July 2, 2010

House Approves Conference Report on Dodd-Frank Wall Street Reform and Consumer Protection Act; Senate to Consider Bill after Independence Day Recess

On June 25, 2010, a U.S. House of Representatives and Senate conference committee agreed to the text of the watershed financial reform legislation that is now titled the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). This bill was subsequently amended by the conference committee on June 29, 2010 in order to ensure its passage in the House and Senate. Once the final bill has been approved by the full House and Senate, it will be sent to the President who has indicated that he will sign it into law. On June 30, 2010, the House approved the Act by a vote of 237-192. The Senate is expected to vote on the Act after the Independence Day recess.

The effects of this legislation may be profound, but they will not be immediately felt. In most cases, the effective date for the reforms are months, if not years, after enactment, and most significant provisions require further regulatory study and implementation. This memorandum is a brief summary of the provisions of the Act. We will continue to monitor the progress of these reforms and will provide you with updates of any significant developments.

Congress' stated purpose in proposing this legislation is to "restore responsibility and accountability in our financial system." The Act intends to accomplish this by:

- establishing the Bureau of Consumer Financial Protection, a new independent watchdog agency under the Federal Reserve system;
- creating the Financial Stability Oversight Council, composed of the federal financial regulators, to act as an "advance warning system" for systemic risks;
- ending "too big to fail" by, among other things, providing resolution authority and liquidation procedures for financial firms;
- reforming the operations of the Federal Reserve;
- overhauling the regulation of the derivatives markets;
- creating a Federal Insurance Office to monitor the insurance industry and streamlining the regulation of surplus lines and reinsurance;
- increasing the regulation of hedge fund and private equity fund investment advisors;
- improving oversight of credit rating agencies;
- imposing new standards on firms that sell asset-backed securities;
- imposing additional executive compensation and corporate governance requirements on public companies, as well as additional provisions aimed at protecting investors;
- revamping bank and thrift regulations;
- reforming mortgage lending practices; and
- increasing oversight of the municipal securities industry.

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The Bureau of Consumer Financial Protection: The Fed's New Watchdog

The Act establishes the Bureau of Consumer Financial Protection (the "Bureau") as an independent agency within the Federal Reserve system. The Bureau is directed to implement consumer financial laws to ensure that all American consumers have access to mortgages, credit cards and other consumer financial products and services and that markets for these financial products and services are fair. The Bureau will be authorized to promulgate rules for consumer protection that govern all financial institutions, including nonbanks, that offer consumer financial products or services. The Bureau's budget will be funded by the Federal Reserve system; however, the Bureau will be autonomous.

In its summary of the Act, Congress stated that the Act "makes one office accountable for consumer protections. With many agencies sharing responsibility, it is hard to know who is responsible for what, and easy for emerging problems to fall through the cracks." The Bureau will therefore consolidate and strengthen most of the consumer financial protection functions currently handled by the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve, the National Credit Union Administration, the Department of Housing and Urban Development and the Federal Trade Commission.

As the nation's financial protection watchdog, the Bureau will aim to ensure that, with respect to consumer financial products and services:

- consumers are provided with timely and understandable information to make responsible decisions about financial transactions;
- consumers are protected from unfair, deceptive, or abusive acts and practices and from discrimination;
- outdated, unnecessary, or unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens;
- federal consumer financial law is enforced consistently, with regard to the status of a person as a depository institution, in order to promote fair competition; and
- markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

The Bureau's primary functions will be:

- conducting financial education programs;
- collecting, investigating, and responding to consumer complaints;

- collecting, researching, monitoring, and publishing information relevant to the functioning of markets for consumer financial products and services to identify risks to consumers and the proper functioning of such markets;

- supervising covered persons for compliance with federal consumer financial law, and taking appropriate enforcement action to address violations of federal consumer financial law; and

- issuing rules, orders, and guidance implementing federal consumer financial law.

There are various exclusions from the Bureau's authority, including exclusions for auto dealers, accountants and tax preparers, lawyers, persons regulated by a state insurance regulator, retailers, merchants, other sellers of non-financial services, real estate brokerage activities, manufactured home retailers, and modular home retailers. The Bureau will also have no authority to license companies providing consumer finance.

The Bureau will be headed by an independent director appointed by the President and confirmed by the Senate to serve for a term of five years. The Director of the Bureau will be charged with establishing the following specific functional units.

- *Research* — responsible for researching, analyzing and reporting on: (a) developments in markets for consumer financial products or services, including market areas of alternative consumer financial products or services with high growth rates and areas of risk to consumers; (b) access to fair and affordable credit for traditionally underserved communities; (c) consumer awareness, understanding and use of disclosures and communications regarding consumer financial products or services; (d) consumer awareness and understanding of costs, risks, and benefits of consumer financial products or services; (e) consumer behavior with respect to consumer financial products or services, including performance on mortgage loans; and (f) treatment of traditionally underserved consumers.

- *Community Affairs* — responsible for providing information, guidance, and technical assistance regarding the offering and provision of consumer financial products or services to traditionally underserved consumers and communities.

- *Collecting and Tracking Complaints* — responsible for establishing a single, toll-free telephone number, a website and a database to facilitate the centralized collection of, monitoring of, and response to consumer complaints regarding consumer financial products or services.

In addition, the Director of the Bureau is charged with establishing within the Bureau several offices.

- The Office of Fair Lending and Equal Opportunity will be responsible for, among other things: (a) providing oversight and enforcement of federal laws intended to ensure the fair, equitable, and nondiscriminatory access to credit for both

individuals and communities that are enforced by the Bureau, including the Equal Credit Opportunity Act and the Home Mortgage Disclosure Act; (b) coordinating fair lending efforts of the Bureau with other federal agencies and state regulators, as appropriate, to promote consistent, efficient, and effective enforcement of federal fair lending laws; (c) working with private industry, fair lending, civil rights, consumer and community advocates on the promotion of fair lending compliance and education; and (d) providing annual reports to Congress on the efforts of the Bureau to fulfill its fair lending mandate.

- The Office of Financial Education will be responsible for developing and implementing initiatives intended to educate and empower consumers to make better-informed financial decisions.

- The Office of Service Member Affairs will be responsible for developing and implementing initiatives for service members and their families intended to: (a) educate and empower service members and their families to make better informed decisions regarding consumer financial products and services; (b) coordinate with the Collecting and Tracking Complaints unit of the Bureau in order to monitor complaints by service members and their families and responses to those complaints by the Bureau or other appropriate federal or state agencies; and (c) coordinate efforts among federal and state agencies, as appropriate, regarding consumer protection measures relating to consumer financial products and services offered to, or used by, service members and their families.

- The Office of Financial Protection for Older Americans will be responsible for, among other things, facilitating the financial literacy of individuals aged 62 years or more regarding protection from unfair, deceptive, and abusive practices and current and future financial choices.

The Director of the Bureau is also charged with establishing a Consumer Advisory Board to advise and consult with the Bureau and to provide information on emerging practices in the consumer financial products or services industry, including regional trends, concerns, and other relevant information. The Consumer Advisory Board will be comprised of experts in consumer protection, financial services, community development, fair lending and civil rights, and consumer financial products or services as well as representatives of depository institutions that primarily serve underserved communities and representatives of communities that have been significantly impacted by higher-priced mortgage loans.

Financial Stability Oversight Council: The "Advance Warning System" for Systemic Risks

The Act establishes the Financial Stability Oversight Council (the "Council"), composed of the federal financial regulators, to act as an advance warning system for systemic risks to U.S. financial stability. The Council is composed of ten voting members, including the Secretary of the Treasury, who will serve as the chairperson, the chairman of the Federal Reserve, the Comptroller of the Currency, the Director of the newly created Bureau of Consumer Financial Protection, the Chairpersons of each of the Securities and Exchange Commission ("SEC"), the FDIC, the Commodity Futures Trading Commission ("CFTC") and the National Credit Union Administration, the Director of the Federal Housing Finance Authority, and an independent member with insurance experience appointed by the President and confirmed by the Senate. A number of non-voting members will also serve in an advisory capacity to the Council.

The purpose of the Council is:

- to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;
- to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the federal government will shield them from losses in the event of failure; and
- to respond to emerging threats to the stability of the United States financial system.

To accomplish its mandate, the Council will collect information from other agencies, utilize the new Office of Financial Research ("OFR") described below, monitor the financial services marketplace, review regulation and identify regulatory gaps that could pose risks to the financial stability of the United States, review and comment on relevant accounting principles and report annually to Congress.

The Council has the authority, with a two-thirds vote of its voting members, including the affirmative vote by the Secretary of the Treasury, to determine that a U.S. or foreign nonbank financial company could pose a threat to the financial stability of the United States due to its state of material financial distress, nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, and should be supervised by the Federal Reserve Board. The Act contains a process for such an entity to appeal the determination of the Council.

