion as to whether they pose systemic risk. In response to concerns that regulators lack adequate information pertaining to the activities of private funds, and thus are unable to assess the extent to which they pose such a risk, the bill generally requires all managers of such funds, other than managers of venture capital funds, to register with the SEC, imposes substantial new recordkeeping and reporting requirements on them regarding the private funds that they manage and subjects them to enhanced SEC scrutiny and audit.

The bill also addresses certain investor protection issues commonly attributed to, or associated with, private funds or their advisers. First, in response to well-publicized failures on the part of the SEC to uncover major fraud perpetrated by certain large investment advisers, the bill shifts the regulatory burden of monitoring many smaller advisers to the states so that the SEC may instead focus its examination resources on larger investment advisers. Second, the bill increases certain financial thresholds that determine investors' eligibility to invest in private funds, with the aim of ensuring that such funds are sold only to sophisticated investors able to appreciate and bear the attendant risks of such investments.

Ultimately, the changes effected by the bill are likely to materially increase the costs of compliance and may cause certain investment advisers, such as non-U.S. advisers, to decline to manage the assets of U.S. investors.

### Investment Adviser Registration Requirements

- **SEC Registration Required for a Broader Range of Advisers.** The bill eliminates (1) the “private investment adviser” exemption contained in Section 203(b)(3) of the Investment Advisers Act and (2) the intrastate registration exemption for investment advisers with any private fund client.
  - Although all investment advisers must comply with the Investment Advisers Act’s anti-fraud provisions, registered investment advisers face additional compliance obligations. For example, such advisers must appoint a chief compliance officer, establish a compliance program and adopt a code of ethics, as well as comply with certain advertisement restrictions and custody and recordkeeping requirements.
- **“Private Fund” Definition.** The bill defines the term “private fund” to be any fund that would be an investment company but for the exemptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act. This definition is similar to the Volcker Rule definition of “hedge fund” and “private equity fund,” which covers an issuer that would be an investment company but for the exemptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act, or such similar funds as the appropriate federal banking agencies, the SEC and the CFTC may, by rule, determine. For more information on the Volcker Rule, see [“The Volcker Rule”](#).
- **Advisers to Venture Capital Funds.** The bill exempts from SEC registration advisers that act as an investment adviser solely to one or more venture capital funds. The bill gives the SEC one year from the date of enactment to issue final rules defining the term “venture capital fund” for purposes of this exemption. Advisers to solely venture capital funds would be subject to recordkeeping and reporting requirements as determined by the SEC.
- **Small Business Investment Company Advisers.** The bill exempts advisers to small business investment companies from SEC registration.

- **Certain Private Fund Advisers.** The bill requires the SEC to provide an exemption from registration to any investment adviser that (1) acts solely as an adviser to private funds and (2) has assets under management in the U.S. of less than \$150 million.
  - Such advisers would, however, be subject to recordkeeping and reporting requirements as determined by the SEC.
- **Mid-sized Private Fund Advisers.** The bill requires the SEC, in prescribing regulations to carry out the registration requirements of Section 203 of the Investment Advisers Act with respect to investment advisers acting as such to “mid-sized private funds,” to take into account the size, governance and investment strategy of such funds to determine whether they pose systemic risk and to provide for registration and examination procedures with respect to such advisers that reflect the level of systemic risk posed by such funds.
  - The bill does not define the term “mid-sized private funds.”
- **Family Offices.** The bill creates an exception for family offices, a term to be defined by the SEC, from the definition of the term “investment adviser,” generally placing such entities outside the scope of the Investment Advisers Act. The bill also requires that when the SEC defines the term “family office” for purposes of the exception, it must do so in a manner that:
  - is consistent with its existing exemptive orders on the subject and the grandfathering provisions set forth in (3) below;
  - recognizes the range of organizational, management and employment structures employed by family offices and
  - does not exclude certain “grandfathered” advisers, *i.e.*, persons who were not registered or required to be registered under the Investment Advisers Act on January 1, 2010, solely because such persons provide investment advice to, and were engaged, prior to January 1, 2010, in providing investment advice to, certain natural persons and entities associated with a family office.
  - Family offices exempted from the definition of the term “investment adviser” by virtue of the grandfathering provision will nevertheless be deemed investment advisers for purposes of certain antifraud provisions of the Investment Advisers Act, namely, Sections 206(1), (2) and (4) of thereunder.
- **“Foreign Private Adviser.”** The bill exempts from registration an investment adviser that, among other things, has no place of business in the U.S. and has, in total, fewer than 15 clients and investors in the U.S. in private funds and aggregate assets under management attributable to clients and investors in the U.S. in private funds of less than \$25 million, or such higher amount as the SEC may, by rule, determine.
- **CFTC Registered Advisers that Advise Private Funds.** The bill provides a conditional SEC registration exemption for investment advisers registered with the CFTC as commodity trading advisors that advise private funds. Such advisers are exempt from SEC registration, however, if after the date the bill is enacted the business of the adviser becomes predominantly the provision of securities-related advice, the adviser must also register with the SEC.
- **Minimum Assets for SEC Adviser Registration.** The minimum assets under management SEC registration threshold for state-regulated investment advisers will be \$100 million in general, but \$25 million for advisers who (1) would not be subject to registration and examinations by their home states or (2) would otherwise be required to register with 15 or more states.



## New Recordkeeping and Reporting Obligations

- **Required Records.** The bill requires advisers to private funds to **maintain**, but not necessarily to **file** with the SEC, certain records and reports pertaining to the following items:
  - amount of assets under management;
  - use of leverage, including off-balance-sheet leverage;
  - counterparty exposure; trading and investment positions;
  - valuation policies and practices;
  - types of assets held;
  - side arrangements or side letters; and
  - trading practices and other information deemed necessary by the SEC, in consultation with the Council.
- **Records Subject to Examination.** The bill subjects all records of a private fund maintained by a registered investment adviser to such fund to periodic and special examination by the SEC. The records subject to examination are not limited to the records required to be kept by law. The bill directs the SEC to conduct periodic examinations of all records of private funds maintained by a registered investment adviser and authorizes the SEC to conduct special examinations as the SEC may prescribe as necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.
- **Availability of Records.** The bill requires registered advisers to make available to the SEC or its representatives any copies or extracts from such records as may be prepared without undue effort, expense or delay as the SEC or its representative may reasonably request.
- **Filing of Records.** The bill requires the SEC to issue rules requiring each investment adviser to a private fund to file reports containing such information as the SEC deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.
- **Information Sharing and Confidentiality.** The bill requires the SEC to share information filed with or provided to the SEC with the Council as the Council considers necessary for assessing the systemic risk posed by a private fund.
  - Such shared information will be kept confidential, except under certain circumstances it may be required to be disclosed to Congress, to a Federal department or agency or any self-regulatory organization requesting the information for purposes within the scope of its jurisdiction, or by court order in an action brought by the U.S. or the SEC.
  - Information provided to the SEC, as well as information provided by the SEC to the Council, is explicitly carved out from Freedom of Information Act disclosure.
  - It is unclear how these protections will apply to information requested by the Office of Financial Research. The bill expressly subjects any data submitted to the Office of Financial Research to the Freedom of Information Act, including the exceptions thereunder, and requires certain data other than “confidential data” to be published. For more information, see [“Data Publication and Confidentiality”](#).
- **Proprietary Information.** Proprietary information is subject to enhanced confidentiality measures.
  - The bill defines the term “proprietary information” to include: “sensitive, nonpublic information regarding (1) the investment or trading strategies of the investment adviser; (2) analytical or research methodologies; (3) trading data; (4) computer hardware or software containing

intellectual property; and (5) any additional information that the [SEC] determines to be proprietary.”

- **Annual Report to Congress.** The bill requires the SEC to report annually to Congress on how the SEC has used data collected from registered advisers to monitor the markets for the protection of investors and the integrity of the markets.
- **Disclosure of Client Identity.** The bill modifies the current Investment Advisers Act prohibition limiting the SEC’s ability to require investment advisers to disclose the identity, investments or affairs of their clients by adding an exception enabling the SEC to require the disclosure of such information insofar as such disclosure is sought “for purposes of assessment of potential systemic risk.”
- **SEC / CFTC Disclosure Rules.** The bill requires the SEC and the CFTC, within 1 year of the date of enactment and after having consulted with the Council, to jointly issue rules regarding the form and content of reports required to be filed with both agencies by dually-registered advisers. For information on these reports, see [“The Office of Financial Research”](#).

## Other Provisions

- **Rules of Construction Relating to the Commodity Exchange Act.** The bill specifies that no provision in the Investment Advisers Act will relieve any person of any obligation or duty, or affect the availability of any right or remedy available to the CFTC or any private party, arising under the Commodity Exchange Act governing commodity pools, commodity pool operators or commodity trading advisers.
- **Custody of Client Assets.** The bill allows for, but does not require, the SEC to promulgate rules to require registered investment advisers to take steps to safeguard client assets over which the adviser has custody. The bill suggests that such rules may, among other things, provide for verification of client assets by independent public accountants.
- **Accredited Investor Standard to be Adjusted for Inflation.** The bill provides that, apparently upon enactment of the bill and for 4 years following the enactment of the bill, the net worth threshold is \$1 million, excluding the value of the investor’s primary residence.
  - One year after the date of enactment, the SEC is authorized to review the definition of the term “accredited investor,” as applied to natural persons, and to promulgate rules adjusting the provisions of the definition, provided that the SEC may not adjust or modify the net worth threshold.
  - The bill requires the SEC, 4 years after the date of enactment and every 4 years thereafter, to review the entirety of the definition of the term “accredited investor,” as applied to natural persons, and authorizes the SEC to modify the definition “as appropriate for the protection of investors, in the public interest, and in light of the economy.”
    - Any net worth threshold must be an amount exceeding \$1 million, excluding the value of the investor’s primary residence.
  - For more information regarding timing, please see Davis Polk slide 16 – Accredited Investors.
- **Qualified Client Standard to be Adjusted for Inflation.** Within 1 year of enactment, and periodically thereafter, the SEC must adjust for inflation any dollar threshold contained in rules permitting an investment adviser to charge certain clients performance-based fees, notwithstanding the Investment Advisers Act’s general prohibition against doing so. Thus, the \$750,000 assets under management and \$1.5 million net worth tests for determining a client’s status as a “qualified client” would be adjusted for inflation no later than 1 year after the date of enactment and every 5 years thereafter.

- **Definition of “Client” for Purposes of 206(1) and 206(2).** The bill prohibits the SEC from defining the term “client” for purposes of Sections 206(1) and 206(2) of the Investment Advisers Act to include investors in a private fund. This is consistent with current law.

## Effective Date

- **One Year Transition Period.** Unless otherwise specified, Title IV’s provisions become effective one year after the date of enactment.
  - For additional information regarding implementation of Title IV’s provisions, please see Davis Polk slide 17 – Regulation of Advisers to Hedge Funds and Others.

## Studies

- **Private Fund Self-regulatory Organization.** Within 1 year of the date of enactment, the GAO must conclude a study on the feasibility of forming a self-regulatory organization to oversee private funds and submit a report regarding the same to Congress.
- **Short Sales**
  - Within 1 year of the date of enactment, the SEC must conclude a study and submit a report to Congress on the feasibility, benefits and costs of (1) requiring reporting of short sale positions of publicly listed securities in real time to the public or, in the alternative, to only the SEC and FINRA and (2) a voluntary pilot program in which public companies agree to have trades of their shares marked “short,” “market maker short,” “buy,” “buy-to-cover” or long” and reported in real time through the Consolidated Tape.
  - Within 2 years of the date of enactment, the SEC must conclude a study on the state of short selling after recent rule changes and the incidence of failures to deliver shares sold short and the delivery of shares on the fourth day following a short sale transaction and submit a report regarding the same, including recommendations for market improvements, to Congress. See also [“Broker-Dealer Regulation – Short Sales”](#).
- **Accredited Investor Status.** Within 3 years of the date of enactment, the GAO must conclude a study on the criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in private funds and submit a report regarding the same to Congress.
- **Custody Rule Costs.** Within 3 years of the date of enactment, the GAO must conclude a study regarding (1) the compliance costs associated with Rules 204-2 and 206(4)-2 promulgated pursuant to the Investment Advisers Act, which relate to custody of client funds or securities by investment advisers and (2) the additional costs if subsection (b)(6) of Rule 206(4)-2, relating to operational independence, were eliminated, and submit a report regarding the same to Congress.

## Investor Protection and Improvements to the Regulation of Securities

### Increasing Investor Protection and Strengthening Broker-Dealer Regulation

The bill contains a miscellaneous assortment of provisions that are intended to improve investor protection and strengthen broker-dealer regulation. In addition, a variety of studies are required on broker-dealer topics that have been discussed within the industry for many years. Notable provisions

include a SEC study regarding the standard of conduct applicable to broker-dealers and investment advisers in their dealings with retail customers and authorization of SEC rulemaking to harmonize the duties of broker-dealers and investment advisers to retail customers depending on the findings of the study. For more information regarding implementation of these provisions, please see Davis Polk slide 18 – Investor Protection.

## Broker-Dealer Regulation

- **Fiduciary Duty.** The bill does not impose a new fiduciary duty on broker-dealers or investment advisers. Instead, the SEC is required to undertake a study and provided discretionary authority to adopt a fiduciary duty rule.
  - **Fiduciary Duty Study.** The bill requires the SEC to complete a study of any gaps, shortcomings or overlaps in the standard of conduct and supervision of brokers-dealers and investment advisers providing personalized investment advice about securities to retail customers.
    - The study must be completed no later than 6 months after the enactment of the bill.
    - The SEC is required to seek public comment as part of the study.
    - Although the considerations for this study do not include whether investment advisers should be regulated by an SRO, a separate provision of the bill provides for such a study.
  - **Rulemaking.** The SEC is provided discretionary rulemaking authority to require investment advisers in providing personalized investment advice to retail customers to act in the best interest of the customer without regard to the financial or other interest of the investment adviser providing the advice. This standard must be no less stringent than the standard provided by section 206(1) and (2) of the Investment Advisers Act. The SEC is also provided discretionary rulemaking authority to apply to broker-dealers providing personalized investment advice to retail customers the standard of conduct applicable to an investment adviser providing personalized investment advice to retail customers.
    - Importantly, the SEC's rulemaking authority is discretionary.
    - Sections 206(1) and 206(2) of the Investment Advisers Act are general antifraud provisions, which prohibit investment advisers from employing any device, scheme or artifice to defraud any client or prospective client and from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client, respectively. The U.S. Supreme Court has interpreted these provisions as imposing on all investment advisers, regardless of whether the adviser is registered with the SEC, the fiduciary duties of loyalty and care to their clients. In light of their status as fiduciaries, the SEC has stated that investment advisers owe their clients, among other things, a duty of “undivided loyalty.”
      - As a more practical matter, the fiduciary obligation of investment advisers has been interpreted to require them to, among other things, allocate securities and investment opportunities amongst clients on a fair and equitable basis and to seek best execution of securities transactions made on behalf of clients. In addition, sections 206(1) and (2) likely require some manner of disclosure and consent for principal trades.
    - Any rule promulgated by the SEC must provide that any material conflicts of interest shall be disclosed and may be consented to by the customer.
    - **Retail Customers Include All Natural Persons and Their Legal Representatives.** The SEC also can apply its rules to other customers. In promulgating rules under the

Investment Advisers Act, the SEC is not permitted to define “customer” to include an investor in a provide fund managed by an investment adviser where the private fund has entered into an advisory contract with the adviser.

- **No Continuing Duty.** Broker-dealers are not subject to a continuing duty of care or loyalty after providing personalized advice to retail customers.
- The amendments to the Exchange Act allow the SEC to adopt rules that require a broker-dealer to provide notice to a retail customer regarding, and to obtain the consent or acknowledgment of the retail customer with respect to, the broker-dealer selling only proprietary or other limited range of products. A similar provision is not included with respect to the Investment Advisers Act.
- **Enhanced Disclosure.** The SEC is also required to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with broker-dealers and investment advisers, including any material conflicts of interest, and to examine, and where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers-dealers and investment advisers.
- **Securities Lending.** The bill amends the Exchange Act to grant the SEC explicit authority to issue rules regarding securities lending.
  - The bill requires the SEC, within 2 years after the enactment of the bill, to promulgate rules designed to increase the transparency of information available regarding securities lending.
- **Short Sales.** The bill requires the SEC to adopt rules for public disclosure of the amount of short sales by institutional investment managers subject to section 13f of the Exchange Act, which shall be disclosed at a minimum every month. The bill also requires broker-dealers to notify customers that they may elect not to allow their fully paid securities to be loaned to cover others' short sales, and that the broker-dealer may receive compensation for lending the customer's securities. The SEC can prescribe the form, content, time, and manner of delivery of any such notice. Manipulative short selling is added as an unlawful activity, and the SEC is authorized to adopt rules to provide enforcement options and remedies to address manipulative short selling.
- **Portfolio Margining.** The bill encourages portfolio margining by providing SIPC protection to futures and options on futures in portfolio margining accounts. The derivatives provisions provide the SEC and CFTC with exemptive authority to permit portfolio margining in futures and securities accounts.
- **Self-Regulatory Organization Filing Procedures**
  - The bill revises the self-regulatory organization rule filing process to put into effect self-regulatory organization rule filings if the SEC fails to act within specified timeframes. The bill provides that an self-regulatory organization rule filing is deemed filed with the SEC if the SEC does not declare it incomplete within 7 days of receiving it, or 21 days for a complex filing. An self-regulatory organization rule filing is deemed published for comment after the self-regulatory organization publishes on a publicly accessible website a notice of the rule change if the SEC fails to send the rule filing notice to the Federal Register for publication within 15 days. Moreover, an self-regulatory organization rule filing is deemed approved if the SEC does not approve, disapprove, or initiate disapproval proceedings regarding the filing within 45 days, subject to a 45-day extension, after the date of publication.
  - The category of rule filings that are “effective on filing” are expanded to include filings of fees charged to non-members, such as market data fees.
- **Point of Sale Disclosures.** The bill provides the SEC with express authority to issue rules designating disclosures that must be provided by a broker-dealer to a retail investor before the

purchase of an investment product or service by the retail investor. The bill also requires that any documents or information that the SEC requires to be disclosed to retail investors include information about investment objectives, strategies, costs, and risks, and any compensation or financial incentive received by a broker-dealer or other intermediary in connection with the retail customer's purchase of the product.

- **Investor Advisory Committee / Investor Advocate / Investor Testing**
  - The bill establishes an Investor Advisory Committee with membership that represents, among others, individual investors and state securities commissions. The SEC is required to issue a public statement assessing any findings or recommendations of the committee.
  - The bill establishes an Office of Investor Advocate that is charged with assisting retail investors. The Investor Advocate is appointed by the SEC Chairman, in consultation with the Commissioners.
  - The bill provides the SEC with express authority to engage in investor testing programs.
- **SIPC Assessment.** The bill increases the minimum assessment to 0.02 percent of gross revenues from the securities business of the SIPC member.
- **Senior Investment Protection.** The bill provides grants to states contingent on their limiting use of misleading designations for persons selling securities and insurance and adopting suitability rules for recommendations of securities and insurance, including annuities.
- **Required Studies**
  - **Financial Literacy.** The SEC is required to study ways to improve the financial literacy of retail investors and the most effective means of communicating costs and conflicts of interest involving investments in securities.
    - The SEC must report to Congress on its study not later than 2 years after the enactment of the bill.
  - **SEC Study on Investor Access to Information About Investment Advisers and Broker-Dealers.** The SEC is required to study ways to improve access of investors to registration information about investment advisers, broker-dealers and their associated persons, and requires the SEC to implement any recommendations of the study.
    - The study must be completed not later than 6 months after enactment of the bill.
    - Not later than 18 months after the date of completion of the study, the SEC shall implement any recommendations of the study.
  - **Mutual Fund Advertising.** The GAO is required to study mutual fund advertising.
    - The study must be completed not later than 18 months after the enactment of the bill.
  - **GAO Study on Conflicts of Interest.** The GAO is required to study the potential conflicts of interest that exist between securities underwriting and securities analyst functions within the same firms.
    - The GAO must report to Congress on the study not later than 18 months after the date of enactment of the bill.
  - **GAO Study on Financial Planners and the Use of Financial Designations.** The GAO is required to study the effectiveness of state and federal regulations to protect consumers from individuals who hold themselves out as financial planners through the use of misleading designations.

- The GAO also must study the oversight and gaps in the regulation of financial planners and other individuals who provide or offer to provide financial planning services to consumers.
- The study must be completed not later than 180 days after the enactment of the bill.
- **Investment Adviser Examinations.** The SEC is required to study enhancing examination and enforcement resources for investment advisers.
  - The study includes consideration of the frequency of SEC examinations of investment advisers over the 5 years preceding the date of the bill, whether Congress should authorize the SEC to designate one or more self-regulatory organizations to augment the SEC's efforts, and the current and potential approaches to examining the investment advisory activities of dually-registered or affiliated broker-dealers and investment advisers.
  - The study must be completed not later than 180 days after the enactment of the bill and the SEC shall use the findings of the study to revise its rules and regulations, as necessary.
- **GAO Study of Person to Person Lending.** The bill requires the GAO to conduct a study of person to person lending to determine the optimal Federal regulatory structure.

## Securities Laws Enforcement

### Capital Markets

- **Disqualifying Felons and other “Bad Actors” from Regulation D Offerings.** The bill requires the SEC to issue rules disqualifying an offering or sale of securities as a Regulation D offering where the person offering the securities:
  - Has been convicted of a felony or misdemeanor in connection with purchase or sale of any security or in connection with a false filing with the SEC; or
  - Is barred from association with regulated entities or from engaging in the business of securities, insurance, banking or in savings association or credit union activities for fraud, manipulation or deception.
- **Clarification that Section 205 of the Investment Advisers Act Does not Apply to State Registered Advisers.** The bill revises Section 205 to clarify that any investment adviser not registered or required to be registered with the SEC is not subject to Section 205's restrictions on investment advisory contracts. This is consistent with current law. It also deletes the condition that investment advisers must use mails or any means or instrumentality of interstate commerce in order to be subject to Section 205.

### Securities Laws Enforcement

There are 3 general categories of enforcement-related provisions in the bill. First, the bill expands the scope of the securities laws to permit both SEC enforcement proceedings and, in some cases, private civil actions that are not currently available under the securities laws, as well as making existing actions easier to bring. Second, the bill eliminates a number of procedural barriers and arms the SEC with additional enforcement tools. Finally, the bill changes the way the SEC carries out its internal functions. For more information regarding timing, please see Davis Polk slide 18 – Investor Protection.

- **SEC Authority to Restrict Mandatory Pre-Dispute Arbitration.** The bill requires the SEC to conduct rulemaking prohibiting or limiting the use of mandatory arbitration pre-dispute agreements between broker-dealers and investment advisers.

- **SEC’s Aiding and Abetting Authority.** The bill amends the securities laws to allow recklessness as well as knowledge to satisfy the mental state requirement for SEC aiding and abetting actions. The bill gives the SEC explicit authority under the Securities Act, the Investment Company Act, and the Investment Advisers Act to bring enforcement actions against aiders and abettors.
- **Whistleblower Protection.** The bill requires the SEC, in any action in which it levies sanctions in excess of \$1 million, to compensate whistleblowers who provide original information with between 10% and 30% of the amount of the sanctions. This expands the SEC’s current authority under the Exchange Act, which caps such compensation at 10% of collected penalties, and restricts whistleblower compensation to the insider trading context.
  - The bill establishes an Investor Protection Fund, intended to grow to a maximum of \$300 million through revenues from certain sanctions, that the SEC may use to compensate whistleblowers and fund the Inspector General’s activities.
  - The bill provides whistleblowers with an express private right of action against employers who retaliate against them.
  - The bill extends whistleblower protection to employees of nationally recognized statistical rating organizations.
  - The bill extends the current statute of limitations on Sarbanes-Oxley whistleblower claims from 90 days to 180 days. The bill also provides that any rights or remedies provided for whistleblowers under Sarbanes-Oxley may not be waived.
    - For information regarding the statute of limitations on securities fraud generally, see “Criminal Penalties.”
- **Extends Whistleblower Protection.** The bill subjects subsidiaries and affiliates that are consolidated with public companies for financial accounting purposes to the Sarbanes-Oxley whistleblower provisions.
- **Collateral Bars.** The bill permits the SEC to impose collateral bars prohibiting offenders from associating with a broad range of SEC regulated entities, rather than only the type of entity in which the violation occurred.
- **Equal Treatment of Self-Regulatory Organization Rules.** The bill prohibits any person from waiving compliance with any rule of a self-regulatory organization.
- **No Private Civil Action for Aiding and Abetting.** The bill does **not** include a provision allowing for private civil actions against individuals who *knowingly or recklessly* aid or abet a violation of the Exchange Act. Instead, the bill requires a GAO study on the impact of authorizing such a private right of action.
- **Fair Fund Amendments.** The bill allows the SEC to add civil penalty payments to a fund for distribution to the victims of a securities law violation regardless of whether the SEC also obtains disgorgement against the violator, as is required by current law.
- **Lost and Stolen Securities.** The bill expands the reporting of problems with securities to include securities that have been cancelled, and other securities determined by the SEC.
- **Nationwide Service of Subpoenas.** The bill provides that nationwide service of subpoenas is available in civil SEC actions filed in federal courts.
- **Authority over Formerly-Associated Persons.** The bill makes clear that the SEC may bring suits against persons formerly associated with a registered entity to prevent individuals from avoiding a penalty or bar simply because they are not longer associated with that registered entity.



- **SIPC Reforms.** The bill expands the customer cash amount protected under the Securities Investor Protection Act from \$100,000 to \$250,000. The bill prohibits a member of SIPC with customer accounts from entering into an insolvency, receivership, or bankruptcy proceeding without the consent of SIPC.
- **Protecting Confidentiality of Materials Submitted to the Commission.** The bill provides that the SEC may not be compelled to disclose information obtained from registered persons under the Advisers Act, except to comply with requests from Congress or other Federal agencies or an order of a U.S. court in an action brought by the U.S. or the Commission.
- **Expansion of Audit Information to be Produced and Exchanged with Foreign Counterparts.** The bill provides that a foreign public accounting firm must, if requested, produce its audit work papers to the SEC and PCAOB if it “issues an audit report, performs audit work, conducts interim reviews, or performs material services upon which a registered public accounting firm relies.”
  - The bill provides that any registered public accounting firm that relies on the work of a foreign public accounting firm in issuing an audit or interim review must produce the foreign firm’s audit work papers, if asked, and secure the agreement of the foreign firm that it will cooperate as a condition of such reliance.
- **Sharing Privileged Information with Other Authorities.** The bill allows the SEC and domestic and foreign securities authorities and law enforcement authorities to share information without waiving any privilege applicable to that information. The bill prevents the SEC from being compelled to disclose privileged information obtained from a foreign securities authority or law enforcement authority, if the foreign authority represented to the SEC in good faith that the information is privileged.
- **Enhanced Application of Anti-fraud Provisions.** The bill expands the Exchange Act market manipulation and short sales authority.
  - Section 9, relating to market manipulation, and 10(a)(1), relating to short sales, are extended to cover any security “other than a government security,” rather than just securities “registered on a national securities exchange.”
  - Section 9(b), which relates to options, is extended to non-exchange transactions in options.
  - Section 9(c) is amended to subject all brokers and dealers to the provision, not just “member[s] of a national securities exchange.”
  - Section 15(c)(1)(A) is amended to cover exchange transactions, not just over-the-counter transactions.
- **Penalties in Cease and Desist Proceedings.** The bill provides the SEC with uniform authority to seek civil penalties in cease and desist proceedings.
- **Extraterritorial Jurisdiction of the Antifraud Provisions of the Federal Securities Laws.** The bill extends the reach of the jurisdiction of the antifraud provisions of the securities laws, but only with respect to actions by the U.S. or the SEC. In these actions, jurisdiction would include “conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors” as well as “conduct occurring outside the United States that has a foreseeable substantial effect within the U.S.” This would prevent any extension of the holding in the recent *Morrison* case to actions by the U.S. or SEC, which states that Section 10(b) and Rule 10b-5 apply only in connection with a purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States. In addition, requires an SEC study on the impact of applying the above test to private actions.

- **Control Person Liability under the Exchange Act.** The bill clarifies that the SEC may impose joint and several liability on control persons.
- **Records of Persons with Custody or Use.** The bill adds a provision to the Investment Advisers Act that subjects the records of persons (not just investment advisers) having custody or use of the securities, deposits or credits of a client, that relate to such custody or use, to such reasonable periodic, special or other examinations and other information and document requests by representatives of the SEC as the SEC deems necessary or appropriate in the public interest or for the protection of investors. The bill also adds a similar provision to the Investment Company Act.
- **Deadline for Completing Examinations, Inspections and Enforcement Actions.** The bill requires that an SEC enforcement action be filed within 180 days after the SEC has provided any person with a written Wells notification. The bill requires the SEC to inform the subject of an examination in writing, within 180 days from the date on which the SEC completes the on-site portion of its examination, whether the examination has concluded without findings or the staff requests the entity undertake corrective action. In both instances, provides a 180 day extension for complex matters.

## Credit Rating Agencies

Credit rating agencies have faced criticism for the failure of credit ratings to accurately reflect the riskiness of complex structured products in the lead-up to the financial crisis. As the financial crisis unfolded and the assumptions underpinning rating methodologies for such instruments were shown to be overly optimistic, rating downgrades contributed to a pricing collapse that left the market for structured products virtually non-existent. In evaluating the performance of credit rating agencies and, in particular, nationally recognized statistical rating organizations (“**NRSROs**”), critics and regulators have attributed such rating failures to a lack of internal controls, conflicts-of-interest inherent in the issuer-pay business model, a lack of transparency and a perceived absence of accountability for credit rating agencies. In addition, various commentators have asserted that the use of credit ratings in U.S. statutes and regulations has contributed to an over-reliance on credit ratings and an incorrect assumption that such credit ratings bear an implicit government seal-of-approval.

### Credit Rating Agency Regulation Generally

- The bill increases internal controls, requires greater transparency of rating procedures and methodologies, provides investors with a private right of action, and provides the SEC with greater enforcement and examination tools regarding NRSROs.
- These provisions will raise costs and litigation exposure for NRSROs with few, if any, ongoing benefits from NRSRO registration.
- **Timing.** Unless otherwise specified, required rulemaking must be completed within 1 year of enactment.

### Governance and Compliance of NRSROs

- **Independent Board.** The bill requires each NRSRO to have a Board of Directors with at least one-half, but no fewer than 2, independent members, some portion of which must be users of NRSRO ratings.
  - The bill requires the NRSRO Board to oversee: policies and procedures for management of conflicts of interest; policies and procedures for determining ratings and the effectiveness of internal controls with respect to such policies and procedures; and policies and procedures for compensation and promotion.

- **Compliance Officer.** An NRSRO's designated compliance officer may not perform credit ratings or marketing or sales functions, participate in developing ratings methodologies or models, or participate in establishing compensation levels (except for compliance personnel).
  - The designated compliance officer's compensation may not be linked to the NRSRO's financial performance and must be arranged so as to ensure independence.
  - Compliance officers must establish procedures for the receipt of, retention and treatment of complaints regarding credit ratings, models, methodologies, and compliance with the securities laws, as well as confidential, anonymous complaints by employees or users of ratings.
- **Compliance Report.** The bill requires an annual report to be submitted to the NRSRO and SEC by the designated compliance officer addressing compliance with securities laws and the NRSRO's policies and procedures. This report must describe material changes to the NRSRO's code of ethics and conflict of interest policies and must include a certification of accuracy and completeness.

## Penalties and Liability

- **Penalties for Certain Actions**
  - **Penalties.** In addition to the existing sanctions available with respect to an NRSRO, the bill establishes penalties that the SEC may impose on persons associated with an NRSRO for specified misconduct. The bill also expands the misconduct to which penalties apply to include failure to reasonably supervise an individual who commits a violation of the securities laws.
  - **Suspension or Revocation of Registration.** The bill allows the SEC to suspend or revoke the registration of an NRSRO with respect to a particular class or subclass of securities upon a determination, after notice and hearing, that the NRSRO lacks adequate financial or managerial resources to consistently produce ratings with integrity.
    - The SEC must consider whether the NRSRO failed to produce accurate ratings over a sustained period, which places the SEC in the difficult position of assessing the quality of ratings and the means necessary to produce accurate ratings.
  - **No Antifraud Defense.** The bill clarifies that the Exchange Act's prohibition against regulating the substance of credit ratings, or procedures and methodologies for determining ratings, may not be construed as affording a defense to an antifraud action or proceeding brought by the SEC.
- **Obligation to Report Violations of Law.** Each NRSRO must refer to law enforcement or regulatory authorities any credible information received from a third party that alleges that an issuer of securities rated by the NRSRO committed or is committing a material violation of law.
- **Filing of Documents.** Subjects NRSROs to increased liability for certain documents submitted to the SEC by requiring them to be filed rather than furnished.
- **Expert Liability.** The bill nullifies Rule 436(g) under the Securities Act, which provides an exemption for credit ratings provided by NRSROs from being considered part of a registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the Securities Act. As a result, registrants, in order to include an NRSRO credit rating in a registration statement, would be required to file the NRSRO's consent along with the registration statement. NRSROs that consent to the inclusion of a rating in a registration statement would be exposed to liability as experts under Section 11 of the Securities Act for material misstatements or omissions with respect to such included ratings.
  - The need to obtain consents from NRSROs may significantly increase costs and complicate the timing of offerings.

- The rescission of Rule 436(g) may result in an increase in Rule 144A transactions.