As part of Congress' plan to prevent future bailouts of "too big to fail" financial firms, the Council can make recommendations to the Federal Reserve for increasingly strict rules for capital, leverage, liquidity, and risk management, if necessary, to mitigate the systemic risks to the financial stability of the United States. Accordingly, if the Board of Governors determines that

a bank holding company with total consolidated assets of $50 billion or more or a nonbank financial company that is supervised by the Federal Reserve poses a “grave threat,” then it may, upon a two-thirds vote of the Council, limit the company’s ability to merge with, acquire, consolidate with, or become affiliated with another company, restrict the company’s ability to offer a financial product, terminate certain activities, or impose conditions on the manner in which a company conducts its activities. If the Board of Governors determines that such action is inadequate to mitigate a threat to the financial stability of the U.S., then the Board of Governors and the FDIC, in consultation with the Council, may also require the company to divest assets or off-balance-sheet items. Congress described this as a “last resort.”

Office of Financial Research

In order to assist the Council in its mission, the Act creates the OFR within the Department of Treasury. The Director of the OFR will be appointed by the President and confirmed by the Senate, and will serve a term of six years. The Director of the OFR will also serve as a non-voting advisory member to the Council and is required to testify annually to Congress.

In providing support to the Council, the OFR is tasked with, among other things, collecting certain data relating to risks to the U.S. financial system and using the data that it collects to perform applied and long-term research in order to generate reports on systemic risk and on disruptions and failures in the financial markets and to provide advice on the impact of policies related to systemic risk.

The OFR can coordinate with other financial regulatory agencies to obtain necessary data, but it also has the ability to subpoena additional data if needed to conduct its duties.

Ending “Too Big to Fail” and Protecting Taxpayers

Orderly Resolution Authority

The Act establishes a process by which failing financial companies that pose a significant risk to the financial stability of the United States may be liquidated in a manner that mitigates the risk and minimizes moral hazard. The Secretary of the Treasury may appoint the FDIC as receiver for a financial company if, upon the recommendation of two-thirds of both the Federal Reserve Board of Governors and the Board of Directors of the FDIC (or the SEC, in the case of a broker-dealer, or the Director of the Federal Insurance Office, in the case of an insurance company), the Secretary determines that a financial company is in default or in danger of default, and its failure under otherwise applicable federal or state law will cause serious adverse effects on U.S. financial stability. The Secretary of the Treasury must also determine that there is no viable private sector alternative to prevent default, that the impact of using the orderly resolution on the creditors, counterparties and shareholders of a company as well as other market participants is appropriate, given the impact that any action taken under the Act would have on the financial stability of the U.S., that the course of action would mitigate the adverse effects on the financial system, that a federal agency has ordered the company to convert all of its regulatory mandated convertible debt instruments to equity, and that the company satisfies the definition of a “financial company.” This provision contemplates an up-front judicial review process in the event that the company does not consent to the appointment of the FDIC as receiver.

The Act allows the FDIC to exercise many of the same kinds of receivership powers that it has under the Federal Deposit Insurance Act. However, the liquidation authority granted to it under the Act also includes a number of provisions that are based on the Bankruptcy Code to compensate for the fact that the liquidation authority may be used for a broader range of businesses, including nonbanking institutions.

“Funeral Plans”

In an effort to prevent future taxpayer-funded bailouts, the Act provides the Federal Reserve with the authority to require certain large bank holding companies with assets equal to or greater than $50 billion and nonbank financial companies that are supervised by the Federal Reserve to periodically submit plans to the Federal Reserve, the Financial Stability Oversight Council, and the FDIC that outline how they could be resolved in a rapid and orderly fashion. These plans have often been referred to as “funeral plans.” Such companies are also required to submit reports on the nature of their credit exposure to other significant nonbank financial companies and significant bank holding companies, and the extent to which those entities have exposure to those companies.

In addition to providing a roadmap for dissolution in the event of a bank failure, these “funeral plans” are intended to offer the regulators insight into the internal structure of the large financial institutions. Legislators also hope that the process will encourage institutions to think about operations that may not be easily unwound. If a covered company does not submit a credible plan, then the Federal Reserve and the FDIC may jointly impose more stringent capital,

leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company or any of its subsidiaries, and may also order divestitures.

No Taxpayer Bailouts

The Act expressly prohibits the use of taxpayer funds to bail out failing financial companies. The FDIC can borrow to facilitate a liquidation, but such borrowings must be repaid by the sale of the company's assets. The FDIC will have a priority claim against the receivership for repayment of such funds. If the FDIC needs additional funds to repay the borrowed amount, it may seek assessments from large bank holding companies, nonbank financial companies that are supervised by the Federal Reserve, and other large financial companies.

Under the Act, the FDIC is authorized "to create a widely available program to guarantee obligations of solvent insured depository institutions or solvent depository institution holding companies (including any affiliates thereof) during times of severe economic distress" but only following the written consent of the Secretary of the Treasury and a two-thirds vote from each of the seated members of the Board of Directors of the FDIC and the Board of Governors of the Federal Reserve. Following these procedures, the Act then requires the Secretary of the Treasury to approve the terms and conditions of the guarantee and to set a cap on overall guarantee amounts, after which the President may submit the guarantee to Congress for approval.

Payment, Clearing and Settlement Supervision

To reduce systemic risk, the Act subjects systemically important financial market utilities and activities (as determined by the Council) to enhanced regulation by the Federal Reserve, the SEC and the CFTC.

Use of United States Funds for Foreign Governments

The Act also amends the Bretton Woods Agreements Act to oppose the use of United States funds for foreign governments. Specifically, prior to the extension of a loan from the International Monetary Fund or World Bank to a middle-income country, the United States Executive Director at the International Monetary Fund is required to oppose any proposed loans that, after evaluation (if the country's public debt exceeds its annual gross domestic product), is determined unlikely to be repaid in full.

Reforming the Federal Reserve

The Act significantly amends the Federal Reserve's emergency lending authority under Section 13(3) of the Federal Reserve Act by requiring it to establish an emergency lending program or facility "for the purpose of providing liquidity to the financial system, and not to aid a failing financial company, and [to ensure] that the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion." In other words, the amended provisions of the Section 13(3) lending authority prohibits the Federal Reserve from extending a liquidity facility to any individual company or to any failing company as it did during the recent financial crisis.

Once a program or facility is initiated and assistance thereunder is made available, the Board of Governors is required to provide the House of Representatives, within seven days, with a report that identifies the recipients of the authorized assistance, justifies the assistance and discloses the terms thereof. Thereafter, the Board of Governors is required to provide the House of Representatives with written updates every 30 days regarding any outstanding assistance offered under the program or facility. In addition to these disclosures to the House of Representatives, the Act also requires the Board of Governors to make public certain information relating to its authorized programs and facilities as well as the accounting, financial reporting, and internal controls of the Board and the Federal Reserve banks.

In addition, the Act creates the position of Vice Chairman for Supervision, who will develop policy recommendations regarding supervision and regulation for the Board of Governors and will report to Congress semi-annually on Board supervision and regulation efforts. The Vice Chairman for Supervision will be a member of the Board of Governors of the Federal Reserve designated by the President.

Lastly, the Act requires the GAO to conduct (a) a one-time audit of all Federal Reserve 13(3) emergency lending that took place during the financial crisis, the details of which are to be published on the Federal Reserve website by December 1, 2010 and (b) a study of the current system for appointing Federal Reserve Bank directors, in order to examine whether the current system effectively represents the diversity of the public and whether there are actual or potential conflicts of interest created when the directors of Federal Reserve banks, which execute some of the supervisory functions of the Board of Governors of the Federal Reserve system, are elected by member banks.

Transparency and Accountability for Derivatives

Background

The Act[1] accomplishes a sweeping reform of the previously largely unregulated derivatives market. Even once enacted, however, the full scope of the Act and its effect on the derivatives marketplace will not be known. The Act provides broad authority to the CFTC or the SEC to define terms, implement regulations and, with respect to certain key provisions, determine which types of swaps[2] and entities will be required to comply with its provisions. The agencies generally have up to one year to implement the provisions of the Act and certain provisions of the Act such as the derivatives "push-out" provision (see below) have an even longer phase-in period.

Geographical Reach

The geographical reach of the Act is based on an "effects test," which provides that the Act will not apply to activities outside the United States unless those activities:

- have a direct and significant connection with activities in, or effect on, U.S. commerce; or
- contravene such rules or regulations as the CFTC may prescribe as necessary or appropriate to prevent any evasion of the Act.

Derivatives Push-Out Provision

By withholding federal assistance, including in the form of FDIC insurance and access to the Federal Reserve discount window, the Act will cause insured depository institutions to divest themselves of a substantial portion of their swap dealer activities. In a last minute compromise reached in the conference committee, depository institutions are permitted to continue to act as swap dealers with respect to hedges of their own activities, to enter into rate swaps and swaps referencing assets permitted for investment by a national bank (which would also cover foreign exchange swaps), but are not permitted to act as swap dealers with respect to credit default

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[1] References to the "Act" in this section refer to The Wall Street Transparency and Accountability Act of 2010, Title VII of the Act.

[2] The Act divides the swap universe into two types of swaps: "swaps" regulated by the CFTC and "security-based swaps" regulated by the SEC and two corresponding sets of actors: "swap dealers" and "major swap participants" with respect to swaps, and "security-based swap dealers" and "major security-based swap participants" with respect to security-based swaps. As the provisions relating to the different types of swaps and actors are similar, we use the terms "swap," "swap dealers" and "major swap participants" to refer to both types of swaps and actors.

swaps unless such swaps are cleared. The Act specifically authorizes the spin-off by depositary institutions of impermissible swap dealer activities to affiliates controlled by the same bank holding company. Insured depositary institutions will have up to 24 months (extendible in special circumstances for an additional year) to divest themselves of impermissible swap dealer activities. Swaps entered into prior to the end of the transition period for a particular depositary institution will not be affected by the push-out provision.

Clearance and Trading

Clearing Requirement

The Act makes it unlawful for any person to "engage" in a swap if the swap is required to be cleared unless the swap is submitted to a derivatives clearing organization ("DCO"). The determination as to whether a swap or any group, category, type or class of swaps is required to be cleared is to be made by the applicable regulator (CFTC or SEC) based either on its own initiative or the submission of a DCO, which is required to submit each type of swap it plans to accept for clearing. In the latter case, the applicable regulator is required to make its determination as to whether clearance is required within 90 days (or such longer period as agreed by the DCO), and in each case it is required to provide at least a 30-day public comment period about the clearance requirement. The applicable regulator has one year after the enactment of the Act to implement regulations for reviewing submissions.

Grandfathering

Swaps entered into before the effectiveness of the Act or after the effectiveness of the Act but before such swaps are required to be cleared are exempt from clearing, if reported to a registered swap repository (as discussed below) or the applicable regulator.

Clearing Exceptions

Notwithstanding the clearance requirement, there exists an exemption available on an individual basis to an entity which:

- is not a financial entity;
- uses swaps to hedge commercial risks; and
- notifies the CFTC or the SEC, as applicable, how it generally meets its financial obligations under non-cleared swaps.

Included within the definition of "financial entity" are swap dealers, major swap participants, commodity pools, private funds, employee benefit plans and entities predominantly engaged in activities that involve banking or are financial in nature. The Act clarifies that "financial entity" does not include any finance company that finances the purchase or lease of products that it (or its affiliate) manufactures and that uses derivatives for interest rate or foreign exchange hedging related to such financing.

Execution Requirements

The Act requires that each swap that is required to be cleared also be traded on an exchange or a swap execution facility, unless no such entity accepts the swap.

Swap Reporting

If a swap is not required to be cleared and/or was entered into before the effectiveness of the Act, it must be reported to a swap data repository. If a swap is cleared, the DCO is required to provide the applicable regulator all information the regulator needs to perform its responsibilities. The applicable regulator is authorized to provide for the public availability of "real-time" data, including transactional price and volume information for both cleared and non-cleared swaps.

Regulation of Swap Dealers and Major Swap Participants

Definitions

A "swap dealer" is a person who:

- holds itself out as a dealer of swaps;
- makes a market in swaps;
- regularly enters into swaps; or
- engages in any activity causing that person to be commonly known in the trade as a dealer or market maker in swaps.

The Act explicitly exempts anyone who enters into swaps for its own account, either individually or in a fiduciary capacity, but not as part of a regular business. It also exempts any insured depositary institution to the extent it offers to enter into a swap with a customer in connection with a loan to that customer.[3] In addition, the CFTC or the SEC, as applicable, may exempt an entity if its swap dealing is de minimis.

A "major swap participant" is a person who is not a swap dealer and:

- who maintains "a substantial position" in swap for any of the major categories (as determined by the CFTC or the SEC, as applicable), excluding (a) positions held for hedging or mitigating commercial risks and (b) positions maintained by any employee benefit plan under ERISA for the primary purpose of hedging or mitigating any risks directly associated with the operation of the plan;[4]

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[3] This exemption does not apply to security-based swap dealers.

[4] Clause (b) does not apply to major security-based swap participants.

- whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets; or
- who is a financial entity that (a) is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency and (b) maintains a "substantial position" in outstanding swaps in any major category (as determined by the CFTC or the SEC, as applicable).

The Act explicitly exempts captive finance facilities that use derivatives to hedge interest rate or foreign currency exposures if 90% or more of the exposures arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by its parent or another subsidiary of its parent.[5]

The CFTC and the SEC are required to define "substantial position" by rule or regulation at prudent thresholds, taking into consideration the entity's position in non-cleared swaps and, at the CFTC's or SEC's option, the value and quality of collateral held against counterparty exposures.

In each case, a person may be a swap dealer or major swap participant for just one or more type, class or category of swaps and not for other types, classes or categories. These definitions are subject to further rulemaking by the CFTC and the SEC, including for the purpose of bringing in transactions and entities that have been structured to evade the Act's requirements.

Registration and Margin Requirements

All swap dealers and major swap participants are required to register with the CFTC or the SEC, as applicable. All registered dealers and major participants are subject to capital and margin, reporting and recordkeeping, business conduct, documentation standards and internal systems and procedures requirements.

Swap dealers and major swap participants are subject to minimum capital requirements and minimum initial and variation margin requirements prescribed by the applicable regulators on non-cleared swaps. Regulators have the discretion to permit the use of noncash collateral when prescribing margin requirements. But unlike the Senate bill, there is no express exemption if one of the counterparties is not a swap dealer, major swap participant, or financial entity, and such counterparty is eligible for and is using the exemption from clearing available to non-financial entities.[6] The Act does not include explicit language prohibiting the retroactive application of margin requirements to existing swaps.

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[5] This exemption does not apply to major security-based swap participants.

[6] However, Chairmen Dodd and Lincoln clarify in their letter to Chairmen Frank and Peterson dated June 30, 2010, that the intent of Congress is that margin and capital requirements are not

Duty of Care for Swap Dealers and Major Swap Participants

The Act imposes a new duty of care on swap dealers and major swap participants in dealing with customers and counterparties, and in particular in dealing with a newly defined class of customers or counterparties called "Special Entities." "Special Entities" include federal agencies, states, state agencies, political subdivisions, municipalities, pension plans, retirement plans and endowments. The Act empowers the applicable regulator to adopt business conduct standards for transactions with Special Entities.

When dealing with all counterparties other than other swap dealers or major swap participants, swap dealers and major swap participants must disclose the material risks and characteristics of the swap and material incentives or conflicts of interest. In addition, swap dealers and major swap participants are required to provide daily marks to their counterparties (upon request of the counterparty in the case of cleared swaps).

If a swap dealer or major swap participant proposes to enter into a swap with a Special Entity (or depending upon some conflicting language in the provision, Special Entities that are governmental entities), it is required to comply with any duty established by the applicable regulator that requires such entity to have a reasonable basis to believe that the Special Entity has a representative, independent of the swap dealer or major swap participant, capable of evaluating the transaction and acting in the best interests of the counterparty, who will provide written representations to the Special Entity regarding the fairness of the pricing and the appropriateness of the transaction.

If a swap dealer or major swap participant proposes to act as an adviser to a Special Entity, it is required to act in the best interests of the Special Entity and is required to make reasonable efforts to ensure that it has information necessary to determine what is in the best interests of the Special Entity. In addition, under the caption dealing with action as agent, the Act contains a general anti-fraud provision applicable to transactions with Special Entities, the language of which is broad enough to cover dealings by swap dealers and major swap participants, whether or not acting as agent.

Position Limits

Under Section 4a(a) of the Commodity Exchange Act, without giving effect to the Act, the CFTC has authority to set position limits on trading on exchanges and swap execution facilities, as it finds is necessary to prevent undue burdens on interstate commerce resulting from excessive speculation. The Act would extend the jurisdiction of the CFTC to non-exchange traded "swaps that perform or affect a significant price discovery function with respect to registered entities." Bona fide hedging transactions (to be further defined by the CFTC) are not included

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imposed on end users. For uncleared swaps between swap dealers and end users, margin should not be imposed on the end user, and instead margin on the dealer side of the swap should reflect the counterparty risk of the transaction.

within these limits, but the CFTC is required to impose concurrent position limits on contracts that are “economically equivalent” to contracts subject to the position limits. Positions acquired prior to the effective date of the Act (see below) are not subject to such limits.

Timing and Phase-In

After the Act is enacted, the CFTC and the SEC are required to promulgate rules and regulations within 360 days, except as otherwise specified in the Act. The effective date of the Act is the later of (1) 360 days from its enactment and (2) if rulemaking is required, 60 days after the publication of the final rules or regulations, except as otherwise specified in the Act. The derivatives push-out provision is effective starting two years after the effective date of the Act.

Insurance

Federal Insurance Office

The Act creates a Federal Insurance Office ("FIO") within the Department of the Treasury, to be headed by a Director appointed by the Secretary of the Treasury. The FIO is intended, in part, to remedy the current lack of insurance expertise at the federal level. The scope of FIO's oversight extends to all lines of insurance except health insurance, long-term care insurance,[7] and federal crop insurance. The authority granted to the FIO is well short of a regulatory role. There is no federal chartering component to the legislation.

The FIO is tasked with monitoring the insurance industry and gathering information, including "identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system." It is empowered to gather information from the insurance industry, to analyze such data and to issue reports. The FIO has fairly broad authority and may require insurers (and their affiliates) to submit data, and the FIO Director is empowered to issue subpoenas to gain such information. On the other hand, the legislation requires FIO to obtain data from federal and state regulatory agencies or publicly available sources, if possible, before requiring insurers to submit such data.