### Private Right of Action

- **Statements Made by Credit Rating Agencies.** The bill establishes that the enforcement and penalty provisions of the Exchange Act apply to statements made by **credit rating agencies** in the same manner and to the same extent as they apply to statements made by registered public accounting firms or securities analysts under the securities laws. The bill also clarifies that statements made by credit rating agencies are not forward-looking statements for purposes of the Exchange Act's Section 21E safe-harbor.
- **State of Mind.** The bill modifies the requisite "state of mind" requirements for private securities fraud actions for money damages against a **credit rating agency** or controlling person.
  - It is now sufficient to state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation of the rated security with respect to factual elements relied upon by its own methodology for evaluating credit risk or to obtain reasonable verification of such factual elements from sources independent of the issuer and underwriter that the credit rating agency considered competent.

### Management of Conflicts of Interest

- **Internal Firewalls.** The SEC must issue rules to prevent sales and marketing considerations from influencing the production of ratings.
  - If upon notice and hearing, the SEC finds a violation of such internal firewalls that affected a rating, the NRSRO's registration must be suspended or revoked.
- **Look-back Requirement.** The bill requires that each NRSRO establish, maintain and enforce a look-back policy applicable when an employee of an entity subject to, or with securities subject to, an NRSRO rating was employed by the NRSRO and participated in determining ratings for such entity during the 1-year period preceding a rating action.
  - The SEC shall periodically review such look-back policies and the implementation of such policies.
  - **SEC Policy Review.** The SEC must review the code of ethics and conflicts of interest policy of each NRSRO annually and upon material modification or amendment.
- **Prohibition on Advising and Rating Issuers.** The bill provides a sense of Congress that the SEC should exercise its rulemaking authority to prevent conflicts of interest arising from employees of NRSROs providing services to issuers of securities that are unrelated to the issuance of credit ratings.
- **Public Disclosure of Employment Transitions.** Each NRSRO must report to the SEC employment of persons associated with the NRSRO within the previous 5 years by an entity for which the NRSRO rated an instrument during the 12-months prior to such employment. The SEC will make such information available to the public.
  - These employment reporting requirements are limited to senior officers and persons that participated in determining ratings for such entity.

## Accountability for Ratings Procedures

- **Internal Controls.** Each NRSRO must establish, maintain, enforce and document an internal control structure to govern implementation of and adherence to policies, procedures and methodologies for determining ratings.
  - The SEC must require an annual internal controls report, including an attestation by the NRSRO's CEO, that describes management responsibility in establishing and maintaining internal control structure and assesses effectiveness of internal control structure.

## Procedures and Methodologies

- **Procedures and Methodologies Rules.** The SEC must issue rules with respect to procedures and methodologies (including qualitative and quantitative data and models) used by NRSROs.
  - The rules must require each NRSRO to:
    - Ensure ratings are determined in accordance with procedures and methodologies approved by the NRSRO's Board of Directors and in accordance with policies and procedures for development of such procedures and methodologies.
    - Ensure that when material changes to rating procedures and methodologies occur, they are applied consistently to all ratings to which they apply, including current ratings (to the extent surveillance procedures and methodologies are impacted), and the reason for the change is publicly disclosed.
    - Notify ratings users of: the version of a procedure or methodology used with respect to ratings; when a material change is made to a procedure or methodology and the likelihood of this resulting in a change to current ratings; when a significant error is identified in a procedure or methodology that may result in credit rating actions.
- **Outside Information.** In producing a rating, an NRSRO must consider information about an issuer that it has or receives (other than from issuer or underwriter), if it finds the information credible and potentially significant to the rating decision.
- **Ratings Symbols.** The SEC must adopt rules that require each NRSRO to establish, maintain and enforce policies and procedures that clearly define and disclose the meaning of any ratings symbol and that apply this symbol consistently for all instruments for which the symbol is used. An NRSRO may use distinct sets of symbols to denote credit ratings for different types of instruments.
- **Rules to Establish Substantive Contours of a Rating.** The SEC must issue rules requiring each NRSRO to establish, maintain and enforce policies and procedures that assess the probability that an issuer will default, fail to make timely payments, or otherwise not make payments in accordance with the terms of an instrument.
  - This provision standardizes the meaning of ratings, requiring certain NRSROs to change the meaning of their ratings.
  - This provision raises questions about whether such rules, as envisioned, would conflict with Exchange Act Section 15E(c)(2), which states that the SEC may not "regulate the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings."
- **Qualifications for Ratings Analysts.** The SEC must issue rules to ensure persons employed to perform ratings are tested for knowledge of the rating process and meet standards of training, experience and competence necessary to produce accurate ratings.

## Disclosure

- **Elimination of Regulation FD Exemption.** The bill requires the SEC to remove the current exemption in Regulation FD for credit rating agencies.
  - Revision must occur within 90 days of enactment.
  - This provision does not limit credit rating agencies' use of other exemptions in Regulation FD.
- **Ratings Performance.** To allow assessment of accuracy and establish comparability across NRSROs, the SEC must issue rules to require each NRSRO to publicly disclose performance information on initial ratings and any subsequent changes.
  - The required disclosures must include, among other things, performance information over a range of years for a variety of types of ratings, including withdrawn ratings, and an attestation affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the rated instruments and that the rating was an independent evaluation of the instrument's risks and merits.
  - The disclosures must be comparable among NRSROs and must be clear and informative for investors with a range of sophistication.
- **Form to Accompany Ratings.** The SEC must, by rule, require each NRSRO to prescribe a form to accompany the publication of each rating disclosing information about: assumptions underlying procedures and methodologies; data relied upon to determine the rating; if applicable, how servicer or remittance reports were used to conduct surveillance; and other items that might help users of ratings better understand ratings in each class.
  - This ratings form must be easy to use, be directly comparable across types of securities and include specified qualitative and quantitative content.
- **Due Diligence Reports for Structured Finance Products.** The issuer or underwriter of an asset-backed security must make publicly available the findings of any third-party due diligence report obtained. Third-party due diligence providers must provide NRSROs issuing a rating with a certification, which will be made public, designed to ensure that a thorough review has been conducted.

## Use of Ratings in Statutes and Regulations

- **Removal of Statutory References.** The bill requires the removal of certain statutory references to credit ratings effective 2 years from enactment.
- **Removal of References from Regulations.** The bill requires all federal agencies to review and modify regulations to remove references to or reliance upon credit ratings and substitute an alternative standard of creditworthiness. Each agency must report any such modifications to Congress. This must be completed no later than 1 year after enactment.

## SEC Oversight

- **Establishment of SEC Office of Credit Ratings.** The SEC must establish a new Office of Credit Ratings.
  - **Penalties.** The SEC must establish fines and other penalties for violations by NRSROs.
  - **Duties.** The Office of Credit Ratings shall administer SEC rules with respect to NRSRO practices in determining ratings.

- **Annual Examination.** The Office of Credit Ratings shall conduct an annual examination of each NRSRO and issue a public annual report summarizing essential findings of examinations, responses by the NRSRO to identified material deficiencies and whether previous SEC recommendations have been addressed.

## Studies and Reports

- **Structured Finance Rating Study and Subsequent Rulemaking.** The bill requires an SEC study of the credit rating process for structured finance products and the conflicts of interest associated with issuer-pay and subscriber-pay models, the range of metrics to determine the accuracy of ratings, and alternative means of NRSRO compensation to create incentives for accurate ratings. The bill also requires that the SEC study the feasibility of establishing an independent utility or self-regulatory organization to assign NRSROs to determine credit ratings of structured finance products, including an assessment of fee mechanisms and payment methods and potential moral hazard or constitutional concerns.
  - The SEC must provide a report to Congress on the results no later than 24 months after enactment.
  - **System for NRSRO Assignment.** After the submission of the SEC report, the SEC must, as it determines is necessary or appropriate, establish a system for the assignment of NRSROs to determine credit ratings of structured finance products, in a manner that prevents issuer, sponsor or underwriter selection of NRSROs.
    - In issuing this rule, the SEC must implement the system described in the Franken Amendment that was included in section 939D of H.R. 4173 (111th Congress), as passed by the Senate, unless the SEC determines that an alternative system would be more appropriate.
- **Alternative Business Model Study.** The GAO must conduct a study of alternative means for compensating NRSROs to create incentives to provide more accurate ratings.
  - The GAO must provide a report to Congress on the results no later than 18 months after enactment.
- **NRSRO Independence Study.** The bill requires an SEC study of the independence of NRSROs and how this affects ratings issued. The study must evaluate, among other things, management of conflicts of interest by NRSROs providing non-rating services and potential impact of a prohibition on such services.
  - The SEC must provide a report to Congress on the results no later than 3 years after enactment.
- **Independent Professional Analyst Organization Study.** The GAO must conduct a study on the feasibility and merits of creating an independent professional organization for NRSRO rating analysts that would establish independent standards and an ethics code and oversee the profession.
  - The GAO must provide a report to Congress on the results no later than 1 year after publication by SEC of rules relating to qualification standards for credit rating analysts.
- **Standardization Study.** The SEC must conduct a study of the feasibility and desirability of standardizing credit ratings terminology across credit rating agencies and across asset classes; standardizing market stress conditions under which ratings are evaluated; and requiring a quantitative correspondence between ratings and a range of default probabilities and loss expectations under standardized stress conditions.
  - The SEC must provide a report to Congress on the results no later than 1 year after enactment.

## Credit Retention Requirements

Congress adopted the view that securitization abuses were a major contributing factor to the financial crisis. In an attempt to better align market participants' incentives, the bill creates a framework for a scheme whereby securitizers will be required to retain a portion of the credit risk with regard to asset-backed securities they sell. However, many key details will only emerge in regulations yet to come. Additional provisions require heightened disclosure and reporting relating to asset-backed securities under the securities laws.

### Credit Retention Requirements

- **Credit Retention Requirements.** The federal banking agencies and SEC must jointly prescribe regulations that require securitizers of asset-backed securities, by default, to maintain 5% of the credit risk in assets transferred, sold or conveyed through the issuance of asset-backed securities.
  - The risk retention requirement will be less than 5% if underwriting/diligence meets high underwriting standards specific to the class of the securitized asset.
  - Regulators will allocate the risk retention obligation between securitizers and originators.
  - **Timeframe.** The rules must be adopted within 270 days from the date of enactment. They become effective 1 year after publication in the Federal Register for residential mortgage-backed securities, and 2 years after such publication for all other classes of asset-backed securities.
  - **Key Definitions**
    - **Asset-Backed Security.** Asset-backed security is defined as a “fixed-income or other security collateralized by any type of self-liquidating financial asset, including a loan, a lease, a mortgage, or a secured or unsecured receivable, that allows the holder of the security to receive payments that depend primarily on cash flow from the asset,” specifically including collateralized mortgage obligations, collateralized debt obligations (“**CDOs**”), collateralized bond obligations, CDOs of asset-backed securities, CDOs of CDOs and any security that the SEC determines to be an asset-backed security for this purpose.
      - Exclusion for securities “issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.”
    - **Securitizer.** Securitizer is defined as “(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.”
    - **Originator.** Originator is defined as “a person who: (A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (B) sells an asset to a securitizer.”
- **“Qualified Residential Mortgage” Carve-Out.** The regulations will not require a securitizer to retain any part of the credit risk for an asset that is transferred, sold or conveyed through the issuance of an asset-backed security by the securitizer if all of the assets that collateralize the asset-backed security are qualified residential mortgages.
  - The criteria for “qualified residential mortgages” will be defined jointly by the Federal banking agencies, the SEC, HUD and FHFA, taking into account underwriting and product features



indicating a lower risk of default. The term may not be defined more broadly than the definition of “qualified mortgage” in the Truth in Lending Act.

- The federal banking agencies, SEC, HUD and FHFA must jointly prescribe regulations to exempt qualified residential mortgages from the risk retention requirements. However, such regulations cannot exempt an asset-backed security that is collateralized by tranches of other asset-backed securities.
- The SEC must require an issuer to certify, for each issuance of an asset-backed security collateralized exclusively by qualified residential mortgages, that the issuer has evaluated the effectiveness of the internal supervisory controls of the issuer with respect to the process for ensuring that all assets that collateralize the asset-backed security are qualified residential mortgages.
- **Asset Classes.** Regulators must establish different asset classes with different credit retention rules, including asset-backed securities backed by residential mortgages, commercial mortgages, commercial loans, auto loans and any other class of assets deemed appropriate.
- **No Hedging of Retained Credit Risk.** By default, a covered party may not hedge the required retained credit risk.
- **Collateralized Debt Obligations.** The regulations will establish standards for risk retention with respect to CDOs, securities collateralized by CDOs and similar instruments.
- **Exemptive Authority.** Regulators can jointly issue exemptions, exceptions or adjustments to the risk retention rules.
- **FDIC Securitization Rule.** The bill's credit retention standards overlap with those proposed by the FDIC as amendments to its “securitization rule.” It is unclear how the FDIC will choose to proceed with its proposed amendment in light of the bill's requirements.
- **Studies**
  - The Federal Reserve, in consultation with the OCC, FDIC and SEC, must study the effects of the credit risk retention requirements and FAS 166 and 167 on each class of asset-backed security established and issue a report to Congress within 90 days of enactment.
  - The Chairperson of Financial Services Oversight Council must study the macroeconomic effects of the credit risk retention requirements, focusing in particular on potential benefits with respect to real estate price bubbles and market stability, and report to Congress within 180 days of enactment.

### Prohibitions on Conflicts of Interest Relating to Certain Securitizations

- **Prohibition on Conflicts of Interest for 1 Year Following First Sale.**
  - The bill prohibits an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, of an asset-backed security (as defined in the Exchange Act, and including synthetic asset-backed security) from engaging in any transaction for 1 year after the first closing of the sale of the asset-backed security that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.
- **Exception.** Prohibition does not apply to:
  - Risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent,

initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship; or

- Purchases or sales of asset-backed securities made pursuant to and consistent with:
  - commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the asset-backed security, or
  - *bona fide* market-making in the asset backed security.
- **Rulemaking and Effective Dates.** The SEC is required to issue rules for purposes of implementing the prohibition within 9 months days of enactment. The prohibition will take effect on the date of issuance of final rules by the SEC.

## Reporting, Disclosure and Registration

- **Heightened Reporting and Disclosure.** The SEC will adopt rules requiring issuers of asset-backed securities to disclose information on the assets backing each tranche or class of security. In addition, SEC rules will require securitizers to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer.
- **Representations and Warranties in Asset-Backed Securities.** Within 180 days of enactment, SEC will adopt rules requiring credit rating reports to describe how representations, warranties and enforcement mechanisms for asset-backed securities differ from those of similar securities.
- **Removal of Exemption from Registration.** The bill deletes the exemption from registration for certain specific categories of mortgage backed securities provided by Section 4 of the Securities Act.
- **Registration Statement for Asset-Backed Securities.** Within 180 days of enactment, SEC will adopt rules requiring an issuer of an asset-backed security to perform a review of the assets underlying the asset-backed security and to disclose the nature of the review.
- **SEC Regulation AB.** Some of the bill's revisions to reporting, disclosure and registration requirements overlap with those proposed by the SEC as amendments to Regulation AB. It is unclear how the SEC will choose to proceed its proposed amendments in light of the bill's requirements.

## Municipal Securities

The bill provides authority to the Municipal Securities Rulemaking Board (the “**MSRB**”) over “municipal advisors” and increases the independence of the MSRB by mandating a majority of board members that are independent of municipal securities market participants. Several studies are required, including whether to repeal the “Tower Amendment,” which prohibits the SEC and the MSRB from requiring municipal issuers to file disclosure documents.

## Oversight of Municipal Advisors

- The bill requires registration and oversight of “municipal advisors” that solicit or provide advice to issuers of municipal securities or “obligated persons” with respect to the issuance of municipal securities, investment of proceeds of municipal offerings or derivatives on municipal securities.
  - **Municipal Advisors.** “Municipal advisors” includes any person that provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues, or undertakes solicitation of a municipal entity.

- The definition explicitly includes financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders, and swap advisors, if such persons are described in the definition noted above.
- The bill clarifies that the term “municipal advisor” does not include underwriters, investment advisers, commodity trading advisers advising on swaps, attorneys, or engineers.
- **Obligated Persons.** “Obligated persons” include an issuer or other person who is either generally or through an enterprise, fund, or account of such person, committed by contract or other arrangement to support the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities.
- **Fiduciary Duty.** Municipal advisors are deemed to have a fiduciary duty to an advised municipal entity. The bill prohibits a municipal advisor from acting in any way that is not consistent with this duty.
  - The MSRB is required to adopt rules reasonably designed to prevent acts, practices and courses of business as are not consistent with a municipal advisor’s fiduciary duty to its clients.