The most substantial authority granted to the FIO is in the area of international agreements. Under the Act, the Secretary of the Treasury and U.S. Trade Representative are jointly authorized to enter into agreements with foreign governments relating to the recognition of prudential measures for the business of insurance or reinsurance. In implementing such agreements, the FIO will have the authority to preempt state law if it is determined that the state law is inconsistent with the international agreement and treats a non-U.S. insurer less favorably than a U.S. insurer.

This authority is limited in several respects. Nevertheless, the conferees have specifically identified reinsurance collateral as an area where the authority may be used.

The FIO will also have a role in the new systemic risk supervision. Its Director is a non-voting member of the Council, and it is charged with making recommendations to the Council regarding the designation of any insurers as a systemically significant entity requiring additional supervision by the Federal Reserve. It will also administer the Terrorism Risk Insurance Program under the Terrorism Risk Insurance Act.

Surplus Lines and Reinsurance Regulation

The Nonadmitted and Reinsurance Reform Act ("NRRA"), Subtitle B (State Based Insurance Reform) of Title V of the Act, which was originally introduced in 2006 and approved by

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[7] To the extent that long-term care insurance includes an annuity component, FIO will be empowered to oversee it.

the House in successive Congresses, is intended to eliminate regulatory inefficiencies associated with State-based surplus lines insurance and reinsurance regulation.

Surplus Lines

The NRRA provides that the home state of the insured will have exclusive authority to regulate the placement of nonadmitted insurance. Only the insured's home state will be permitted to collect premium taxes on nonadmitted insurance, and the legislation establishes a uniform system for allocation of premium tax obligations through an interstate compact or other procedures established by the states.

The NRRA would also establish uniform standards for surplus lines eligibility criteria by requiring that the capital and surplus requirements for U.S.-domiciled insurers conform to those in the National Association of Insurance Commissioners ("NAIC") Nonadmitted Insurance Model Act. Additionally, states may not prohibit surplus lines brokers from doing business with nonadmitted insurers listed on the *Quarterly Listing of Alien Insurers* maintained by the NAIC's International Insurance Division ("IID"). In effect, therefore, any IID-listed insurer will have trading privileges throughout the United States without having to be separately listed by any state.

Finally, the surplus lines part would preempt state diligent search requirements for certain sophisticated commercial purchasers, provided the surplus lines broker has disclosed to the purchaser that such insurance may be available on the admitted market, and the purchaser has requested nonadmitted placement in writing.

Reinsurance

NRRA's reinsurance part provides that a ceding insurer's state of domicile will be the single point of regulation with respect to credit for reinsurance, provided that state is NAIC-accredited or has financial solvency requirements substantially similar to those required for NAIC-accreditation. It also provides that the ceding insurer's state of domicile will be the single point of regulation for purposes of (a) the rights of the parties to provide for dispute resolution through arbitration agreements, (b) choice of law, and (c) imposition of standard terms different than those in the reinsurance contract. Finally, the reinsurance part provides that a reinsurer's state of domicile will be solely responsible for regulating the reinsurer's solvency, provided it is an NAIC-accredited state. Other states are prohibited from requiring any financial information other than what the domiciliary state requires.

Enhanced Regulation of Hedge Funds and Private Equity Advisers

The Act includes a number of provisions that will increase the regulation of hedge funds and private equity funds. For example, the Act amends the Investment Advisers Act of 1940 by largely eliminating the “private adviser” exemption on which many hedge fund and private equity advisers currently rely, which exempts from registration investment advisers who do not hold themselves out to the public as investment advisers and have fewer than 15 clients. The Act also increases the threshold above which investment advisers will be federally regulated from $25 million in assets under management to $100 million in assets under management. Accordingly, advisers to private funds with an aggregate of $100 million or more of assets under management will generally be obligated to register with the SEC as investment advisers, subject to certain exceptions.

Registered investment advisers will be required to file reports and maintain records regarding the private funds they advise, and such records will be subject to examination by the SEC at any time. The reports and records must contain descriptions of the amount of assets under management and the use of leverage, the counterparty risk exposure, trading and investment positions, valuation policies and practices, types of assets held, side arrangements, trading practices, and any other information that the SEC and the Council can use for the assessment of systemic risk. In addition, the SEC is instructed to implement new rules obligating investment advisers (regardless of whether they are required to register) to file such reports with the SEC as the SEC deems necessary or appropriate to assess systemic risk. The SEC may make these reports available to the Council, to any other federal department or agency or SRO for purposes within its jurisdiction or as necessary to comply with a court order.

There are several exceptions to the registration requirements created by the Act, including for advisers that “solely” advise venture capital funds (such term to be later defined by the SEC) and advisers that “solely” advise private funds and have assets under management in the United States of less than $150 million. Also exempt from registration is any foreign adviser that has no place of business in the United States, has fewer than 15 clients and investors in the United States in private funds, has aggregate assets under management attributable to United States clients of less than $25 million and does not hold itself out to the public as an investment adviser or act as an investment adviser to any investment company registered under the Investment Company Act or any business development company. Family offices are also specifically exempted from the Investment Advisers Act. Many exempted advisers will nevertheless be subject to such recordkeeping and reporting obligations as the SEC determines is necessary and appropriate in the public interest or for the protection of investors. Mid-sized investment advisers who have assets under management between $25 million and $100 million are required to register with the securities authority in the state in which they maintain their principal office and place of business, except that they may register with the SEC if they would be required to register in 15 or more states.

Finally, for purposes of the private placement safe harbors in Regulation D under the Securities Act of 1933, the Act adjusts the definition of "accredited investor" to require that the individual net worth of any natural person be more than $1 million, excluding the value of the primary residence of such person. The SEC is also directed to periodically review the definition of "accredited investor" not less frequently than every four years. In addition, the SEC is directed to review the dollar threshold for Qualified Clients within one year from the enactment of the Act and every five years thereafter, and adjust any such threshold to account for the effects of inflation on such test.

Credit Rating Agency Regulation

The Act contains three broad themes with regard to the role of credit rating agencies in the financial markets and the regulation of such agencies: (a) increased liability; (b) increased regulation and oversight; and (c) reduced reliance.

Increased Liability

The Act expands the liability of credit rating agencies for private actions against credit rating agencies and essentially subjects the agencies to a gross negligence standard. A complaint must state, with particularity, facts giving rise to a strong inference that the agency "knowingly or recklessly" failed either to conduct a reasonable investigation in the course of the rating process or to obtain reasonable verification of factual elements from sources independent of the issuer and underwriter. In a similar vein, the Act also legislatively overrules Rule 436(g) under the Securities Act of 1933, with the effect that credit rating agencies become "experts" subject to Section 11 liability for ratings included in registration statements in the same manner that registered public accounting firms and securities analysts are subject to liability under Section 11. This provision, which would also require an issuer to obtain an agency's written consent to include a ratings section in a registration statement, is effective immediately upon the Act becoming law.

Increased Regulation and Oversight

The Act directs the SEC to establish a new Office of Credit Ratings, which will conduct, at least annually, examinations of each credit rating agency, with an emphasis on internal supervisory controls, governance, and "revolving door" practices (as when rating agencies employees are hired by issuers they formerly rated). The Act also imposes a number of Sarbanes-like governance, transparency, reporting, and attestation requirements on credit rating agencies. In addition, the Act directs the SEC to develop exams, essentially for the purposes of licensing credit rating analysts. These exams will test the analyst's "knowledge of the credit rating process."

Reduced Reliance

Many federal and state statutes and regulations contain provisions which use "investment grade" ratings and in some cases specific ratings as a regulatory threshold. The Act directs various federal agencies to remove references to such ratings "and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations."

Potential Impact on Credit Rating Agencies

A consequence of the pending legislation was captured in a headline on June 29, 2010 — "S&P Puts Moody's on CreditWatch." The two items S&P cited were "an increased level of business risk…[that] could result…[from] a change in the applicable pleading standards for

certain litigation brought against rating agencies" and potential reduced investor demand for ratings as a result of decreased reliance on ratings as legal investment guidelines in regulations.

S&P may be correct in its assessment. The credit rating agencies have long been difficult to sue on their ratings, arguing successfully that their ratings were basically journalistic opinions protected by the First Amendment. Reduced investor demand also seems a possible consequence of the legislation, along with increased costs flowing from the increased oversight and regulation. In short, the credit rating agency business model and systemic reliance on ratings may undergo significant transformation.

However, the demand for credit analysis, and particularly, for the credit analysis of structured products, will undoubtedly increase, as investors and regulators turn to alternatives, such as non-NRSRO analytical firms, and perhaps enlarging in-house credit staff.

Securitization Risk Retention

"Skin in the Game" Requirement

The Act mandates, as a general matter, that securitizers and issuers maintain "skin in the game" by retaining, together, "not less than five percent of the credit risk for any asset" other than "qualified mortgages." The definition of "qualified mortgages" is left to regulatory definition (with the defining regulators being, jointly, the FDIC, the Office of the Comptroller of the Currency, the Federal Reserve, the SEC, the Department of Housing and Urban Development, and the Federal Housing Finance Agency), but can be no broader than "qualified mortgage" as defined in the Truth in Lending Act. The Act requires the promulgation of implementing regulations for "skin in the game" requirements within 270 days after enactment.

Conflicts of Interest

Additionally, the Act prohibits certain identified conflicts of interest relating to certain securitizations. Specifically, an underwriter, placement agent, initial purchaser or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security shall not, for a one-year period following the first closing of the sale of the security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity. These prohibitions do not apply to certain risk-mitigating hedging activities or to purchases or sales of asset-backed securities made pursuant to and consistent with commitments to provide liquidity or bona fide market-making activities. The Act further requires the SEC to promulgate implementing regulations within 270 days after enactment. This provision becomes effective upon the effective date of such final rules.

Additional Disclosure Requirements

Also mandated by the Act are increased disclosure requirements relating to the assets backing a securitization and the promulgation of regulations by the SEC regarding "the use of representations and warranties in the market for asset-backed securities," with an emphasis on the disclosure of "fulfilled and unfulfilled repurchase requests" relating to such representations and warranties in a securitizer's asset-backed securitization program.

Potential Impact on Securitization Markets

The securitization provisions of the Act, although helpful at this point in time, are not as helpful as they could be in clearing up the current "regulatory uncertainty" surrounding the securitization markets. Although many senior government officials, including the Secretary of the Treasury and the Chairman of the FDIC, have stated repeatedly and publicly that the securitization markets need to restart as a condition precedent to a robust economic recovery, a substantial amount of inhibiting regulatory uncertainty will remain in this market if the Act becomes law. The Act provides that "exemptions, exceptions and adjustments" to the key risk

retention requirement may be made by the FDIC, the Office of the Comptroller of the Currency, the Federal Reserve and the SEC, and the regulations have an effective date of two years (one year for residential mortgage-backed securities) after final rules are published in the Federal Register. In the meantime, in addition to what is mandated by the Act, both the SEC (in its process of amending Regulation AB) and the FDIC (in the process of amending its “safe harbor” regulation) continue down related, but different, paths with regard to securitization risk retention and disclosure. Adding to that, if the pending covered bond legislation moves forward, involving a wholly different regulatory regime for that product (ignoring government-sponsored enterprise reform for now), the federal government would appear to be taking multiple paths, creating the kind of confusion the Act was supposed to eliminate.

The Act also implies that the “originate to distribute” model, which was arguably present in the residential mortgage space during the boom years, was a systemic problem across all asset classes. Many originators of other consumer (*e.g.*, auto) and commercial products (*e.g.*, other leases) strongly disagree.

Executive Compensation, Corporate Governance, and Other Investor Protections

Executive Compensation and Corporate Governance

The Act contains several provisions that focus on corporate accountability and executive compensation.

- *Say-on-Pay* — A non-binding shareholder vote on executive compensation, as disclosed in the proxy statement, will be required at least once every three years. Further, shareholders are to determine every six years, in a separate non-binding vote, whether the vote on compensation should be held every one, two or three years. So-called "golden parachute" compensation for executive officers relating to mergers, acquisitions, and similar transactions is required to be disclosed in proxy statements for those transactions. Further, a non-binding shareholder vote on such compensation is required, unless the compensation was subject to a previous say-on-pay vote. Institutional investment managers are required to report annually how they voted on each of the above. The say-on-pay provisions will be effective for shareholder meetings occurring six months after enactment.

- *Independence of Compensation Committees and Compensation Committee Advisers* — The SEC, not later than 360 days after enactment, is required to direct national securities exchanges to prohibit the listing of equity securities of issuers that do not comply with the following requirements: (a) all compensation committee members must be independent and meet heightened independence standards to be set by the exchanges, taking into account the source of their compensation and their affiliation with the issuer; (b) the compensation committee must select any compensation consultants, legal counsel and other advisers only after considering independence factors determined by the SEC, including the factors described in the Act; (c) the compensation committee will have sole discretion to retain, and be directly responsible for the appointment, compensation and oversight of, compensation consultants, legal counsel and other advisers; and (d) disclosure regarding compensation consultant conflicts of interest will be included in proxy statements for annual meetings occurring one year after enactment of the Act.

- *Pay vs. Performance and Internal Pay Equity* — Issuers are required to disclose pay versus performance information in proxy statements for annual meetings, including the relationship between executive compensation actually paid and the financial performance of the issuer. Specifically, issuers must disclose: (a) the median annual total compensation of all employees of the issuer, excluding the chief executive officer; (b) the annual total compensation of the chief executive officer; and (c) the ratio of the amounts in (a) and (b). "Total compensation" is defined as the total compensation shown in the Summary Compensation Table

of the proxy statement (this provision apparently will require companies to gather Summary Compensation Table information for each employee).

- *Clawbacks* — The SEC is required to direct national securities exchanges to prohibit the listing of securities of issuers that do not develop a policy for: (a) disclosure of the issuer's policy on incentive compensation based on reported financial information; and (b) recovery of excess incentive-based compensation paid to current or former executive officers during the three years prior to an accounting restatement as a result of material noncompliance of the issuer with financial reporting requirements.

- *Hedging* — Issuers are required to disclose in proxy statements for annual meetings whether any employee, director or designee may hedge ownership of the issuer's equity securities.

- *Covered Financial Institution Compensation Arrangements* — Federal regulators are required to prescribe, not later than nine months after enactment, regulations to: (a) require enhanced disclosure of incentive-based compensation offered by covered financial institutions; and (b) prohibit incentive-based compensation that encourages inappropriate risks by providing compensation to employees, directors or principal shareholders that is excessive or could lead to material financial loss. "Covered financial institution" is broadly defined and may be expanded by the federal regulators. Covered financial institutions with assets of less than $1 billion are exempt from these requirements.

- *Broker Non-Votes* — Discretionary voting by brokers will be prohibited in the election of directors and on executive compensation (with the scope of the prohibition relating to executive compensation unclear), as well as on any other matters determined by the SEC.

- *Chairman/CEO* — Similar to current SEC rules, the Act requires that issuers disclose in proxy statements for annual meetings reasons for combined or separate chairman/CEO positions.

The Act did not mandate proxy access or majority voting.

- *Proxy Access* — The Act does not mandate proxy access, but rather gives the SEC discretionary authority to adopt rules for implementation and eligibility. Further, the Act does not contain any minimum ownership or other eligibility requirements.

- *No Majority Vote Requirement* — While the Senate version of the bill contained a majority vote requirement for the election of directors, the Act does not contain such a requirement.

Strengthened SEC Enforcement

The Act contains a number of provisions that are meant to improve the SEC's ability to enforce the securities laws.

- *Incentives for Whistleblowers* — The Act establishes a whistleblower fund, from which awards of up to 30% of the funds recovered by the SEC in an action may be paid to whistleblowers who voluntarily provide original information to the SEC that leads to a successful enforcement action resulting in monetary sanctions exceeding $1 million. In addition, the Act prohibits retaliation by an employer against a whistleblower employee who provides information to the SEC.

- *Aiding and Abetting Actions* — The Act expands the SEC's ability to bring aiding and abetting actions for violations of securities laws.

- *Cease-and-Desist Proceedings* — The SEC also will have the ability to impose civil penalties on persons in any cease-and-desist proceeding.

- *SEC Enforcement Deadlines* — New deadlines will be imposed on SEC investigations and communications. Not later than 180 days after providing a Wells notification, the SEC staff will be required to file an action or to give notice to the Director of the SEC Division of Enforcement of its intent to not file an action. In addition, not later than 180 days after the SEC staff completes an on-site compliance examination or inspection or receives all records requested from an entity being examined or inspected, the SEC staff shall provide such entity with written notification indicating that the examination or inspection has concluded, that it has concluded without findings, or that the SEC requires the entity to undertake corrective action. Both deadlines may be extended for certain complex cases.

- *Extraterritorial Jurisdiction* — The Act provides U.S. courts with jurisdiction over actions alleging violations of certain securities laws involving (a) conduct within the U.S. that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the U.S., or (b) conduct occurring outside the U.S. that has a foreseeable substantial effect within the U.S.

- *SEC Management* — The Act contains provisions that are designed to improve the SEC's management structure and responsiveness to investors and the financial markets. The Act creates the Office of the Investor Advocate at the SEC. In addition, an Investment Advisory Committee composed of the Investor Advocate, a representative of state securities commissions and individuals who represent the interest of investors will be created to advise the SEC on its regulatory priorities and initiatives. The Act also directs the Investor Advocate to appoint an ombudsman to liaise with retail investors. The Act mandates a comprehensive study of the SEC by outside consultants, an annual assessment of the SEC's internal supervisory controls, and a GAO review of SEC management.

- *Studies and Rulemakings* — The SEC is also directed to undertake a number of other studies and rulemakings, including studies on the following: (a) enhancing investment adviser examinations; (b) financial literacy among investors; (c) mutual fund advertising; (d) conflicts of interest between staffs of investment banking and equity and fixed income securities analyst functions within the same firm; (e) improved investor access to information on investment advisers and broker-dealers; (f) financial planners and the use of financial designations; and (g) extraterritorial private rights of action. Two other significant studies and rulemakings involve a possible alternative mechanism by which credit rating agencies determine their fees and improvements to the asset-backed securitization process.