### Municipal Securities Rulemaking Board

- **Expanded MSRB Rulemaking Authority.** The bill expands the rulemaking authority of the MSRB over broker-dealers, municipal securities dealers and municipal advisors with respect to the issuance of municipal securities, investment of proceeds of municipal offerings or derivatives on municipal securities.
  - The bill expands the MSRB’s authority to regulate advice provided to or on behalf of obligated persons.
  - The bill requires the MSRB to adopt rules that require continuing education requirements and professional standards for municipal advisors.
  - The bill mandates that MSRB rules not impose an inappropriate regulatory burden on small municipal advisors.
- **MSRB Governance**
  - The bill reconstitutes the MSRB with a majority of board members that are independent of broker-dealers, municipal dealers or municipal advisors.
  - The bill authorizes the MSRB to assist the SEC and FINRA in examinations and enforcement actions regarding MSRB rules, and retain half of any fines collected by the SEC and 1/3 of all fines collected by FINRA in such enforcement actions.
  - The bill authorizes the MSRB to establish information systems as repositories of information from municipal market participants and assess fees for the use of these systems, except that the Board may not charge a fee to municipal entities or obligated persons to submit documents or other information to the Board or charge a fee to any person to obtain information directly from the internet site of the MSRB.
  - The bill requires the MSRB to meet with the SEC and FINRA at least twice a year to share information about the interpretation of their rules and examination and enforcement of compliance with MSRB rules.
- **Effective Date.** The provisions described above shall take effect on October 1, 2010.

## Studies and Other Matters

### ▪ **Municipal Security Studies**

- The bill requires the GAO to study the value of enhanced municipal issuer disclosure and the repeal of the Tower Amendment prohibition on the SEC or MSRB requiring issuer disclosure.
    - The study must be completed not later than 24 months after the date of the enactment of the bill.
  - The bill requires the GAO to study the municipal securities markets, including an analysis of the mechanisms for trading, quality of trade executions, market transparency, trade reporting, price discovery, settlement, clearing, and credit enhancements, fairness and liquidity, and the potential uses of derivatives.
    - The study must be completed not later than 18 months after the date of enactment of the bill.
  - The bill requires the GAO to study the role and importance of the Government Accounting Standards Board in municipal securities markets and the manner and level at which the Government Accounting Standards Board has been funded.
  - The study must be completed no later than 180 days after the date of enactment of the bill.
- **SEC Office of Municipal Securities.** The bill formalizes within the SEC an Office of Municipal Securities reporting to the Chairman.
  - **Funding for the Government Accounting Standards Board.** The bill authorizes the SEC to require FINRA to establish an annual accounting support fee to fund the Government Accounting Standards Board.

## Executive Compensation and Corporate Governance

### Executive Compensation

- The financial reform bill includes provisions relating to compensation arrangements at financial institutions and public companies. The bill does not impose rigid limits and prohibitions of the nature contained in previous TARP legislation, and most of the principles-based provisions require implementing regulations. Notable provisions include the requirement for listed companies to have independent compensation committees and a mandatory non-binding say on pay vote.
- **Hedging Disclosure for Employees and Directors.** The SEC must issue rules requiring companies to disclose whether employees and directors are allowed to hedge the value of any equity securities.
- **Independence Requirement for Compensation Committee Members.** Within 1 year following the bill's enactment, the SEC must issue rules directing national securities exchanges and associations to require all members of a listed company's compensation committee to be independent, taking into account advisory or other fees and affiliate status and any other factors that are established by the SEC. The standards to be articulated by the SEC could be more stringent than the standards currently in place at the stock exchanges. The SEC's rules must provide reasonable opportunity for a company to cure noncompliance with this requirement. This requirement will not apply to, among other entities, controlled companies, certain foreign private issuers and open-end investment companies.
- **Factors for Hiring Compensation Committee Advisors.** Within 1 year following the bill's enactment, the SEC must issue rules directing national securities exchanges and associations to require the compensation committee of a listed company to consider the independence of an advisor

when selecting a consultant, legal counsel or other advisor. The SEC is required to identify factors affecting independence. Such factors must be competitively neutral among categories of advisers and include certain factors identified in the bill, such as other work the advisor performs for the company. The SEC's rules must provide reasonable opportunity for a company to cure noncompliance with this requirement.

- Compensation committees, in their sole discretion, are authorized to engage consultants, legal counsel and other advisors. Compensation committees must be directly responsible for the appointment, compensation and oversight of the work of such advisors and are required to disclose whether a compensation consultant was retained and whether the work of the compensation consultant raised any conflict of interest.
- **Pay and Performance Disclosure.** The SEC must issue rules requiring companies to disclose the relationship between a company's executive compensation actually paid and its financial performance, including any change in the value of the company's shares, dividends and distributions.
- **Internal Pay Equity Disclosure.** The SEC must issue rules requiring 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 median employee annual total compensation to that of the CEO. Annual total compensation is calculated in accordance with the rules governing the calculation of the "Total" column in the Summary Compensation Table.
- **Broker Discretionary Vote Eliminated for Certain Matters.** Brokers are prohibited from voting without customer instruction with respect to the election of directors, executive compensation or any other significant matter, as determined by the SEC. This does not include a vote with respect to the uncontested election of directors of any investment company registered under the Investment Company Act of 1940. This provision will prohibit broker discretionary voting with respect to the say-on-pay and say-on-golden parachute advisory votes that the bill makes mandatory.
- **Say on Pay.** Not less frequently than once every 3 years, at any annual or other meeting of shareholders occurring 6 months after the bill's enactment, companies must provide their shareholders with a non-binding shareholder vote to approve the compensation of executives as disclosed pursuant to the SEC rules. Shareholders will also be provided with a non-binding shareholder vote, at least once every 6 years, to determine whether this vote should be held every 1, 2 or 3 years.
- **Say on Golden Parachutes.** In any proxy or consent solicitation for a meeting of shareholders occurring 6 months after the bill's enactment at which shareholders are asked to approve an M&A transaction, companies must provide shareholders with a non-binding vote to approve payments made to any named executive officer in connection with such M&A transaction.
  - Institutional investors must report annually how they voted on any say on pay and golden parachutes.
- **Clawback.** The SEC must direct listing exchanges to enforce the implementation of policies relating to (1) disclosure of incentive-based compensation that is based on publicly reported financial information and (2) clawback policies enabling the recovery of incentive-based compensation from current or former executive officers following a restatement. The trigger would be based on material noncompliance with any financial reporting requirements that led to the restatement, during the 3-year period preceding the date on which a company is required to prepare the restatement. The amount to be clawed back is the amount in excess of what would have been paid under the restated results.
- **Executive Compensation at Financial Institutions.** Federal regulators must, within 9 months of the enactment of the bill, jointly prescribe regulations to (1) require covered financial institutions to report the structures of all incentive-based compensation arrangements and (2) prohibit incentive-based payment arrangements that encourage inappropriate risks by providing employees, directors

or principal shareholders with excessive compensation or that could lead to material financial loss to the covered financial institution.

- Federal regulators include the SEC, the Federal Reserve, the OCC, the FDIC, the OTC, the National Credit Union Administration Board and the Federal Housing Finance Agency.
- Covered financial institutions include depository institutions and depository institution holding companies, broker dealers, credit unions, investment advisors, Fannie Mae and Freddie Mac, and any other financial institution determined by the appropriate federal regulators. Covered financial institutions with assets of less than \$1 billion are excluded.
- In establishing standards for compensation, Federal regulators must (1) ensure that the standards are comparable to the standards established under the Federal Deposit Insurance Act and (2) take into consideration the compensation standards described in section 39(c) of the Federal Deposit Insurance Act, which includes considerations such as the combined value of cash and noncash benefits provided to an individual and the financial condition of the institution.
- For more information regarding timing, please see Davis Polk slide 19 – Executive Compensation.

### Corporate Governance

- The financial reform bill highlights 3 areas of corporate governance at financial institutions and public companies. First, the bill requires certain financial and non-financial companies to establish a risk committee. Second, the bill requires companies to provide additional disclosure regarding its organization structure. Finally, the financial reform bill clarifies the SEC's authority to adopt proxy access.
- **Proxy Access.** The SEC is authorized to issue rules permitting shareholders to use the company's proxy solicitation materials to nominate director candidates. The SEC may determine the appropriate standards and procedures and can exempt certain issuers.
- **Chairman and CEO Structure Disclosure.** The bill requires the SEC, within 180 days after enactment, to issue rules requiring companies to disclose in the proxy statement why they have separated, or combined, the positions of chairman and CEO.
- **Risk Committees at Public Companies.** The bill requires risk committees for systemically important, publicly traded nonbank financial companies, as well as any publicly traded bank holding companies with total consolidated assets of \$10 billion or more. The Federal Reserve may impose the requirement on publicly traded bank holding companies with less than \$10 billion in assets as necessary or appropriate to promote sound risk-management practices. Risk committees must have the number of independent directors as determined by the Federal Reserve, and include 1 risk management expert having experience in risk management at large complex companies.
  - The Federal Reserve must issue final rules to carry out this provision within 1 year after the transfer date, and such rules must take effect within 15 months after the transfer date.
  - We believe it is likely that the Federal Reserve will not impose this requirement on foreign parent companies.
- **Majority Voting.** The conference deleted a provision that would have required directors at public companies to be elected by majority vote.
- **Board Committee Approval Required for Certain Swap Exemptions.** Effective 1 year after enactment, any issuer of registered securities or reports under the Exchange Act wishing to use the clearing exemption must have an appropriate committee of the board of directors review and approve the use of swaps subject to the exemption.

- For more information regarding implementation of these corporate governance requirements, please see Davis Polk slide 20 – Corporate Governance.

## SEC Management and Funding

### Changes to SEC Management

- **Report and Certification of Internal Supervisory Controls.** The bill requires the SEC to submit a yearly report to Congress that assesses the effectiveness of the internal supervisory controls of the SEC and the procedures that SEC staff use to perform examinations, enforcement investigations, and reviews of filings. Additionally, the SEC must certify, 90 days after the end of each fiscal year, that it has adequate internal supervisory controls to carry its regulatory duties.
- **Triennial Report on Personnel Management.** The bill requires the GAO to submit a triennial report to Congress that evaluates the following areas in the SEC: the effectiveness of supervisors, promotion decisions, communication between different units of the SEC, turnover, whether there are an excessive number of managers, initiatives to improve staff competency, and actions taken regarding employees who fail to perform their duties.
  - The report must also include recommendations on how the SEC can use human resources more effectively.
  - The SEC must submit a response 90 days after the GAO report is submitted detailing its response to the recommendations.
- **Annual Financial Controls Audit.** The bill requires the SEC and GAO separately to submit a yearly report to Congress, 6 months after the end of each fiscal year, assessing the SEC's internal control structure and procedures for financial reporting.
- **Report on Oversight of FINRA.** The bill requires the GAO to submit a report to Congress once every 3 years on the oversight by the SEC of FINRA that evaluates FINRA's governance; examinations; executive compensation; arbitration services; review of member advertising; cooperation with state securities administrators to promote investor protection; funding; policies regarding employment of former employees by members; effectiveness; transparency; and public and internal confidence in FINRA.
- **Compliance Examiners.** The bill provides the Division of Trading and Markets and the Division of Investment Management of the SEC with a staff of examiners to perform compliance inspections and examinations of entities under the jurisdiction of those Divisions.
- **Commission Organizational Study and Reform.** The bill requires the SEC to employ a consultant to study the internal operations, structure, funding, and the need for comprehensive reform of the SEC, as well as the SEC's relationship with and reliance on self-regulatory organizations.
- **Study on SEC Revolving Door.** The bill requires a GAO study on turnover of staff that work for financial institutions regulated by the SEC and to determine if greater post-employment restrictions are necessary.
- **Suggestion Program for Employees of the Commission.** The bill requires the Inspector General of the SEC to establish a hotline for the receipt of suggestions by employees of the SEC for improvements and allegations by employees of waste, abuse, misconduct, or mismanagement.
  - The program allows the Inspector General to "recognize" informants, possibly financially.
  - The program requires the Inspector General to take appropriate action in response to such suggestions and allegations. Also requires a yearly report to Congress on such suggestions and allegations.

## SEC Match Funding

- The bill raises the SEC's funding but maintains the role of the Appropriations Committees in setting the annual budget for the SEC. The SEC will collect transaction fees and assessments that are designed to recover the costs to the Government of the annual appropriation to the SEC by Congress.

## Sarbanes-Oxley

- **Sarbanes-Oxley Exemption for Nonaccelerated Filers.** The bill exempts small issuers that are neither a large accelerated filer nor an accelerated filer from complying with the Section 404(b) internal control rules of Sarbanes-Oxley. Directs the SEC to conduct a study to determine how to reduce the burden of complying with section 404(b) for companies whose market capitalization is between \$75,000,000 and \$250,000,000.
- **PCAOB Authority to Share Information with Foreign Authorities.** The bill amends the Sarbanes-Oxley Act to provide for the sharing of information with foreign auditor oversight authorities without waiving confidentiality or privilege.
  - The bill requires the foreign authority give a description of the applicable information systems and controls that it has in place, as well as the laws and regulations of the foreign authority that are relevant to information access.
- **PCAOB Review of Auditors of Broker-Dealers.** The bill extends the authority of the Public Company Accounting Oversight Board (the "PCAOB") to auditors of registered broker-dealers. PCAOB is permitted to refer investigations, as well as release documents and information gathered in investigations, to a registered broker-dealer's self-regulatory organization.
  - This provision is effective 180 days after the date of enactment.
  - Under current law, auditors of registered broker-dealers must be registered with the PCAOB. However, these auditors are not otherwise subject to the PCAOB oversight, which applies only to public companies.

## Elimination of the OTS

Initially, the Treasury proposed consolidating all prudential regulatory authority over federally-chartered depository institutions under 1 agency, but the bill instead dissolves the OTS and redistributes the agency's powers among the Federal Reserve, the OCC and the FDIC. Title III orchestrates this power transfer. It also contains a number of revisions to the FDIC's deposit insurance program. For more information regarding the implementation of this power transfer, please see Davis Polk slide 21 – Institutional Changes to Bank Regulation.

## Elimination of the OTS

- **OTS and the Thrift Charter.** The bill abolishes the OTS. Although it maintains the federal thrift charter, it eliminates the most important advantages of the thrift charter and imposes new penalties for failure to comply with the qualified thrift lender ("QTL") test. As a result, it is likely that most holders of a thrift charter will have a powerful incentive to convert it into a bank charter. A thrift that converts to a bank is permitted to retain its branches and to establish additional branches within states where it operated a branch prior to becoming a bank to the same extent permitted to state-chartered banks in such states by applicable state law.



- **Reallocation of Powers Among Federal Reserve, OCC and FDIC.** Supervisory and rulemaking authority previously vested in the OTS is divided among existing federal banking regulators.
  - **Federal Reserve:** The Federal Reserve assumes the OTS's powers with respect to thrift holding companies and their non-depository institution subsidiaries, as well as rulemaking authority relating to thrift transactions with affiliates, loans to insiders and tying arrangements. The Federal Reserve maintains authority over state member banks, notwithstanding proposals during the legislative process that would have reduced it.
  - **OCC:** The OCC assumes the OTS's powers with respect to federal thrifts, as well as rulemaking authority over all thrifts (except for the limited rulemaking authority transferred to the Federal Reserve). The OCC is required to designate a Deputy Comptroller responsible for the supervision and examination of federal thrifts.
  - **FDIC:** The FDIC assumes the OTS's powers, other than rulemaking, with respect to state thrifts.
  - **FDIC Board:** The director of the Consumer Bureau takes the FDIC board seat previously held by the OTS Director.
- **Timing**
  - **Implementation Plan.** Within 180 days of enactment, the Federal Reserve, OCC and FDIC are required to jointly submit a plan to the Congressional Banking Committees and the Inspectors General of the Treasury, FDIC and Federal Reserve to implement the transfer of powers, personnel, and employees from the OTS to the Federal Reserve, the OCC and FDIC.
    - Within 60 days of receiving the plan, the Inspectors General of the Treasury, FDIC and Federal Reserve must jointly provide a written report to the Federal Reserve, FDIC, OCC and OTS, with a copy to the Congressional Banking Committees, on whether the plan conforms with the requirements set forth in Title III.
    - Every 6 months following submission of the report, the Inspectors General must jointly provide a report on the status of the implementation to the Federal Reserve, FDIC, OCC and OTS, with a copy to the Congressional Banking Committees.
  - **Transfer of Powers.** The transfer of powers from the OTS to the Federal Reserve, OCC and FDIC will occur on the transfer date, which is defined as 1 year after enactment (the "**transfer date**").<sup>9</sup> The transfer date may be extended to a date not later than 18 months after enactment by the Treasury Secretary in consultation with the heads of the Fed, OCC and FDIC, upon a written determination that the extension is necessary to promote an orderly process. Upon an extension, the Treasury Secretary must provide a description of the steps to effect a timely transition.
  - **Dissolution of the OTS.** The OTS dissolves 90 days after the transfer of powers.

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<sup>9</sup> The effective dates of several bank regulatory changes in Title VI are also keyed off the transfer date.