Standard of Conduct for Broker-Dealers and Investment Advisers

The SEC is directed to conduct a study to evaluate the effectiveness of existing legal or regulatory standards of care for broker-dealers and investment advisers and persons associated with brokers-dealers or investment advisers, for providing personalized investment advice and recommendations about securities to retail customers, and to determine whether there are any legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to such standards of care. The SEC must submit a report on the study to Congress within six months after the enactment of the Act.

The Act also provides the SEC with authority to promulgate rules governing the standard of conduct for broker-dealers and investment advisers for providing personalized investment advice and recommendations about securities to retail customers. The standard of conduct under such rules would be: "to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." The rules shall provide that the standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of the Investment Advisers Act of 1940. Section 206 is a general antifraud statute that the U.S. Supreme Court has interpreted to impose on investment advisers an affirmative duty to clients of "utmost good faith and full and fair disclosure of all material facts" and an affirmative obligation "to employ reasonable care to avoid misleading" clients. Any rules must also provide that material conflicts of interest shall be disclosed and may be consented to by the customer. This provision would not require a broker-dealer to have any continuing duty of care or loyalty to the customer after providing personalized investment advice about securities. The Act also states that the receipt of compensation based on commission or fees will not, in and of itself, be considered a violation of the standard.

The SEC may also promulgate rules that require broker-dealers that sell only proprietary or other limited ranges of products to provide notice and obtain consent or acknowledgment from each retail customer.

The SEC is authorized to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers-dealers and investment advisers, including any material conflicts of interest. The SEC may also promulgate rules prohibiting certain

sales practices, conflicts of interest, and compensation schemes for broker-dealers and investment advisers that it deems contrary to the public interest and protection of investors.

Short Sale Reforms

The Act also amends portions of the Securities Exchange Act of 1934 to impose additional disclosure obligations and transactional restrictions relating to certain short sales. These enhanced disclosure obligations require each registered broker-dealer to provide notice to its customers of their right to elect not to allow their fully paid securities to be used in connection with short sales. If a customer fails to exercise this right and a broker-dealer subsequently uses that customer's securities in connection with a short sale, the broker-dealer must notify the customer that the broker-dealer may receive compensation in connection with lending the customer's securities. The Act also requires the SEC to adopt rules requiring public disclosure of certain information relating to short sales of publicly traded securities, including the name of the issuer and the title, class, CUSIP number and aggregate amount of the number of short sales of such securities. Lastly, the Act also prohibits "manipulative short sales" and directs the SEC to adopt rules necessary to enforce this restriction.

Regulation D Restrictions for "Bad Actors"

The Act directs the SEC, not later than one year after the enactment of the Act, to issue rules that would bar certain persons from utilizing the Regulation D private placement safe harbor under the Securities Act of 1933. The prohibition will extend to a person who:

- is subject to a final order of a state securities commission, a state authority that supervises or examines banks, savings associations, or credit unions, a state insurance commission, a federal banking agency, or the National Credit Union Administration, that (i) bars the person from (a) association with a regulated entity; (b) engaging in the business of securities, insurance, or banking; or (c) engaging in savings association or credit union activities; or (ii) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of the filing of the order or sale; or

- has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.

SOX 404 Exemption for Non-Accelerated Issuers

Non-accelerated filers will be permanently exempt from the requirement to provide an auditor attestation report on the effectiveness of their internal control over financial reporting.

Additional Disclosure Requirements

- *Congo Conflict Minerals* — The Securities Exchange Act of 1934 is amended to require the SEC, not later than 270 days after the date of enactment of the Act, to promulgate regulations to require persons for whom conflict minerals originating in the Democratic Republic of Congo ("DRC") or an adjoining country are necessary to the functionality or production of a product manufactured by such person to disclose annually whether such conflict minerals did originate in the DRC. If so, such persons must submit to the SEC a report describing the measures taken by such person to exercise due diligence on the source and chain of custody of the materials (which will include an independent private-sector audit) and the products manufactured that are not "DRC conflict free," the facilities used to process the conflict minerals, the country of origin, the entity conducting the audit, and the efforts to determine the mine or location of origin with the greatest possible specificity. Conflict minerals include columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives, or any other mineral or its derivatives determined by the Secretary of State to be financing conflict in the DRC or an adjoining country.

- *Coal or Other Mine Safety* — A reporting company that is an operator, or that has a subsidiary that is an operator, of a coal or other mine, will be required to include, in each periodic report filed with the SEC on or after the date of the enactment of the Act, information for the time period covered by such report relating to, among other things, (a) for each coal or other mine, the number of violations of mandatory health or safety standards that could significantly and substantially contribute to the cause and effect of a coal or other mine safety or health hazard under the Federal Mine Safety and Health Act of 1977 ("FMSHA") for which the operator received a citation from the Mine Safety and Health Administration ("MSHA") and the number of orders and citations issued, flagrant violations and imminent danger orders under provisions of the FMSHA, the dollar value of assessments from the MSHA and the total number of mining-related fatalities; (b) a list of such coal or other mines that receive written notice from the MSHA of a pattern of violations of mandatory health or safety standards that could have contributed to certain health and safety hazards or the potential to have such a pattern; and (c) any pending legal action before the Federal Mine Safety and Health Review Commission involving such coal or other mine. In addition, a Current Report on Form 8-K will be required to be filed upon the receipt of an imminent danger order or receipt of written notice that the coal or other mine has a pattern of violations of mandatory health or safety standards that could have contributed to certain health and safety hazards or has the potential to have such a pattern.

- *Payments by Resource Extraction Issuers* — The Securities Exchange Act of 1934 is amended to require the SEC, not later than 270 days after the enactment of the Act, to issue final rules requiring disclosure by reporting companies that engage in the commercial development of oil, natural gas, or minerals to include

in their annual reports information relating to any payment made by such issuer or its subsidiaries or controlled companies to a foreign government or the federal government for the purpose of the commercial development of oil, natural gas, or minerals, including the type and total amount of such payments made (a) for each project and (b) to each government.

Volcker Rule

Perhaps the most discussed provision in the Act is Section 619, which has been referred to as the "Volcker Rule." As originally conceived, the Rule would have imposed a flat ban on banks' ability to conduct proprietary trading activities or invest in hedge funds or private equity funds. The form of the Volcker Rule in the Act provides banks with a bit more flexibility. In particular, trading in certain government securities and hedging activities are allowed. In addition, in connection with their provision of investment advisory, trust or fiduciary services, a bank or its affiliates may finance the establishment of hedge funds or private equity funds and maintain a de minimis investment after marketing the funds for a year.

Though the Volcker Rule may have a profound effect on certain banks and their affiliates, its impact may not be felt for years. The Rule must be implemented through regulations to be promulgated by federal banking agencies, the SEC and the CFTC. The deadline for implementing regulations may be as long as 15 months from the date of enactment, and the effective date of the Rule may be as long as two years after enactment. In addition, there will be other transition periods, whose interrelationship is somewhat unclear.

The Volcker Rule is summarized in greater detail in Annex A to this memorandum.

FDIC Moratorium on Actions Relating To Certain Banks

The Act imposes a three-year moratorium on FDIC approvals of applications for deposit insurance under Section 5 of the Federal Deposit Insurance Act that are received after November 23, 2009 for any industrial bank, credit card bank or trust bank (as such entities are defined in the Bank Holding Company Act) that is directly or indirectly owned or controlled by a commercial firm.

During the moratorium, federal banking agencies may not approve a change in control of an industrial bank, credit card bank or trust bank, except in certain circumstances.

The Act requires the Comptroller General to conduct a study of the exemptions under Section 2 of the Bank Holding Company Act and deliver a report to the House of Representatives within 18 months after enactment.

Repeal of "Fed-Lite"

The Gramm-Leach-Bliley Act provided that the Board of Governors of the Federal Reserve would be the umbrella supervisor of bank holding companies and financial holding companies, but limited the Board of Governors' authority to examine, impose capital requirements on or obtain reports from subsidiaries of financial holding companies that are regulated by the SEC or the state insurance regulators (referred to in the Bank Holding Company Act as "functionally regulated subsidiaries"). This approach as been referred to as "Fed-Lite."

The Act repeals the Fed-Lite approach by removing the limitations on the Board of Governors' ability to supervise and examine functionally regulated subsidiaries.

Revised Capital Requirements

The Act contains minimum leverage- and risk-based capital requirements for a number of banking entities, including insured depository institutions, bank and thrift holding companies, and systemically important nonbank financial companies. As a result of these requirements, large banking institutions will not be able to include trust preferred securities in Tier 1 capital. Institutions with more than $15 billion in assets have five years to phase out trust preferred securities from their Tier 1 capital. Certain bank holding companies and savings and loan holding companies with less than $15 billion in assets will be permitted to continue their use of trust preferred securities issued prior to May 19, 2010.

Additionally, bank holding companies with total consolidated assets equal to or greater than $50 billion or nonbank financial companies supervised by the Federal Reserve may be subjected to other stringent prudential standards, including: maintaining a 15-to-1 debt-to-equity ratio; including off-balance sheet activities in computing capital requirements; conducting annual stress tests; observing short-term debt limits; or establishing a risk committee.