- **Savings Provisions.** The bill contains savings provisions providing that, after the transfer date:
  - The rights, duties or obligations of the United States, the OTS, or other persons existing before the transfer date continue.
  - Actions or proceedings commenced by or against the OTS continue, and the Federal Reserve, OCC and FDIC will be substituted as party to the action, as appropriate.
  - Existing OTS orders, resolutions, determinations, agreements, regulations, interpretative rules, other interpretations, guidelines, procedures and other advisory materials will continue in effect, and will be enforceable by or against the Federal Reserve, OCC or FDIC, as appropriate, until modified, terminated, set aside or superseded.
- **List of Regulations that Will Continue**
  - By the transfer date, the Federal Reserve, OCC and FDIC must publish a list of OTS regulations that they will continue to enforce.
  - The OCC and the FDIC are required to consult with one another in identifying the list of continuing OTS regulations.
  - Proposed regulations of the OTS will be deemed regulations of the OCC or the Federal Reserve, as appropriate.

## Institutional Changes

- **Office of Women and Minority Inclusion.** Specified agencies must establish offices of minority and women inclusion to promote equal employment opportunity and increased participation of women- and minority-owned businesses in the agencies' programs and contracts.
- **Changes in Powers and Removal of Inspectors General.** The bill changes the way powers are delegated to the Inspectors General of the Federal Labor Relations Authority, the National Archives and Records Administration, the National Credit Union Administration, the National Endowment for the Arts, the National Endowment for the Humanities and the Peace Corps.
  - If a board or commission is the head of the designated federal entity, removal of an Inspector General may only be made by a 2/3 majority of that board or commission.
  - The bill establishes a Council of Inspectors General on Financial Oversight that will facilitate the sharing of information among Inspectors General.
  - **Corrective Responses by Agency Heads to Deficiencies Identified by Inspectors General.** The bill requires the Chairmen of the Federal Reserve, SEC and other agencies to take action to address deficiencies identified by a report or investigation of the agency's Inspector General.
- **Assessment Powers.** The bill expands the regulators' abilities to assess fees on regulated institutions, effective on the transfer date.
  - The Federal Reserve is required to collect assessments it deems necessary or appropriate to carry out its responsibilities with respect to bank and thrift holding companies with assets of \$50 billion or more and systemically important nonbank financial companies. These fees will take into account the costs of the Federal Reserve's heightened regulatory responsibilities with respect to these entities.
  - The OCC is permitted to collect assessments it deems necessary or appropriate to carry out its responsibilities.
  - The FDIC is permitted to collect assessments to cover the costs of regular and special examinations.

- For more information on the implementation of fees, see slide 26, “Timeline of New Fees.”

## Deposit Insurance Reforms

- **Assessments Based on Assets:** The FDIC must base deposit insurance assessments on an insured depository institution’s average consolidated total assets minus its average tangible equity, rather than on its deposit base, though the FDIC may reduce the assessment base for custodial banks and banker’s banks.
  - This revision to the assessment calculations shifts the distribution of assessments to the larger banks, which fund a greater percentage of their balance sheet through non-deposit liabilities. As drafted, it also brings foreign deposits into the assessment base.
  - The provision that no institution may be denied the lowest-risk category solely because of its size is repealed.
  - The anticipated result will be to shift more of the cost of federal deposit insurance to the larger banks that rely on funding sources other than domestic deposits.
- **Minimum Reserve Ratio Increase:**
  - There is no longer an upper limit for the reserve ratio designated by the FDIC each year. The minimum designated reserve ratio may not be less than 1.35% (raised from 1.15%) of insured deposits or the comparable percentage of the assessment base.
  - The bill overrides existing statutory provisions on restoring the reserve ratio to its minimum required percentage by allowing the FDIC until September 30, 2020 to raise the ratio to 1.35%.
  - The FDIC is to “offset the effect” of increased assessments on insured depository institutions with total consolidated assets of less than \$10 billion. This could be accomplished by assessing large and small banks equally until the reserve ratio reaches 1.15%, then requiring the larger banks to bear the cost of raising the reserve ratio to 1.35%.
  - Under prior law, if the reserve ratio exceeded 1.5%, the FDIC was required to pay dividends to its member institutions equal to the amount the fund exceeded the 1.5% level. If the reserve ratio was greater than 1.35%, but less than 1.5%, the FDIC had to pay dividends equal to half the amount the fund exceeded 1.35%. The bill eliminates both requirements.
  - Given the stress on the FDIC insurance fund during the current crisis, the FDIC may be reluctant to cap the growth of the fund or commence initiating dividends, regardless of the reserve ratio. Regardless, insured institutions can anticipate substantial deposit insurance premiums for many years as the FDIC replenishes the fund (note that the current reserve ratio is *negative* 0.38%).
- **FDIC Deposit Insurance Increase:** The maximum deposit insurance amount permanently increases to \$250,000, with retroactive effect for institutions for which the FDIC was appointed receiver or conservator between January 1, 2008 and October 3, 2008. The retroactivity will benefit creditors of a number of financial institutions such as IndyMac that failed before the temporary increase in deposit insurance coverage during the height of the financial crisis.
- **Transaction Account Insurance:** The FDIC will insure the full amount of qualifying “noninterest-bearing transaction accounts” for 2 years beginning December 31, 2010. The coverage extension does not apply to all accounts currently covered under the FDIC’s Transaction Account Guarantee program, such as NOW accounts. Certain accounts paying minimal interest were previously covered under the FDIC’s program.

- **Information Access:** Existing FDIC rights to require reports and collect information for deposit insurance purposes are strengthened.
- **Study on Core Deposits and Brokered Deposits.** The FDIC is required to conduct a study on the definition of core deposits and brokered deposits and report to Congress within one year after enactment.

## Amendments to Regulation of Bank and Thrift Holding Companies and Depository Institutions

The bill provides for stricter regulation of, as well as increased supervision, examination and enforcement powers over depository institution holding companies and their subsidiaries. Key provisions include the strengthening of the Section 23A / 23B restrictions between insured depository institutions and their affiliates, modifications to the Gramm-Leach-Bliley “Fed lite” provisions and new limits on M&A activity. Furthermore, existing “bank” exemptions under the Bank Holding Company Act are made subject to a study and related moratorium. For additional information regarding timing, please see Davis Polk slide 22 – Changes to Holding Company Regulation.

### Study and Related Moratorium on Bank Holding Company “Bank” Exemptions

- **Moratorium on Nonbank Bank Applications.** Effective immediately, the FDIC may not approve any application for deposit insurance, received after November 23, 2009, for an industrial bank, credit card bank or trust bank that is, directly or indirectly, owned or controlled by a commercial firm.
  - Furthermore, the appropriate federal banking agency must disapprove any change in control that would result in direct or indirect control by a commercial company of an industrial bank, industrial loan company, credit card bank or trust bank, with exceptions when:
    - The acquired institution is in danger of default;
    - The change in control results from the merger or whole acquisition of the commercial company parent of the depository institution; or
    - The change in control results from an acquisition of voting shares of a public company that controls an industrial bank, credit card bank or trust bank if after the acquisition less than 25 percent of any class of voting shares of the public company are held by the acquiring shareholder or group; or
    - Provided, in each of the foregoing cases, all required regulatory approvals were obtained.
  - In this context, a “commercial firm” is defined as one that derives less than 15% of its consolidated annual gross revenues from activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act, or are derived from the ownership or control of 1 or more depository institutions.
  - The moratorium and change of control provisions sunset 3 years after enactment of the bill.
- **GAO Study on Nonbank Bank Exemptions.** The bill calls for a GAO study on whether it is necessary, in order to strengthen the safety and soundness of institutions or the stability of the financial system, to eliminate certain historical and grandfathered exemptions from the definition of “bank” in the Bank Holding Company Act, which have the effect of exempting their holding companies from regulation under the Bank Holding Company Act. These include exemptions for holding companies of credit card banks, trust banks, industrial banks or industrial loan companies; thrift

holding companies; and certain trust companies and certain mutual savings banks that have a single bank subsidiary in the same state. The GAO must report to Congress within 18 months after the date of enactment.

## Regulation of Bank and Thrift Holding Companies

- **Exclusion from Thrift Holding Company Regulation.** The bill excludes holding companies of thrifts that function solely in a trust or fiduciary capacity from regulation under the Home Owners' Loan Act as savings and loan holding companies.
- **Countercyclical Capital and Leverage Requirements.** The bill requires the banking regulators to make capital requirements 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. For further information on capital and leverage requirements, see "[Minimum Leverage and Risk-Based Capital Requirements.](#)"
  - Basel III proposal would also require countercyclical capital.
- **Modification of "Fed Lite."** The bill modifies the Gramm-Leach-Bliley Act "Fed lite" provisions, and therefore expands the Federal Reserve's authority to require reports from, examine, prescribe regulations or otherwise take any action pursuant to any provision of the Bank Holding Company Act or Section 8 of the Federal Deposit Insurance Act with respect to all subsidiaries of a bank holding company, including functionally regulated subsidiaries.
  - **Expanded Examination Authority.** The bill gives the Federal Reserve authority to examine compliance with Federal law by functionally regulated subsidiaries and insured depository institutions with respect to those Federal laws that the Federal Reserve has specific jurisdiction to enforce, and other than in the case of an insured depository institution or functionally regulated subsidiary, any provision of Federal Law. The Federal Reserve's examination authority is made subject to the Bureau's authority in respect of Federal consumer financial law.
  - **Limits on Capital Standards Maintained.** The bill maintains limitations on the Federal Reserve's power to prescribe capital adequacy standards on certain functionally regulated subsidiaries.
  - **Use of Existing Reports.** With respect to requiring reports, the Federal Reserve is required to use reports and other supervisory information that the bank holding company or any subsidiary has provided to other regulatory agencies, externally audited financial statements, or information otherwise available. The current process which requires the Federal Reserve to obtain reports of functionally regulated subsidiaries by first requesting that the appropriate regulatory authority or self-regulatory organization obtain such report is eliminated. With respect to examinations, the Federal Reserve is required to use existing reports and to coordinate with other regulators of functionally regulated subsidiaries to avoid duplication of examination efforts, reporting requirements, and information requests.
  - **Notice and Consultation with Appropriate Federal Banking Agency.** The Federal Reserve is required to provide notice to and consult with the appropriate Federal banking agency, the SEC, the CFTC, or State regulatory agency, as appropriate, before commencing an examination with respect to a functionally regulated subsidiary or a depository institution subsidiary.
  - The bill makes a corresponding change to the Home Owners' Loan Act to provide the Federal Reserve with similar powers over thrift holding companies and their subsidiaries.
  - **Expands Functionally Regulated Subsidiary.** The bill expands the definition of "functionally regulated subsidiary" to (1) include an entity that is subject to registration with, as opposed to solely regulation by, the CFTC; and (2) include in the consideration of whether such an entity is

a functionally regulated subsidiary, activities conducted as a futures commission merchant, commodity trading adviser, commodity pool, commodity pool operator, swap execution facility, swap data repository, swap dealer, major swap participant, and activities that are incidental to such commodities and swaps activities.

- Provisions are effective on the transfer date. The “**transfer date**” is the date when the OTS’s power and duties are transferred to the Federal Reserve, OCC and FDIC, as applicable. It occurs one year after enactment, subject to an extension by up to 6 months by the Treasury Secretary. The Treasury Secretary must publish any extension of the transfer date in the Federal Register within 270 days after enactment.
- **Examination and Enforcement Authority Against Non-Depository Subsidiaries.** The bill requires the Federal Reserve to examine the bank permissible activities of each non-depository institution subsidiary that is not a functionally regulated subsidiary or a subsidiary of a depository institution in the same manner, subject to the same standards and with the same frequency as would be required if such activities were conducted in the lead insured depository institution. The Federal Reserve’s examination authority is made subject to the Bureau’s authority in respect of Federal consumer financial law.
  - **Coordination with State Supervisors.** The bill requires coordination with state supervisors, and permits the Federal Reserve to conduct examinations in a joint or alternating manner with a state regulator, if the Federal Reserve determines that an examination of a nondepository institution subsidiary conducted by a state carries out the same purpose of the section.
  - **Back-Up Examination.** The appropriate federal banking agency for the largest depository institution subsidiary may exercise back-up authority to examine the activities of the subsidiary if the Federal Reserve does not conduct the required examinations. The examination must consider whether the activities pose a material threat to the safety and soundness of any insured depository institution, are conducted in accordance with applicable state law, and are subject to appropriate monitoring and control. The appropriate Federal banking agency recommend that the Federal Reserve take enforcement action against the nondepository institution subsidiary. If the Federal Reserve does not take action within 60 days, then the Federal banking agency may take the recommended enforcement action.
    - The appropriate Federal banking agency that conducts an examination may collect a fee that is necessary or appropriate to carry out its responsibilities in connection with the examination.
  - The provision is effective on the transfer date.
- **Holding Company Level Capital and Management Requirements.** Effective on the transfer date, financial holding companies must be well-capitalized and well-managed on a consolidated basis at the holding company level as well as at the depository institution level. Savings and loan holding companies must be well capitalized and well managed in the same manner as bank holding companies in order to engage in the expanded financial activities permissible only for a financial holding company.

- **M&A Limits**
  - ***New Financial Stability Factor.*** Effective on the transfer date, the Federal Reserve must consider the impact of acquisitions on U.S. financial stability in approving or disapproving proposed bank and nonbank acquisitions.
  - ***Large Nonbanking Acquisitions by Financial Holding Companies.*** Effective on the transfer date, financial holding companies must provide prior notice to the Federal Reserve before acquiring a company engaged in financial activities that has \$10 billion or more of consolidated assets.
    - There is some ambiguity as to how this provision will interact, in the case of a bank holding company with more than \$50 billion in assets, with the new approval requirements (and the related exemptions) in the systemic risk regime.
    - ***Elimination of Hart-Scott Exemption.*** For the large nonbank acquisitions described above, the bill eliminates the statutory exemption from the Hart-Scott-Rodino Act filing requirements that is available in transactions for which prior Federal Reserve approval is required.
  - ***New Capital and Management Requirements for Interstate Bank Acquisitions.*** The Federal Reserve may approve a Section 3 application by a bank holding company to acquire control, or substantially all of the assets, of a bank only if the bank holding company is well capitalized and well managed. The federal banking agencies may approve interstate merger transactions only if the resulting bank will be well capitalized and well managed after the transaction. This requirement is also effective on the transfer date.
  - ***Expansion of Nationwide Deposit Cap.*** The bill prohibits acquisitions by insured depository institutions and their holding companies of additional depository institutions where the applicant would control more than 10% of the total amount of deposits of insured depository institutions. Current law imposes a deposit cap on bank holding companies, but not other insured depository institution holding companies. The bill provides an exemption for insured depository institutions in default or in danger of default. This requirement is effective upon enactment.
- **Source of Strength.** The bill requires all companies that directly or indirectly control an insured depository institution, *i.e.*, all depository institution holding companies, including commercial companies that own industrial banks or industrial loan companies or are grandfathered thrift holding companies, to serve as a source of strength for the institution. Regulations implementing this requirement must be issued within 1 year after the transfer date.
  - ***Source of Strength Defined.*** The term “source of financial strength” is defined as the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event it experiences financial distress.
  - ***Compliance Reporting.*** Companies that are not bank or thrift holding companies and are subject to the source of strength requirement may be required to submit reports under oath concerning their ability to serve as a source of strength and to comply with the source of strength requirement.
- **Dividends by Mutual Holding Companies.** Effective on the transfer date, the board of directors of each thrift subsidiary of a mutual holding company must give notice to the appropriate Federal banking agency and the Federal Reserve notice no later than 30 days before the date of a proposed dividend declaration. The bill permits a mutual holding company to waive the right to receive any dividend by a subsidiary of the mutual holding company under certain conditions.

- **Concentration Limits (“Liability Cap”).** The bill prohibits a “financial company” from merging with or acquiring substantially all of the assets or control of another company if the resulting company’s total consolidated liabilities would exceed 10 percent of the aggregate consolidated liabilities of all financial companies at the end of the prior calendar year. There is an exception for acquisitions where the target bank is in default or in danger of default.
  - **“Financial company”** defined as an insured depository institution, a bank holding company, a savings and loan holding company, a company that controls an insured depository institution, a systemically important nonbank financial company and a foreign bank or company treated as a bank holding company for purposes of the bill.
  - **Council Study on Concentration Limits.** Council required to complete a study of concentration limits within 6 months of enactment and make recommendations regarding their implementation, including any “modifications” to the concentration limit that would “more effectively implement” the concentration limits. Concentration limits may be largely inevitable despite Council study requirement.
  - **Rulemaking.** The appropriate Federal banking agencies would be required to issue final rules implementing the concentration limits in light of the Council’s recommendations within 9 months after the completion of the study.