"Hotel California" Provision

The Act contains a provision, which has been referred to as the "Hotel California" provision, that ensures that any bank holding company having total consolidated assets of at least $50 billion as of January 1, 2010 that received financial assistance under the Capital Purchase Program or under the Troubled Asset Relief Program, will remain under the supervision of the Board of Governors as a systemically important nonbank financial company supervised by the Board of Governors.

The Act contains a process for such an entity to appeal to the Council its treatment as a nonbank financial company supervised by the Board of Governors. If the Council denies the appeal, it is still required to review and reevaluate the decision no less than once a year.

Back-Up Examination Authority for Nondepository Subsidiaries

The Act requires the Board of Governors to examine the activities of a nondepository institution subsidiary, other than a functionally regulated subsidiary or a subsidiary of a depository institution, of a depository institution holding company 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 of the depository institution holding company.

In the event that the Board of Governors does not conduct such examinations, the federal banking agency for the lead insured depository institution may recommend in writing that the Board of Governors perform the examination. If the Board of Governors does not commence an examination within 60 days after receiving such recommendation, the federal banking agency for

the lead insured depository institution may examine such the activities of the nondepository institution subsidiary.

Based on the examination described above, the appropriate federal banking agency for a lead insured depository institution may recommend that the Board of Governors take enforcement action against the nondepository institution subsidiary. If the Board of Governors does not take action against the nondepository institution subsidiary, the federal banking agency may take the recommended enforcement action against such nondepository institution subsidiary.

Additional Financial Holding Company Capital and Management Requirements

The Act requires financial holding companies to be well capitalized and well managed at the holding company level.

Enhanced Restrictions on Transactions with Affiliates

The Act expands the scope of Section 23A of the Federal Reserve Act to cover additional transactions with affiliates, such as borrowing and lending securities and derivative transactions, expands the collateral requirements and grants further exemptive authority and eliminates the exceptions for transactions with financial subsidiaries.

Inclusion of Additional Exposures in Lending Limits

Lending limits applicable to national banks must include the credit exposures created by to derivatives, repos, reverse repos and securities lending and borrowing activities.

Prohibition on Conversion in Certain Circumstances

A national banking association or federal savings association may not convert to a state bank or state savings association, and vice versa, during any period in which the bank is subject to an enforcement order.

Insider Transactions

- *Lending limits* **—** Lending limits to insiders will now apply to credit exposure from derivatives, repos, reverse repos and securities lending and borrowing transactions. This provision becomes effective one year after the Transfer Date.

- *Limits on asset purchases* **—** The Act prohibits purchases and sales of assets by an insured depository institution from an insider unless: (a) the transaction is on market terms; and (b) if the transaction represents more than 10% of the capital stock and surplus of the insured depository institution, the transaction has been approved in advance by a majority of the members of the board of directors of the insured depository institution who do not have an interest in the transaction.

The Board of Governors may promulgate additional rules regarding this provision.

Capital Levels

- *Countercyclical capital* — Capital levels of bank holding companies, savings and loan holding companies and insured depository institutions are to be countercyclical, such 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, consistent with the safety and soundness of the company.

- *Source of strength* — Companies that directly or indirectly control an insured depository institution must serve as a "source of financial strength" for any such institution, which entails providing financial assistance in the event of the financial distress.

Securities Holding Company Regime

The Act eliminates the investment bank holding company framework and establishes a new "securities holding company" regime. A "securities holding company" is defined as a person, other than a natural person, that owns or controls one or more broker-dealers registered with the SEC and its associated persons, excluding: (a) a nonbank financial company supervised by the Board of Governors; (b) certain insured banks or savings associations and their affiliates; (c) a foreign bank subject to the Bank Holding Company Act under the International Banking Act of 1978; (d) a foreign bank that controls, directly or indirectly, a corporation chartered under Section 25A of the Federal Reserve Act; or (e) a person who is subject to comprehensive consolidated supervision by a foreign regulator. A securities holding company that is required by foreign regulations to be subject to comprehensive consolidated supervision may register with the Board of Governors to become a supervised securities holding company. The Board of Governors must impose recordkeeping and reporting requirements, conduct examinations and impose capital requirements on supervised securities holding companies.

Limits on Mergers and Acquisitions

The Act restricts a "financial company" from merging or consolidating with, acquiring all or substantially all of the assets of, or otherwise acquiring control of, another company if the total consolidated liabilities of the acquiring financial company, upon consummation of the transaction, would exceed 10% of the aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction. The Board of Governors may approve a merger or consolidation that exceeds the concentration limit in certain circumstances. A "financial company" is 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 nonbank financial company supervised by the Board of Governors or a foreign bank that is treated as a bank holding company.

The Act also restricts interstate merger transactions that result in an insured depository institution, a bank holding company or a savings and loan holding company controlling more than 10% of the total amount of deposits of insured depository institutions in the United States. This restriction does not apply to interstate merger transactions that involve one or more insured depository institutions in default or in danger of default, or with respect to which the FDIC provides assistance.

Intermediate Holding Companies

Pursuant to the Act, the Board of Governors may require grandfathered unitary savings and loan holding companies that conduct activities other than "financial activities" (as defined in the Home Owners Loan Act) to establish and conduct all or a portion of its financial activities in or through an intermediate holding company. A grandfathered unitary savings and loan holding company is a company that was a savings and loan holding company on May 4, 1999, or that became a savings and loan holding company pursuant to an application pending on or before that date, that continues to control at least one savings association that was controlled prior to such date and meets certain other requirements. The Board of Governors is directed to promulgate regulations to establish the criteria for determining whether to require a grandfathered unitary savings and loan holding company to establish an intermediate holding company and to govern the interactions between the intermediate holding company and its parent and affiliates.

The Board of Governors will require a grandfathered unitary savings and loan holding company to establish an intermediate holding company if the Board determines that the establishment of such company is necessary to appropriately supervise activities that are determined to be financial activities or to ensure that supervision by the Board of Governors does not extend to the activities of such company that are not financial activities.

"Internal financial activities" of a grandfathered unitary savings and loan holding company will not be required to be placed in an intermediate holding company. Such activities include internal treasury, investment and employee benefit functions and internal financial activities conducted by a grandfathered savings and loan holding company or its affiliates. In addition, certain "grandfathered" activities of grandfathered unitary savings and loan holding companies may be continued, so long as the Board of Governors determines that the activity does not present undue risk to the company or the financial stability of the United States.

A grandfathered unitary savings and loan holding company that directly or indirectly controls an intermediate holding company shall serve as a source of strength to the subsidiary intermediate holding company.

Additional Provisions

In addition, the Act: (a) allows interest to be paid on demand deposits; (b) restricts the payment of dividends by certain savings associations; and (c) permanently increases deposit insurance for banks, thrifts and credit unions, from $100,000 to $250,000, made retroactive to January 1, 2008.

Elimination of the Office of Thrift Supervision

The Act provides for the dissolution of the Office of Thrift Supervision (the "OTS"), which is currently the primary regulator of all federal and many state-chartered thrift institutions.

The Act preserves the thrift charter, rather than eliminating it altogether, transferring oversight and enforcement over federal thrifts to the Office of the Comptroller of the Currency and its newly-created Deputy Comptroller for Thrifts. The FDIC becomes the regulator of state thrifts, and the Federal Reserve Board becomes the supervisor of savings and loan holding companies. The dissolution of the OTS is scheduled to take place one year from the date of enactment but may be delayed for an additional six months thereafter by the Secretary of the Treasury.

The Act includes a number of provisions aimed broadly at curtailing predatory lending practices of mortgage originators and establishing new national base-line underwriting standards for residential home mortgages. Under these new guidelines, lenders are required to ensure that borrowers can repay home loans by verifying income, credit history and employment status and may only propose modifications to a mortgage where such modification would provide a net tangible benefit to the borrower.

Significantly, the Act also prohibits the payment of origination fees or bonuses identified as “steering incentives” that encourage lenders to steer borrowers into more costly loans and that many lenders have traditionally paid to brokers to inflate the cost of loans. The Act allows borrowers in a foreclosure action to offset from the outstanding balance due on their mortgage any steering incentives paid during the origination of the mortgage at issue. Failure to comply with these provisions subjects a mortgage originator or creditor to liability for the greater of actual damages incurred by the borrower and three times the total amount of direct and indirect compensation or gain accruing to the mortgage originator plus attorney’s fees, if any.

In addition, the Act requires lenders and mortgage brokers to meet enhanced disclosure obligations relating to certain mortgages, for example, by disclosing the maximum a consumer could pay on a variable rate mortgage and by disclosing in the lender’s monthly statements the principal outstanding, the applicable interest rate, and the date on which that rate may next be adjusted.

The Act provides borrowers with defenses to foreclosure actions if the creditor has violated any of the provisions of the Act, limits prepayment penalties, precludes mandatory arbitration of disputes between creditors and borrowers, and requires disclosure prior to the borrower’s waiver of any anti-deficiency laws.