## Regulation of Banks and Thrifts

- **No Conversions When Formal or Informal Supervisory Action is Pending.** The bill generally prohibits charter conversions during any period in which the converting entity is subject to a cease and desist order, a memorandum of understanding, or any other enforcement action issued or entered into with respect to a significant supervisory matter.
  - The bill provides an exception where the agency that would be the appropriate Federal banking agency after the proposed conversion gives the Federal banking agency or State bank supervisor that issued the cease-and-desist order or memorandum of understanding written notice of the proposed conversion including a plan to address the significant supervisory matter, the Federal banking agency or State bank supervisor that issued the cease-and-desist order or memorandum of understanding does not object, and the plan is subsequently implemented.
- **De Novo Interstate Branching.** The bill permits *de novo* interstate branching by national banks and insured state banks by amending the state “opt-in” election. Although not precisely the same interstate branching rule as thrifts now enjoy, due to technical requirements in the Home Owners’ Loan Act, this provision would place banks and thrifts generally on equal footing.
  - Applications for out-of-state *de novo* branches would be approved if, under the law of the state in which the branch is to be located, a state bank chartered by such state would have been permitted to establish the branch.
- **Penalties on Thrifts that Fail the Qualified Thrift Lender Test.** A thrift that fails to become or remain a qualified thrift lender is immediately (1) prohibited from paying dividends, subject to exemptions described below; (2) deemed in violation of Section 5 of the Home Owners’ Loan Act and therefore subject to enforcement thereunder; and (3) as under current law, subject to restrictions on activities and branching.
  - **Exemption for Certain Dividends.** A thrift that fails to become or remain a qualified thrift lender may still pay dividends that:
    - are specifically approved by the OCC and the Federal Reserve;
    - are permissible for a national bank; and



- are necessary to meet the obligations of a company that controls the thrift.
- **Timing and Jurisdictional Issue.** These requirements appear to be immediately effective, although it is unclear why prior to the transfer date, the OCC, not the OTS, would have authority to approve dividends paid by a thrift.
- **Intermediate Holding Companies for Grandfathered Unitary Thrifts.**
  - **Intermediate Holding Company Required for Certain Institutions.** The Federal Reserve must require a grandfathered unitary thrift holding company to establish an intermediate holding company if the Federal Reserve determines that such a holding company is necessary to appropriately supervise the company's financial activities, excluding internal financial activities, or to ensure that Federal Reserve supervision does not extend to commercial activities.
  - **Permissive Authority to Require Intermediate Holding Company.** The Federal Reserve may require commercial firms that control grandfathered unitary thrift holding companies to establish and conduct all or a portion of such financial activities, excluding those for internal purposes, through an intermediate savings and loan holding company. The Federal Reserve must issue regulations implementing this requirement within 90 days after the transfer date.
  - **Grandfathered Activities.** A grandfathered unitary thrift may continue to engage in internal financial activities, subject to review by the Federal Reserve to determine whether engaging in such activities presents an undue risk to the institution or to U.S. financial stability, subject to certain conditions.
  - **Source of Strength.** Grandfathered thrift holding companies that directly or indirectly control an intermediate holding company are required to serve as a source of strength for the subsidiary intermediate holding company.
  - **Reports and Examinations.** The Federal Reserve may periodically examine and require reports for a parent company, issue rules to establish criteria for determining whether to require a grandfathered thrift holding company to establish an intermediate holding company and to establish restrictions on transactions between an intermediate holding company and its parent or affiliates.
- **Interest Bearing Transaction Accounts.** Effective 1 year after enactment, the bill eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts.
- **Broadened Lending for Small Businesses.** Effective immediately, the bill amends the Bank Holding Company Act to permit a credit card bank to make credit card loans to small businesses that are eligible for loans under regulations issued by the Small Business Administration, while still retaining its exemption from the term "bank" under the Bank Holding Company Act.

## Transactions with Affiliates

- **Expansion of 23A Covered Transactions**
  - **Under Current Law.** Covered transactions currently include: (1) any loan or extension of credit to an affiliate; (2) any purchase of, or investment in, securities issued by an affiliate; (3) any purchases of assets, including assets subject to an agreement to repurchase from an affiliate, unless specifically exempted by the Federal Reserve, which is not a broad exclusion; (4) any transaction in which the covered bank holding company accepts securities issued by an affiliate as collateral for a loan or extension of credit to any entity; and (5) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.

- **Expansion of “Covered Transactions.”** Effective 1 year after the transfer date, the bill expands the scope of transactions treated as “covered transactions” for purposes of Section 23A of the Federal Reserve Act to include:
  - Credit exposure on derivatives transactions;
  - Credit exposure resulting from securities borrowing and lending transactions; and
  - Acceptance of affiliate-issued debt obligations (other than securities) as collateral for a loan or extension of credit.
- The bill does not define term “credit exposure” as used in this context.
- **Collateral Requirements.**
  - **Collateral to be Maintained at All Times.** The bill requires collateral be maintained at all times for covered transactions required to be collateralized. Currently, collateral is required only at the time the transaction is entered into.
  - **Expands Transactions Required to be Collateralized.** The bill also expands the scope of covered transactions required to be collateralized to include credit exposure on repos, as well as the new covered transaction categories of derivatives and securities borrowing and lending that create credit exposure.
  - **Limitation on Acceptable Collateral.** In addition to the existing limits on collateral, the bill prohibits the use of debt obligations issued by an affiliate to satisfy the Section 23A collateral requirements.
- **Financial Subsidiaries.** The bill prospectively eliminates exceptions for transactions with financial subsidiaries under Section 23A.
- **Advised Investment Funds Considered “Affiliates.”** The bill treats investment funds for which a covered bank or an affiliate thereof is an investment adviser, registered or not, as affiliates.
- **Revises Exemptive Authority for Covered Transactions**
  - **In General.** The bill permits the FDIC and OCC, in addition to the Federal Reserve, to grant exemptions from Section 23A with respect to banks and thrifts under their supervisory power.
  - **FDIC Concurrence.** The bill prohibits the FDIC, OCC and the Federal Reserve from granting an exemption from Section 23A if the FDIC determines that such exemption presents an unacceptable risk to the Deposit Insurance Fund.
  - **Federal Reserve.** In order to issue an exemption from Section 23A, the Federal Reserve must notify the FDIC of the proposed exemption and provide the FDIC 60 days to object in writing to the exemption if the FDIC determines that the exemption presents an unacceptable risk to the Deposit Insurance Fund.
  - **OCC.** In order to issue an exemption from Section 23A with respect to a national bank or thrift, the OCC must notify the FDIC of the proposed exemption and provide the FDIC 60 days to object in writing to the exemption if the FDIC determines that the exemption presents an unacceptable risk to the Deposit Insurance Fund.
- **Netting Arrangements.** The bill permits the Federal Reserve to issue regulations or interpretations with respect to the manner in which a bank may take netting agreements into account under Section 23A in determining the amount of a covered transaction with an affiliate, including whether a covered transaction is fully secured.
  - Interpretations with respect to a specific member bank, subsidiary or affiliate will be issued jointly with the appropriate Federal banking agency.

- **Volcker Rule Ban on Covered Transactions.** The Volcker Rule imposes Section 23A and 23B limits on banking entities engaged in certain funds activities. For information on these limits, see ["23A and 23B Limitations on Transactions with Advised or Managed Funds."](#)
- For details on the timing of provisions affecting transactions with affiliates, see slide 9, "Affiliate Transactions and Lending Limits" and slide 22, "Changes to Holding Company Regulation."

## Transactions with Insiders

- **Loans to Insiders.** The bill strengthens insider loan restrictions by expanding the types of transactions subject to insider lending limits to include derivative transactions, repurchase agreements, reverse repurchase agreements, and securities lending or borrowing transactions. The requirements are effective 1 year after the transfer date.
- **Insider Asset Sales.** The bill also imposes limitations on the sale of assets to or purchase of assets from, insiders by requiring that any asset sale between an insured depository institution and its executive officers, directors or principal shareholders and related interest's must be on market terms and, if the transaction represents more than 10% of the capital and surplus of the institution, it must be approved by a majority of the disinterested board members. The provision takes effect on the transfer date.
  - The bill requires the Federal Reserve to consult with OCC and FDIC before proposing or adopting rules to implement this requirement.
  - The bill repeals the existing restriction in Section 22(d) of the Federal Reserve Act on purchases and sales of assets by member banks to insiders.
- For details on the timing of provisions affecting transactions with insiders, see slide 22, "Changes to Holding Company Regulation."

## Lending Limits

- **Inclusion of Derivatives in Lending Limits.** Effective 1 year after the transfer date, the bill treats credit exposure from derivatives, repos and securities loans as a "loan or extension of credit" when applying lending limits applicable to national banks and thrifts. The bill permits liabilities to advance funds to or on behalf of a person to be included in this calculation.
  - A derivative transaction is defined as "any transaction that is a contract, agreement, swap, warrant, note, or option that is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, 1 or more commodities, securities, currencies, interest or other rates, indices, or other assets.
- **Derivatives Activity Contingent on State Lending Limit Laws.** The bill prohibits an insured state bank from engaging in derivative transactions unless the state's lending limit laws take into consideration credit exposure to derivative transactions. The provision is effective 18 months after the transfer date.
- For details on the timing of provisions affecting lending limits, see slide 9, "Affiliate Transactions and Lending Limits" and slide 22, "Changes to Holding Company Regulation."

## Securities Holding Companies

- **New Supervision Program Replaces Elective Investment Bank Holding Company Program.** The bill replaces the elective investment bank holding company program with a new "securities holding company" supervision program implemented and overseen by the Federal Reserve.

- **Purpose.** The bill permits a securities holding company that is required by a foreign regulator to be subject to comprehensive consolidated supervision to register with the Federal Reserve to become a “supervised securities holding company.”
- **Eligibility.** The regime is available for "securities holding companies," or firms that own or control a SEC-registered broker-dealer, but are not systemically important nonbank financial companies, are not subject to comprehensive supervision by a federal banking agency, and are not already subject to comprehensive consolidated supervision by a foreign regulator.
- **Capital and Risk Management.** The bill requires the Federal Reserve to prescribe capital adequacy and other risk management standards for supervised securities holding companies, which may differentiate among supervised securities holding companies on an individual basis or by category.
- **Examinations and Recordkeeping.** The Federal Reserve is permitted to examine a supervised securities holding company and any affiliate other than a bank (for example, an uninsured national trust bank). The Federal Reserve is also permitted to impose recordkeeping requirements.
- **Bank Holding Company Act and Federal Deposit Insurance Act.** In general, supervised securities holding companies are subject to the provisions of the Bank Holding Company Act other than the restrictions on nonbanking activities and investments in Section 4 of the Bank Holding Company Act, but including the requirement in Section 3 of the Bank Holding Company Act to obtain prior Fed approval for acquisitions of more than 5 percent of any class of voting shares of a bank or bank holding company. Certain provisions of Section 8 of the FDIA apply to supervised securities holding companies and most nonbank subsidiaries as if the Federal Reserve were such entities' appropriate federal banking agency.
- **SEC Alternative Net Capital Rule.** Elimination of investment bank holding company status does not end the eligibility for the alternative net capital treatment under the SEC's net capital rule, which continues to apply to large broker-dealers owned by holding companies subject to consolidated supervision by the Federal Reserve (and formerly, the SEC).

## Payment, Clearing and Settlement

The payment, clearing, and settlement provisions of the legislation are meant to reduce the risks of contagion among financial firms and markets. Recognizing that financial market utilities that conduct or support multilateral payment, clearing or settlement functions, and related financial activities, have the potential to create and concentrate risks to the financial system, the bill aims to reduce these risks through greater prudential regulation and oversight of these entities and activities.

The impact of this provision will largely be limited to financial market utilities and those organizations that engage in payment, clearing, and settlement activities. Utilities and these organizations will face the prospect of being designated, or having a portion of their activities designated, as systemically important, thereby subjecting the utility or organization to the payment, clearing and settlement provisions outlined below, including risk management standards and examinations by regulators.

## Designation and Oversight of Financial Market Utilities and Payment, Clearing and Settlement Activities

- **Designation as Systemically Important.** The bill allows for the designation of systemically important financial market utilities and payment, clearing and settlement activities.
  - Designation as systemically important requires a 2/3 vote of the Financial Stability Oversight Council, including an affirmative vote by the Chairperson of the Council.

- Before being designated as systemically important, the Council is required to consult with the institution's primary regulator and the Federal Reserve, provide notice in the Federal Register, and provide the financial market utility or financial institution with the opportunity for notice and a hearing, with exceptions for emergency situations.
- The designation can subsequently be rescinded.
- The definition of "financial market utilities" includes clearing organizations, but excludes exchanges and alternative trading systems with respect to pre-trade activities such as trade comparison services.
- For details regarding a proposed designation, see slide 23, "Systemically Important Payment, Clearing, and Settlement Activities."
- **Prudential Regulatory Authority.** The SEC, CFTC, and financial institution regulators are provided prudential regulatory authority over the financial market utilities and organizations engaged in payment, clearing, and settlement activities that they primarily supervise. This includes rulemaking, examination and enforcement authority. The Federal Reserve is given back-up authority over these utilities and activities.
  - The prudential standards authorized under the bill can include margin and collateral requirements, capital and financial resource requirements and participant or counterparty default policies and procedures. and the ability to complete timely clearance and settlement of financial transactions.
  - The bill provides that the standards governing the conduct of designated activities by financial institutions shall, where appropriate, establish a threshold as to the level or significance of engagement in the activity at which a financial institution will become subject to heightened supervision.
  - The primary regulator is required to consult with the Council and the Federal Reserve.
  - Service providers that provide a service integral to the operation of a designated financial market utility are subject to examination under the bill.

## Reporting Requirements and Other Matters

- **Back Office Activities.** Payment, clearing, and settlement activities of financial institutions potentially can include certain normal back office activities, such as holding customer securities in street name. Asset managers' back office activities may potentially be covered.
- **Discount Window Access.** Designated financial market utilities are provided access to the Federal Reserve's discount window in unusual or exigent circumstances and upon a showing by the designated financial market utility that it is unable to secure adequate credit accommodations from other banking institutions.
- **Notice of Proposed Rule Changes.** The bill requires designated financial market utilities to provide notice to their supervisory agencies of any proposed changes to its rules, procedures or operations that could affect the risks presented by the utility, and under certain specified circumstances the change may be disallowed, with exceptions for emergencies.
- **Reporting Requirements**
  - The bill authorizes the Council to require designated financial market utilities and financial institutions to submit information necessary to assess whether the institution's activities are systemically important or to assess the safety and soundness of the utility.

- The Federal Reserve or the Council may require any designated institution to report data to the Federal Reserve or the Council, but must first coordinate with other agencies to determine if the information is otherwise available.
- **Risk Management.** The bill requires the CFTC and SEC, in coordination with the Federal Reserve, to jointly develop a risk management supervision program for clearing organizations that must be submitted to Congress.
- **Derivatives Clearing.** The SEC and CFTC are required to consult with the Federal Reserve regarding certain derivatives clearing matters, such as which products are approved for clearing or are subject to mandatory clearing.

## Bureau of Consumer Financial Protection

The bill establishes the Bureau of Consumer Financial Protection as a new executive agency with very broad powers and a substantial budget. The Bureau will assume most of the consumer protection functions exercised by regulators under certain existing federal consumer protection laws. The Bureau will also enjoy independent authority under the Dodd-Frank Bill itself with respect to covered persons. Carved out from the Bureau's authority are a number of entities and activities, including persons regulated by the SEC and the CFTC and the business of insurance.

The greatest impact of Title X will be felt by banking organizations with assets of \$10 billion or more, with respect to which the Bureau will have exclusive rulemaking and examination, and primary enforcement, authority under Federal consumer financial law. Smaller banks will not escape the rulemaking authority of the Bureau, but will be largely free of Bureau supervision and enforcement authority. Certain nonbank covered persons will also be subject to the full complement of Bureau rulemaking, supervisory and enforcement authority.

Title X establishes a new framework for federal preemption of state consumer financial laws applicable to national banks and thrifts. Most significantly, the drafters of Title X have sought to curtail the OCC's preemption authority by providing that the OCC may preempt a state law only in accordance with the holding of the Supreme Court in *Barnett Bank v. Nelson*, on a case-by-case basis and on the basis of "substantial evidence." Title X also expands the authority of state attorneys-general and state regulators in 2 ways: first, by declaring that state consumer financial laws are fully applicable to subsidiaries and affiliates of national banks or thrifts, contrary to the Supreme Court's holding in *Watters v. Wachovia*, and second, by citing the Supreme Court's holding in *Cuomo v. Clearing House Ass'n.* to clarify that no provision of the National Bank Act relating to state visitorial authority may be construed so as to limit the authority of state attorneys-general to bring actions to enforce any applicable law against a national bank.

The passage of Title X will likely bring with it a material increase in compliance costs for covered persons, particularly in light of the 50-state consumer protection regime with which covered persons must comply in the absence of blanket federal preemption. For information relating to the creation and certain authorities of the Bureau, see slide 24, "Consumer Financial Protection Timeline."