The Act also provides $1.5 billion in emergency mortgage relief for unemployed homeowners and an additional $1 billion for the Neighborhood Stabilization Program currently administered by the Department of Housing and Urban Development, which is devoted to rehabilitating, redeveloping, and reusing abandoned and foreclosed properties, and establishes an Office of Housing Counseling within the Department of Housing and Urban Development to provide counseling services relating to home ownership and rental housing.

Improving Access to Mainstream Financial Institutions

The Act aims to encourage initiatives for financial products and services that are appropriate and accessible for millions of Americans who are not fully incorporated into the financial mainstream. Specifically, the Secretary of the Treasury is authorized to work with tax-exempt, not-for-profit corporations, insured depository institutions, community development financial institutions, state, local and tribal government entities and partnerships or other joint ventures composed of one or more of such entities (collectively, “eligible entities”) to:

- promote initiatives designed (a) to enable low- and moderate-income individuals to establish one or more accounts in an insured depository institution that are appropriate to meet the financial needs of such individuals and (b) to improve access to accounts, on reasonable terms, for such individuals; and
- provide low-cost, small loans to consumers that will serve as alternatives to more costly small dollar loans.

Each eligible entity awarded a grant under the Act will be required to promote and take appropriate steps to ensure the provision of financial literacy and education opportunities, such as relevant counseling services, educational courses, or wealth-building programs, to each consumer provided with a loan.

Municipal Securities

Municipal advisors will now be required to register under Section 15B of the Securities Exchange Act of 1934. The Act requires revisions to the rules of the Municipal Securities Rulemaking Board (the "MSRB") to add "municipal advisors" as a category of persons subject to regulation.

"Municipal advisor" is defined in the Act a person (who is not a municipal entity) that:

- (a) 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, or (b) undertakes a solicitation of a municipal entity;
- includes certain financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders, and swap advisors; and
- does not include a broker, dealer, or municipal securities dealer serving as an underwriter, any investment adviser registered under the Investment Advisers Act of 1940, any commodity trading advisor registered under the Commodity Exchange Act, attorneys offering legal advice or providing services that are of a traditional legal nature, or engineers providing engineering advice.

The Act imposes liability on any municipal advisor who engages in any fraudulent, deceptive, or manipulative act or practice. In addition, the Act imposes a fiduciary duty on municipal advisors who act as advisors to any municipal entity.

The MSRB will now be composed of 15 members, including eight members who are, and seven members who are not, independent of any municipal securities broker, municipal securities dealer, or municipal advisor. The MSRB may also provide guidance and assistance to the SEC or a registered securities association on enforcement actions relating to the rules of the MSRB. The MSRB and the SEC will meet at least twice a year to share information regarding MSRB rules and the examination and enforcement of compliance with the rules.

ANNEX A: Section 619 – The Volcker Rule

- Section 619 of the Act prohibits any "banking entity" from engaging in proprietary trading or acquiring or retaining any equity, partnership or other ownership interest in or sponsoring a hedge fund or private equity fund.

  - "Banking entity" means any insured depository institution, any company that controls an insured depository institution, or that is treated as a bank holding company for the purposes of Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of such entity, except that "insured depository institution" does not include certain institutions that function solely in a trust or fiduciary capacity.

- The Rule also imposes additional capital requirements, to be prescribed by future regulations, on nonbank financial companies supervised by the Board of Governors of the Federal Reserve that are (presumably, although it is not clear) not banking entities and that engage in proprietary trading or that take or retain any equity, partnership or other ownership interest in or sponsor a hedge fund or private equity fund.

  - **Permitted Activities:** Subject to further regulation, the following activities are permitted under the Rule:

    - Purchases, sales, acquisitions or dispositions of U.S. government or agency obligations, obligations, participations or other instruments issued by Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, a Farm Credit System institution, or state or municipal obligations.

    - Purchases, sales, acquisitions or dispositions of securities and other instruments in connection with underwriting or market-making-related activities, to the extent that any such activities are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties.

    - 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 on behalf of customers.

    - Investments in one or more small business companies, investments designed primarily to promote the public welfare, or investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure under certain tax laws.

- Purchases, sales, acquisitions or dispositions by a regulated insurance company, or its affiliate, directly engaged in the business of insurance for the general account of the company, if:

    - such purchases, sales, acquisitions or dispositions are conducted in compliance with and subject to the laws of the state or jurisdiction in which the insurance company is domiciled, and

    - the appropriate federal banking agencies have not determined that the laws described immediately above are insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States.

- Organizing and offering a private equity or hedge fund, including serving as a general partner, managing member or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of the fund, including any necessary expenses for the foregoing if:

    - the banking entity provides bona fide trust, fiduciary or investment advisory services;

    - the fund is organized and offered only in connection with the provision of bona fide trust, fiduciary or investment advisory services and only to persons that are customers of such services or the banking entity;

    - the banking entity does not acquire or retain an equity interest, partnership interest, or other ownership interest in the funds other than de minimus investments, which include investments that establish the fund and provide the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors;

        - provided that,

            - the banking entity actively seeks unaffiliated investors to reduce or dilute its investment;

            - not later than one year after the date of establishment of the fund, the fund must be reduced through redemption, sale or dilution to an amount that is not more than 3% of the total ownership interests of the fund and the investment must be immaterial to the banking entity; and

        - the aggregate of such investments may not exceed 3% of the Tier 1 capital of the banking entity;

    - the banking entity may not engage in transactions with any applicable fund that would constitute a covered transaction and Section 23A of the Federal Reserve Act and all transactions with the fund must comply with Section 23B of the Federal Reserve Act, as more fully described below;

    - the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the hedge fund or private equity fund or of any hedge fund or private equity fund in which such hedge fund or private equity fund invests;

    - the banking entity may not share with the hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name;

    - no director or employee of the banking entity may take or retain an equity interest, partnership interest or other interest in the hedge fund or private equity fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the hedge fund or private equity fund; and

    - the banking entity must disclose to prospective and actual investors in the fund, in writing, that any losses in such hedge fund or private equity fund are borne solely by investors in the fund and not by the banking entity and must otherwise comply with any additional regulations.

- Acquiring or retaining any equity, partnership or other ownership interest in, or the sponsorship of, a hedge fund or private equity fund by a banking entity pursuant to Section 4(c)(9) and 4(c)(13) of the Bank Holding Company Act solely outside of the United States, provided that no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or one or more States.

- Such other activity as regulators may allow and that promotes and protects the safety and soundness of the banking entity and the financial stability of the United States.

- **Limitation on Permitted Activities:** The appropriate regulators are authorized to promulgate rules that limit permitted activities that:

    - involve or result in a "material conflict of interest" (as will be defined by rulemaking) between the banking entity and its clients, customers or counterparties;

    - would result, directly or indirectly, in a material exposure by the banking entity to "high-risk assets" or "high-risk trading strategies" (such terms to be defined by rulemaking);

    - would pose a threat to the safety and soundness of such banking entity; or

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

- **Regulatory Process:** The Act requires the Financial Stability Oversight Council to study this provision and make implementing recommendations within six months. Not later than nine months after the completion of the study, the appropriate federal banking agencies, the SEC and the CFTC must consider the study's findings and promulgate regulations to carry out the Volcker Rule.

- **Effective Date:** The Volcker Rule will become effective on the earlier of 12 months from the date of the issuance of final rules and two years after enactment.

- **Transition Period:** Affected entities will be required to comply with the requirements of the Volcker Rule no later than two years after the date on which the requirements become effective. The Board of Governors may grant up to three one-year extensions of the transition period.

    - **Extended transition for illiquid funds:** The Board of Governors may grant one extension of up to five years of the period during which a banking entity, to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010, may take or retain interests in an illiquid fund. It is unclear whether this is in addition to or concurrent with the transition period described immediately above.

    - The Board of Governors is required to issue rules governing the transition period no later than six months after enactment.

- Limitations on relationships with hedge funds and private equity funds:

    - No 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 a hedge fund or private equity fund as a permitted activity, and no affiliate of such entity, may enter into

a transaction with the fund, or with any other hedge fund or private equity fund that is controlled by such fund, that would be a covered transaction under Section 23A of the Federal Reserve Act, with hedge fund or private equity fund, as if such banking entity affiliate were a member bank and the hedge fund or private equity fund were an affiliate thereof.

- **Exception:** the Board of Governors may permit a banking entity or nonbank financial company supervised by the Board of Governors to enter into any prime brokerage transaction with any hedge fund or private equity fund in which a hedge fund or private equity fund managed, sponsored or advised by such banking entity or nonbank financial company supervised by the Board of Governors has taken an equity, partnership or other ownership interest, if:
  - the banking entity or nonbank financial company supervised by the Board of Governors is in compliance with the permitted activity exception for de minimis investments;
  - the chief executive officer, or the equivalent, of the banking entity makes certain annual certifications in writing; and
  - the Board of Governors has determined that such transaction is consistent with the safe and sound operation and condition of the banking entity or nonbank financial company supervised by the Board of Governors.

▪ A banking entity that serves, directly or indirectly, as the investment manager or investment adviser to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund as a permitted activity is subject to Section 23B of the Federal Reserve Act, as if such banking entity were a member bank and such hedge fund or private equity fund were an affiliate thereof.