## Covered Persons and Consumer Financial Products

- **Covered Persons Under the bill.** Bureau has very broad rulemaking, supervisory and enforcement powers over “covered persons,”<sup>10</sup> subject to explicit carve-outs.
  - A “**covered person**” is any person engaged in offering or providing a “consumer financial product or service.”
  - A “**consumer financial product or service**” is a “financial product or service” listed in Section 1002(15) that is “offered or provided for use by consumers primarily for personal, family, or household purposes” or, in the case of certain financial products or services described in 1002(15)(A),<sup>11</sup> “delivered, offered, or provided in connection with” such a financial product or service. Each of the following is defined as a “financial product or service”:
    - Extending credit and servicing loans, including acquiring, purchasing, selling, brokering, or other extensions of credit (other than solely extending commercial credit to a person who originates consumer credit transactions);
    - Extending or brokering leases of personal or real property that are the functional equivalent of purchase finance arrangements, if certain terms are present;
    - Engaging in deposit-taking activities, transmitting or exchanging funds, or otherwise acting as a custodian of funds or any financial instrument for use by or on behalf of a consumer;
    - Providing most real estate settlement services, or performing appraisals of real estate or personal property;
    - Providing or issuing stored value or payment instruments, or selling such instruments, but only if the seller exercises substantial control over the terms or conditions of the stored value provided to the consumer;
    - Providing check cashing, check collection or check guaranty services;
    - Providing payments or other financial data processing products or services to a consumer by any technological means (not including merchants, retailers, or sellers who engage in financial data processing exclusively for purposes of initiating payment instructions by a consumer to pay for a nonfinancial good or service provided directly to the consumer);
    - Providing financial advisory services to consumers on individual financial matters or relating to proprietary financial products or services, including providing consumer credit counseling or services to assist consumers with debt management, debt settlement services, modifying the terms of a loan or avoiding foreclosure, except (1) such services relating to securities provided by an SEC- or state-regulated person, to the extent such person acts in a regulated capacity and (2) publishing any *bona fide* newspaper, news magazine, or business or financial publication of general and regular circulation, including publishing market data, news, or data analytics or investment information or recommendations that are not tailored to the individual needs of a particular consumer.

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<sup>10</sup> Including “service providers,” defined as any person that provides a material service to a covered person in connection with the offering or provision by such covered person of a consumer financial product or service, with certain exceptions for ministerial support services or the provision of advertising space.

<sup>11</sup> Clauses (i), (iii), (ix) or (x).

- Collecting, analyzing, maintaining or providing consumer report or other account information, including information related to consumer credit histories, used or expected to be used in connection with any decision regarding the offering or provision of a consumer financial product or service, subject to exceptions;
- Collecting debt related to any consumer financial product or service; and
- Such other financial product or service as may be defined by the Bureau, by rule, if the Bureau finds that the financial product or service is:
  - entered into or conducted as a subterfuge or with a purpose to evade a Federal consumer financial law; or
  - is permissible for a bank or for a financial holding company to offer or provide under federal law or regulation applicable to such persons and that has, or likely will have, a material impact on consumers.
- The business of insurance<sup>12</sup> and electronic conduit services are excluded from the definition of “financial product or service.”
- **Not to be considered incidental or complementary** to a financial activity permissible for a financial holding company to engage in, and therefore not a “financial product or service”:
  - providing information products or services to a covered person for identity authentication, or for fraud or identity theft detection, prevention or investigation;
  - providing document retrieval or delivery services;
  - providing public records information retrieval; or
  - providing information products or services for anti-money laundering activities.
- **Notable Carveouts from Authority of Bureau**
  - Various persons and activities are exempted from the authority of the Bureau, including:
    - **SEC-regulated persons**, including registered broker-dealers, registered investment advisers, registered investment companies, companies that elect to be regulated as a business development company under the Investment Company Act of 1940, registered national securities exchanges, registered transfer agents, registered clearing corporations, registered self-regulatory organizations, registered credit rating agencies, registered securities information processors, registered municipal securities dealers, any other person required to be registered with the SEC under the Exchange Act, and any employee, agent or contractor acting on behalf of, registered with, or providing services to, any such person, in the case of any of the above only to the extent such persons act “in a regulated capacity.”
    - **CFTC-regulated persons**, including any person that is registered, or required by statute or regulation to be registered, with the CFTC, to the extent that the activities of such persons are subject to the jurisdiction of the CFTC under the Commodity Exchange Act.

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<sup>12</sup> Defined as the writing of insurance or the reinsuring of risks by an insurer, including all acts necessary to such writing or reinsuring and the activities relating to the writing of insurance or the reinsuring of risks conducted by persons who act as, or are, officers, directors, agents, or employees of insurers or who are persons authorized to act on behalf of such persons.



- Although there is some ambiguity in the text with respect to what extent SEC- and CFTC-regulated persons are carved out from **all** authority of the Bureau (e.g., rulemaking, supervisory and enforcement authority), a colloquy in the Congressional Record between Rep. Frank (D-MA) and Rep. Moore (D-KS) clarifies that “there is no intention whatsoever, I believe, that would lead to duplicate supervision by the consumer protection bureau.” In addition, Rep. Moore introduced a clarification for the record noting that “to the extent [persons regulated by the SEC or CFTC] are acting in a ‘regulated capacity’, only their functional regulator - the SEC or the CFTC - has rulemaking, supervisory, examination or enforcement authority over the regulated person or such activities.”
- **Persons regulated by a state insurance regulator**, including any person that is engaged in the business of insurance and subject to regulation by any State insurance regulator, to the extent that such person acts in “such capacity.”
- **Others.** Other persons and activities carved out include, but are not limited to, auto dealers; real estate brokerage activities; accountants and tax preparers; the practice of law; employee benefit and other plans; persons regulated by a state securities commission; insurance; activities relating to charitable contributions; sellers of nonfinancial goods and services; offering certain consumer financial products or services in connection with the sale or brokerage of nonfinancial goods or services. Certain of these carveouts are limited.
- **Bureau Established Within Federal Reserve, but Autonomous.** Bureau is established as an “independent bureau” within the Federal Reserve System, and is deemed to be an Executive agency. A Director will be appointed by the President, by and with the advice and consent of the Senate. Until the confirmation of the Director, the Treasury Secretary is authorized to perform certain functions of the Bureau. Although the Federal Reserve must fund the Bureau, it is forbidden from:
  - intervening in any matter or proceeding before the Director, including examinations or enforcement actions;
  - appointing, directing or removing any officer or employee of the Bureau;
  - merging or consolidating the Bureau, or any of its functions or responsibilities, with any division of the Federal Reserve, including Federal Reserve Banks;
  - reviewing or approving any rule or order of the Bureau, or delaying or preventing the issuance of any such rule or order.

## Rulemaking, Supervisory and Enforcement Authority of the Bureau

- **Federal Consumer Financial Law.** The Bureau is authorized to administer, enforce and otherwise implement the provisions of “Federal consumer financial law,” defined as:
  - the provisions of Title X of the bill;
  - certain “enumerated consumer laws”;
  - the laws for which authorities are transferred under subtitles F and H of Title X of the bill;<sup>13</sup> and

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<sup>13</sup> Subtitle F transfers to the Bureau the consumer financial protection functions of the Federal Reserve; the Comptroller of the Currency; the Director of the OTS; the FDIC; the FTC, except with respect to the FTC’s authority under the Federal Trade (cont.)

- any rule or order prescribed by the Bureau under Title X, an enumerated consumer law, or pursuant to the authorities transferred under subtitles F and H of Title X.

Does not include the Federal Trade Commission Act.

- **Rulemaking.** Bureau may prescribe rules and issue orders and guidance as may be necessary to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions thereof, subject to certain standards. Among other specific rulemaking authorizations, the Bureau may prescribe rules:
  - applicable to a covered person or service provider identifying as unlawful unfair, deceptive or abusive acts or practices in connection with any consumer financial product or service transaction;
  - to ensure that the features of any consumer financial product or service are fully, accurately and effectively disclosed to consumers; the Bureau is required to propose model disclosure for mortgage loan transactions.
- **Exemptive Authority.** Bureau may, by rule, exempt any class of covered persons, service providers, or consumer financial products or services from any provision of Title X or from any rule issued under thereunder.
- **Exclusive Rulemaking Authority.** The Bureau will have exclusive rulemaking authority with respect to assuring compliance with Federal consumer financial laws in the event that the Bureau and another Federal agency are authorized by law to do so.
- **Authority to collect information.** The Bureau is authorized to require persons to file with the Bureau, under oath or otherwise, annual or special reports or answers in writing to specific questions, and to make public such information as is “in the public interest,” subject to confidentiality rules to be prescribed by the Bureau. The Bureau will also have access to any report or examination made by a prudential regulator.
- **Deference.** Courts must afford deference to Bureau interpretations of provisions of Federal consumer financial law as if the Bureau were the only agency authorized to apply, enforce, interpret or administer such provisions.
  - **FTC.** Although the Bureau will assume the rulemaking and certain other authorities of the FTC under the enumerated consumer laws, the FTC will retain its jurisdiction under the Federal Trade Commission Act, as well as the authority to enforce rules issued by the Bureau with respect to covered persons over which it has jurisdiction under the Federal Trade Commission Act. The Bureau will have the authority to enforce rules issued by the FTC with respect to an unfair or deceptive act or practice to the extent such rule applies to a covered person or service provider with respect to the offering or provision of a consumer financial product or service.
- **Authority over “Very Large” Insured Depository Institutions.** With respect to any insured depository institution or insured credit union with total assets in excess of \$10 billion, or any affiliate thereof, to the extent not exempted from the Bureau’s authority:
  - Bureau has **exclusive rulemaking authority** to prescribe rules under any Federal consumer financial law.

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(cont.)

Commission Act or any other law; the National Credit Union Administration; and HUD. Subtitle H makes certain conforming amendments to other laws.

- Bureau has **exclusive examination authority** for purposes of assessing compliance with Federal consumer financial laws.
- Bureau has **primary enforcement authority** with respect to Federal consumer financial laws.
  - Any other Federal agency (other than the FTC) authorized to enforce a Federal consumer financial law may recommend that the Bureau initiate an enforcement action. If the Bureau fails to do so within 120 days of receipt of the recommendation, such other agency is authorized to initiate an enforcement proceeding, and to conduct follow-up supervisory functions incidental thereto.
- **Authority over Smaller Insured Depository Institutions.** With respect to any insured depository institution or insured credit union with total assets of less than \$10 billion (no reference is made in the text to affiliates, although service providers are covered):
  - Bureau has **exclusive rulemaking authority** to prescribe rules to the extent authorized to do so under any Federal consumer financial law.
  - Bureau may **participate in examinations** conducted by prudential regulators to assess compliance with the requirements of Federal consumer financial law.
  - Bureau has **no enforcement authority** with respect to the requirements of Federal consumer financial law — prudential regulators have exclusive enforcement authority.
- **Authority over Nondepository Covered Persons**
  - **Defined.** Although the Bureau must define the class of nondepository covered persons within 1 year after the designated transfer date (in consultation with the FTC), the definition will at minimum reach any “covered person” (other than one that is otherwise exempt from the Bureau’s authority) who:
    - offers or provides origination, brokerage or servicing of consumer real estate loans, or provides loan modification or foreclosure relief services in connection with such loans;
    - is a “larger participant” of a market for other consumer financial products or services, to be defined by rule by the Bureau in consultation with the FTC;
    - is determined by the Bureau (with “reasonable cause”) by order, after notice and a reasonable opportunity to respond, to be “engaging, or [to have] engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services”;
    - offers or provides to a consumer any private education loan, as defined under the Truth in Lending Act; or
    - offers or provides a payday loan to a consumer.
  - Bureau has **exclusive rulemaking authority** to prescribe rules to the extent authorized to do so under any Federal consumer financial law.
  - Bureau has **exclusive examination authority** for purposes of assessing compliance with Federal consumer financial laws.
  - Bureau has **exclusive enforcement authority** with respect to Federal consumer financial laws, subject to coordination with the FTC with respect to enforcement actions by each agency. For more information on the authority retained by the FTC, see the “FTC”.

■ **Checks on Bureau's Rulemaking Authority**

- **Council Stay and Veto Power.** Chairperson of the Council may temporarily stay the effectiveness of a Bureau regulation if petitioned to do so by a member agency, and upon a 2/3 vote of its members the Council may permanently set aside a Bureau regulation.
- **Written Objection of Prudential Regulator.** If a prudential regulator objects in writing to a proposed Bureau rule, the Bureau must include the objection in the rule's adopting release and explain the Bureau's decision regarding the objection.

## Relationship to State Law

- A state consumer financial law<sup>14</sup> is preempted with respect to a national bank if:
  - application of the state consumer financial law would have a discriminatory effect on national banks in comparison with the effect on a bank chartered by such state;
  - the Comptroller of the Currency by order or regulation, or a court, determines "in accordance with the legal standard for preemption in the decision of the Supreme Court in *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner, et al.* . . . . [that] the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers," on a case-by-case basis; or
  - the State consumer financial law is preempted by a provision of Federal law other than Title 12 of the U.S. Code.
- **Case-by-case.** "[C]ase-by-case basis" refers to a determination by the Comptroller of the Currency "concerning the impact of a particular State consumer financial law on any national bank" subject to that law, or another state's law "with substantively equivalent terms."
- **Substantial Evidence.** No preemption regulation or order of the Comptroller of the Currency may be interpreted or applied to invalidate, or otherwise declare inapplicable to a national bank, a provision of a State consumer financial law unless substantial evidence, made on the record of the proceeding, supports the specific finding regarding such preemption in accordance with the legal standard of *Barnett Bank*.
  - **Subsidiaries and Affiliates.** Preemption authority *not* granted with respect to subsidiaries, affiliates or agents of national banks that are not national banks themselves, contrary to the Supreme Court's ruling in *Wachovia Bank v. Watters*.
  - **Judicial Review.** A court reviewing preemption determinations must consider the thoroughness evident in the OCC's consideration, the validity of the reasoning of the OCC, the consistency with other valid determinations made by the OCC, and other factors which the court finds persuasive and relevant to its decision.

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<sup>14</sup> A "State consumer financial law" means a state law that does not directly or indirectly discriminate against national banks and 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.

- **State Actors**
  - Provides that “in accordance with the decision of the Supreme Court of the United States in *Cuomo v. Clearing House*,” the authority of state attorneys-general to bring an action against a national bank in a court of appropriate jurisdiction to enforce an applicable law and to seek relief as authorized by such law is not abridged by the visitorial powers provisions of the National Bank Act.
  - State attorneys-general may bring civil actions against national banks and federal thrifts to enforce the regulations prescribed by the Bureau under Title X — but not to enforce Title X itself.
  - Any state regulator or attorney-general may bring a civil action to enforce Title X or regulations prescribed by the Bureau thereunder with respect to any entity that is state-chartered, incorporated, licensed or otherwise authorized to do business in the state.
  - Any actions brought by state attorneys-general must be brought in a federal or state court in the attorney-general’s own state.
  - Private parties are not precluded from enforcing applicable rights under Federal or State law.
- **Funding.** Bureau would not be funded by assessments on covered companies, but would receive annually from the Federal Reserve an amount up to 10-12% of the Federal Reserve’s total operating expenses, to be adjusted with reference to the employment cost index for state and local government workers.
  - Director authorized to determine that the Bureau is being insufficiently funded. Upon submission of a report to the President and House and Senate appropriations committees, \$200 million additional dollars will be appropriated to the Bureau.
- **Effective Date.** Most of the provisions of the bill will become effective on the “designated transfer date,” which can be no earlier than 6 months after enactment and no later than 18 months (including possible extensions) after enactment.<sup>15</sup>
  - The Treasury Secretary, in consultation with the heads of the Federal Reserve, FDIC, FTC, NCUAB, OCC, OTS, HUD and OMB, must specify the designated transfer date within 60 days after enactment, subject to possible extensions.
  - Notable provisions that are effective immediately upon enactment include:
    - Rulemaking authority under Federal consumer financial law other than under the “enumerated consumer laws,” which authority will not transfer to the Bureau until the designated transfer date.
    - Supervision of nondepository covered persons, subject in part to additional rulemaking and the delayed transfer of authority under the “enumerated consumer laws” upon the designated transfer date.
    - Coordination of supervisory action between prudential regulators and the Bureau with respect to very large depository institutions.

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<sup>15</sup> The designated transfer date for consumer protection is different than the transfer date for bank regulation.

## Other Notable Provisions

- **Restrictions on Card Networks and Card Issuers**
  - Interchange transaction fees must be “reasonable and proportional to the cost” of the card network’s expense for processing the transaction. Federal Reserve must prescribe regulations within 9 months of enactment of the bill to establish standards for determining whether fees are reasonable and proportional, taking into consideration the cost of fraud to card issuers.
    - **Exceptions to the Interchange Transaction Fee Limitations**
      - Card issuers which, together with their affiliates, have less than \$10 billion in assets are exempt from the interchange transaction fee limitation.
      - The interchange transaction fee limit does not apply to transactions involving: (1) a debit or prepaid card issued by a federal, state or local government-administered payment program in which the card can only be used to transfer funds provided pursuant to such program or (2) most prepaid cards.
    - Federal Reserve must prescribe regulations regarding network fees within 9 months of the enactment of the bill in order to ensure that network fees are not used directly or indirectly to compensate issuers with respect to electronic debit transactions.
- **Authority to Restrict Mandatory Predispute Arbitration.** Bureau is authorized to prohibit or limit mandatory predispute arbitration provisions after conducting a study; any such limits must be consistent with the findings of the study.
- **Remittance Transfers.** Imposes disclosure obligations on providers of remittance transfers.
- **Expanded Application of Truth in Lending Act.** Amends the Truth in Lending Act to apply to credit transactions and consumer leases below \$50,000 (instead of \$25,000).
- **Consumer Information Requests.** The bill requires that covered persons comply with consumer requests for information concerning a consumer financial product or service obtained from the covered person, but excludes from the disclosure obligation confidential commercial information, information collected to prevent fraud or money laundering, or to detect or make a report regarding other unlawful conduct, or other nonpublic or confidential information.
- **Criminal Penalties.** The U.S. Sentencing Commission is directed to review and, if appropriate, to amend federal sentencing guidelines and policy statements applicable to securities fraud or financial institution fraud. Statute of limitations for securities fraud offenses extended to 6 years.
- **Civil Penalties.** Civil penalties may be assessed for any violation of law, rule, or final order or condition imposed in writing by the Bureau as follows: up to \$5,000 per day for any violation; up to \$25,000 per day for reckless violations; and up to \$1 million per day for knowing violations.
- **IRS Referrals.** Bureau must provide to the IRS any report of examination or related information identifying possible tax law noncompliance by a covered person.

## Improving Access To Mainstream Financial Institutions

- Authorizes Treasury Secretary to establish multiyear grants, cooperative agreements and other programs to expand access to mainstream financial institutions and provide alternatives to Payday loans. Authorizes the Community Development Financial Institutions Fund to make grants to community development financial institutions to support small dollar loan programs.

## Emergency Stabilization and Federal Reserve Governance

The bill enacts a variety of changes to the Federal Reserve and FDIC's emergency financial stabilization powers, designed to balance the ability of regulators to provide liquidity to the markets during times of distress with concerns regarding the potential moral hazard, costs and conflicts of interest associated with such action. The Federal Reserve would no longer be able to provide lending assistance to a single and specific firm unless it was part of a broad-based program, and new substantive and procedural requirements would govern the FDIC's ability to establish programs like the Temporary Liquidity Guarantee Program. Further changes, including to the Federal Reserve's internal governance and the scope of GAO audit powers, were intended to promote additional accountability and transparency.

### Modifications to 13(3) Emergency Secured Liquidity Powers

- **Limits Power to Market-Wide Programs.** The bill limits Section 13(3) assistance to a "program or facility with broad-based eligibility," rather than to any single and specific individual, partnership or corporation that is not part of such a broad-based program.
- **Policies and Procedures.** The Federal Reserve must establish by regulation, in consultation with the Treasury Secretary, policies and procedures governing emergency lending designed to ensure that any emergency lending program or facility is designed to provide liquidity to the financial system and not to aid a single and specific failing financial company; that collateral for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion.
  - The policies and procedures must require that a Federal Reserve Bank assign a lendable value to all collateral for any loan executed by such a Federal Reserve Bank under amended Section 13(3) to determine whether the loan is secured satisfactorily.
  - The Federal Reserve must also establish procedures to prohibit borrowing from programs and facilities by borrowers that are insolvent.
  - Any program or facility must not be structured to assist a single and specific company.
  - If a recipient of a loan under 13(3) becomes subject to FDIC resolution authority, the Federal Reserve Bank has a claim against the covered entity equal to the amount of any net realized losses on such loans, with the same priority as an obligation to the Treasury Secretary.
- **Approval from Treasury Secretary.** The Federal Reserve is required to obtain the Treasury Secretary's approval before establishing a program or facility under Section 13(3).
- **Reporting Requirements.** The Federal Reserve must provide to Congress, within 7 days, a report that justifies the exercise of authority and describes the material terms of the assistance. Upon the request of the Chairman of the Federal Reserve Board, certain information (including the identity of the participants in the program or facility) may be kept confidential.
- **Additional Federal Reserve Transparency.** GAO is required to conduct a one-time audit of all loans or other financial assistance provided through the Federal Reserve's exercise of 13(3) authority between December 1, 2007 and the enactment of the legislation. GAO will also have authority in the future to audit the Federal Reserve's (13)(3) assistance programs and other credit facilities, for certain purposes.
  - The Federal Reserve is required to disclose on an on-going basis, within specified time periods, additional information regarding the borrowers and counterparties participating in emergency credit facilities, discount window lending programs and open market transactions authorized or conducted by the Federal Reserve or a Federal Reserve Bank. These new transparency

provisions will not affect any pending lawsuit filed under the Freedom of Information Act prior to enactment.

- Within 12 months after the enactment of the legislation, the GAO must also complete an audit of the governance of the Federal Reserve Bank system.

## Emergency Financial Stabilization

- **Eliminates the FDIC's Open Bank Assistance.** The bill limits the FDIC's authority to provide assistance to individual banks upon a systemic risk finding to only those banks that have been placed in receivership and only for the purpose of winding up the institution. The Treasury Secretary is required to report to Congress on the systemic risk finding within 3 days.
- **Liability Guarantee Programs.** The bill provides that the FDIC can create a widely available program to guarantee obligations of solvent depository institutions, depository institution holding companies and affiliates during times of severe economic distress. This authority would replace Section 13(c)(4)(G)(1) of the FDIA as the source of authority for widely available guarantee programs to the extent there is overlap.
- **Policies and Procedures.** FDIC must establish by regulation, in consultation with the Treasury Secretary, policies and procedures governing issuance of such guarantees. Terms and conditions of any guarantee program must be established by the FDIC with the concurrence of the Treasury Secretary. Establishment of a guarantee program requires finding by 2/3 of the FDIC and Federal Reserve that there has been a liquidity event and that a failure to take such action would have serious adverse effects on financial stability or economic conditions in the U.S, as well as a joint resolution of Congressional approval of the maximum amount of debt that can be guaranteed.
  - Liquidity event means either (1) an exceptional and broad reduction in the general ability of financial market participants either to sell financial assets without an unusual and significant discount or borrow using financial assets as collateral without an unusual and significant increase in margin or (2) an unusual and significant reduction in the ability of financial market participants to obtain unsecured credit.
- **No Equity Investments.** The guarantee may not include the provision of equity in any form.
- **Borrowing Power and Costs.** FDIC may borrow from Treasury but must charge fees and other assessments to participants in any emergency stabilization program in such amounts as are necessary to offset projected losses and administrative expenses.
- **Receivership.** The FDIC has authority to appoint itself as receiver for any insured depository institution that defaults on a guarantee provided under an emergency stabilization program or assistance provided under the FDIA.

## Federal Reserve Governance

- **Change in Procedures for Electing FRB Directors.** The bill removes the authority of member banks' representatives (Class A directors) to vote for the President of the Federal Reserve Banks.
- **New Federal Reserve Board Vice Chairman of Supervision.** The bill creates a position of Vice Chairman of Supervision on the Federal Reserve Board, with such individual to be designated by the President by and with the advice and consent of the Senate and to report semi-annually to Congress. The Vice Chairman is to oversee the supervision and regulation of firms under the Federal Reserve's supervisory jurisdiction and make policy recommendations for The Federal Reserve with respect to such firms.



- **New Express Systemic Risk Duties.** Identification and mitigation of risks to financial stability added as a responsibility of the Federal Reserve Board.

## Pay It Back Act

- **Changes to TARP Authorization.** The bill reduces the amount of funding authorized under TARP to \$475 billion and precludes the establishment of any new TARP programs. It also eliminates the revolving feature of TARP authorization but provides that the authorized amount is not reduced by previously repaid TARP funds, committed guarantees that became or become uncommitted or realized losses.
- **Deficit Reduction.** Proceeds from the sale of Fannie, Freddie and Federal Home Loan Bank debt purchased under Treasury's emergency authority and unused funds under the American Recovery and Reinvestment Act of 2009 must be used solely for deficit reduction.

## Insurance

The bill creates a Federal Insurance Office (“**FIO**”) with certain limited powers. Although it will not have substantive regulatory responsibilities, the FIO will facilitate the development of insurance expertise within Treasury and could portend increased federal involvement in the industry. Even with limited powers, the FIO is likely to provide an impetus for efforts to promote greater levels of national uniformity and will provide a federal focus for the coordination of international insurance regulation. In addition, the legislation enacts relatively non-controversial measures to streamline the market for nonadmitted insurance and reinsurance by limiting interstate application of regulation and encouraging implementation of uniform standards in these areas. Rep. Frank (D-MA) stated recently that there will be a “major push” in Congress to provide for an optional federal charter after the passage of broader financial regulatory reform, although he intends to stay neutral in the debate. For information on the creation of, and certain provisions relating to, the FIO, see slide 25, “Insurance Provisions.”

### Federal Insurance Office

- **FIO Establishment.** The FIO is established within Treasury and will be headed by a director to be appointed by the Treasury Secretary.
- **Functions and Powers.** The FIO, under the direction of the Treasury Secretary, would monitor the insurance industry (including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or U.S. financial system), monitor the extent to which underserved consumers and communities, minorities and low- and moderate-income persons have access to affordable insurance products, recommend to the Council any insurers (including their affiliates) that should be treated as systemically important, assist in administering Treasury's Terrorism Insurance Program, represent the U.S. at the International Association of Insurance Supervisors and determine whether state insurance measures are preempted by international agreements (as described below).
  - The FIO's information-gathering powers, which extend to any insurer or affiliate of an insurer that meets a minimum size threshold established by the FIO, includes the authority to issue subpoenas.
    - The FIO is authorized to require submission of data or information from any person that writes insurance or reinsurance in at least 1 state.

- Before collecting information directly from an insurer, the FIO is required to coordinate with other relevant regulators in order to determine whether the information is otherwise available. The FIO must also comply with the Paperwork Reduction Act.
- The Office of Financial Research will also have the power to collect certain data from insurers. It is expected that the Office of Financial Research and the FIO will share data.
- The bill contains a savings provision specifying that it will not be construed to affect development of U.S. trade policy, as well as a requirement that the Treasury Secretary consult with U.S. Trade Representative and Congress before concluding any international insurance agreement.
  - International agreements may only take effect after the expiration of 90 days after the Treasury Secretary and the U.S. Trade Representative submit the agreement to Congress.
- The FIO is granted authority with respect to all lines of insurance except health insurance, long-term care insurance (except to the extent it is included with life or annuity insurance) and crop insurance.
- The director of the FIO serves on the Council in a non-voting advisory capacity, as will a sitting state insurance commissioner. A person appointed by the President with insurance expertise will serve on the Council as a voting member.
- The FIO will coordinate with the Federal Reserve in conducting stress tests, and the FIO's approval is required to subject an insurer (or a company whose largest U.S. subsidiary as measured by total assets is an insurer) to the resolution authority.
- **Preemption.** The bill grants the FIO power to preempt any state insurance regulation that results in less favorable treatment of a non-U.S. insurer as compared to a U.S. insurer admitted in the state and is inconsistent with an international agreement on prudential measures.
  - Covered agreements are written bilateral or multilateral agreements between the United States and foreign governments or regulators regarding prudential measures that achieve a similar outcome in consumer protection as state regulation.
  - The FIO must notify and consult with the relevant state regulator prior to making a preemption determination.
  - The preemption must be limited to the subject matter of the covered agreement.
  - In any action for judicial review of a determination of inconsistency, the court must determine the matter *de novo* (*i.e.*, without providing *Chevron* deference to the FIO's decision).
  - The preemption provisions may not apply to state insurance measures governing rates, premiums, underwriting, sales practices, coverage requirements, the application of antitrust law or measures governing capital or solvency, unless such measures treat non-U.S. insurers less favorably than U.S. insurers.
    - International agreements could, however, potentially be used to reduce the collateral requirements applicable under state insurance laws to reinsurance obtained by a U.S. insurer from a non-U.S., non-admitted reinsurer.
- **Reports.** The bill requires the director of the FIO to submit a number of reports to Congress.
  - Within 18 months, the director must submit a report on improving U.S. insurance regulation, which must cover, among other things: systemic risk issues; capital and liquidity standards; national uniformity; consolidated supervision and international coordination of regulation.

- Additionally, the report must consider costs and benefits of potential federal regulation of insurance; feasibility of regulating only certain lines at the federal level; regulatory arbitrage; developments in the international regulation of insurance; consumer protection; and potential consequences of subjecting insurance companies to a federal resolution authority.
- Annually, beginning September 2011, the director must submit reports to Congress on the insurance industry and on any preemption action taken.
- By September 2012, the director is required to submit a report on the breath and scope of the global reinsurance market and the critical role such market plays in supporting insurance in the U.S.
- By January 2013, the director is required to submit a report on the ability of state regulators to access reinsurance information following the passage of the Nonadmitted and Reinsurance Reform Act (described below), with an update to be provided by January 1, 2015.

## Nonadmitted Insurance Provisions

**Background.** The Nonadmitted and Reinsurance Reform Act, included in as Subtitle B of Title V of the bill, is substantially identical to bipartisan legislation which was unanimously passed by the House on September 9, 2009 before being subsequently referred to the Senate Committee on Banking, Housing, and Urban Affairs. Provisions, which become effective 12 months after enactment, are generally designed to streamline the market for nonadmitted insurance and reinsurance by limiting interstate application of regulation and encouraging implementation of uniform standards.

- **Nonadmitted Insurance Provisions.** The bill limits state regulatory authority with respect to nonadmitted insurance strictly to the home state of the insured, except with respect to certain workers compensation plans.
  - In addition, the bill:
    - prohibits states from imposing eligibility requirements on nonadmitted insurers domiciled in a U.S. jurisdiction except in conformance with the criteria set forth in the National Association of Insurance Commissioners (“NAIC”) model law or otherwise developed to be consistent across states,
    - prohibits any state, other than an insured’s home state, from requiring a surplus lines broker to be licensed in order to sell nonadmitted insurance,
    - eliminates state prohibitions on surplus lines brokers procuring insurance from nonadmitted insurers domiciled outside the U.S. and included on an NAIC list, and
    - prohibits states, other than the home state of the insured, from requiring premium tax payments for nonadmitted insurance and encourages the development of an interstate compact to provide for payment, collection and allocation of such taxes.
  - For certain sophisticated parties who request coverage from nonadmitted insurers, the bill eliminates state requirements that surplus lines brokers undertake diligence searches to determine whether coverage can be obtained from admitted insurers. Such “exempt commercial purchaser” is defined as any person who retains a qualified risk manager to negotiate insurance coverage, has paid aggregate commercial property and casualty insurance premiums in excess of \$100,000 in the prior 12 months, and meets one of another set of criteria (net worth, annual revenues, number of employees, etc.).
  - The bill provides that, beginning 2 years after enactment, states may not collect fees for licensing a surplus lines broker unless it has laws or regulations providing for participation in the NAIC’s national producer database (or an equivalent national database).

- The Comptroller General is required to conduct a study to determine effect of legislation on the size and market share of the nonadmitted insurance market relative to the admitted market.

## Reinsurance Provisions.

- The bill prohibits a state from denying credit for reinsurance if the state of domicile of the ceding insurer recognizes such credit. The bill also reserves the sole responsibility of regulating a reinsurer's financial solvency to its state of domicile.
  - In each case, the home state must be NAIC-accredited or have requirements substantially similar to those necessary for accreditation.
  - It also prohibits a state from requiring a reinsurer to provide financial information other than that which it is required to file with its domiciliary state.

## International Sovereign Assistance and Resources

- **International Sovereign Assistance**
  - Effective immediately, the bill amends Bretton Woods Agreements Act to require the Treasury Secretary to direct the United States Executive Director of the International Monetary Fund to evaluate any proposed loan to a country by the Fund if the amount of the public debt of the country exceeds the gross domestic product of the country and the country is not eligible for assistance from the International Development Association (part of the World Bank that assists poor countries), and determine whether or not the loan will be repaid and certify that determination to Congress.
  - If the Executive Director determines that a loan by the International Monetary Fund to a country will not be repaid, the Treasury Secretary is required to direct the Executive Director to vote in opposition to the proposed loan.
  - If the International Monetary Fund approves such a loan, the Treasury Secretary must provide Congress with periodic assessments of the likelihood that the loans will be repaid in full.
- **Conflict Minerals.** The bill requires public companies to disclose whether certain minerals necessary to the functionality or production of their products originate in the Democratic Republic of the Congo.
- **Reporting Requirements Regarding Coal or Other Mine Safety.** Operators of mines must, in each periodic report filed with the SEC, include information that discloses the number of violations of health or safety standards. Mine operators must also include a list of mines that have a pattern of violations of health and safety standards. A violation of these requirements is considered a violation of the Exchange Act.
- **Disclosure of Payments by Resource Extraction Issuers.** Resource extraction issuers, which are defined as companies that engage in the commercial development of oil, natural gas, or minerals, are required to issue an annual report disclosing any payments made by the issuer to a foreign government or the Federal Government, for the purpose of commercial development of those resources.

If you have any questions regarding the matters covered in this publication, please contact any of the other lawyers listed below or your regular Davis Polk contact.

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**Swaps Pushout Rule**

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## Elimination of the OTS

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**Amendments to Regulation of Bank and Thrift Holding Companies and Depository Institutions**

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