ARNOLD & PORTER LLP

The Dodd-Frank Wall Street Reform and Consumer Protection Act

A Compendium of Advisories

By the Attorneys of Arnold & Porter LLP

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Dear Clients and Friends:

The Dodd-Frank Wall Street Reform and Consumer Protection Act, the most far-reaching financial regulatory legislation since the Great Depression, set the stage for major adjustments in the financial services industry. Dodd-Frank affected regulation, supervision, and in some cases the structure of financial sector companies. Other provisions increased regulation of executive compensation and corporate governance, inside and outside the financial services industry. Over the past several years, regulators have been working to implement the legislation through hundreds of separate rulemakings, a process that is only partially complete.

For affected businesses, the challenges of having to comply with the large number of new rules required by Dodd-Frank are daunting. To better help businesses affected by Dodd-Frank understand the complexities of the legislation, Arnold & Porter LLP has issued a series of Advisories on various aspects of the legislation and new rules. These range from the Financial Stability Oversight Council/Systemic Risk Determination Process to the Consumer Financial Protection Bureau; from resolution plans to conflict minerals; from fair lending issues, to a new framework for mortgages, to restrictions embodied in the "Volcker Rule." This series also includes Advisories discussing Dodd-Frank's impact on derivatives, capital, compensation, and the U.S. operations of foreign banks.

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

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ADVISORY

July 2010

Congress Finalizes Landmark Financial Regulatory Reform Legislation

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

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

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

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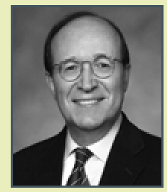

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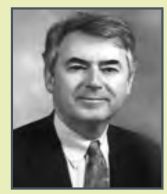

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Financial Regulatory Chart

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

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Title I. Financial Stability

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

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

Title I defines "nonbank financial companies" as those companies, other than bank holding companies or their subsidiaries with either (i) revenues from activities that are financial in nature that comprise at least 85 percent of the consolidated annual gross revenues of the company; or (ii) consolidated assets that are financial in nature that comprise at least 85 percent of the consolidated assets of the company. Activities that are "financial in nature" are those listed in section 4(k) of the Bank Holding Company Act of 1956, as amended—primarily banking, insurance, securities, and passive merchant banking activities.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Title II. Orderly Liquidation Authority

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

In light of its exceptional nature, liquidation of a company under Title II of the Act must be approved by the Federal Reserve, the FDIC, and the Treasury Secretary (in consultation with the President). If the failing company does not consent to the appointment of the FDIC as receiver, the Treasury Secretary must petition the District Court for the District of Columbia for an order authorizing the appointment. The District Court's determination is reviewable by the Court of Appeals for the DC Circuit, whose decision is in turn subject to discretionary review by the US Supreme Court.

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

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

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

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

Title III of the Act abolishes the Office of Thrift Supervision (OTS) and allocates its responsibilities, personnel, and assets among the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the FDIC. The Federal Reserve assumes responsibility for supervision of savings and loan holding companies and their nonbank subsidiaries, while federal savings associations and state savings associations become the responsibility of the OCC and the FDIC, respectively. Prospectively, OTS rulemaking authority is divided between the Federal Reserve and the OCC, and the new position of "Deputy Comptroller for the Supervision and Examination of Federal Savings Associations" is created at the OCC. Existing OTS regulations, orders, legal actions, guidance, and similar materials remain in force until altered or otherwise acted on by the Federal Reserve, the OCC, or the FDIC. These changes generally become effective one year from enactment of the legislation, which may be extended by the Treasury Secretary for up to six additional months (Transfer Date). The abolition of the OTS would become effective 90 days after the Transfer Date. The Director of the newly created Consumer Financial Protection Bureau would then replace the Director of the OTS on the FDIC Board of Directors.

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

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

Title IV. Regulation of Advisers to Hedge Funds and Others

Title IV of the Act amends the Investment Advisers Act of 1940 (Advisers Act) to impose Securities and Exchange Commission (SEC) registration, reporting, and record-keeping obligations on investment advisers to "private funds" that have assets under management in the United States of $150 million or more, subject to limited exemptions. Advisers to such funds (which include hedge funds, private equity funds, and other private funds not subject to an exemption) will be subject to Advisers Act regulation through elimination of the "private adviser" exemption in the Advisers Act that applies to investment advisers who, during the course of the preceding 12 months, had fewer than 15 clients (with a fund counting as a single client) and who do not hold themselves out to the public as an investment adviser or act as an investment adviser to a registered investment company. Elimination of the "private adviser" exemption applies to investment advisers generally, not just those that act as advisers to private funds.

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

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

Records and Reports. The SEC is authorized to require advisers to private funds to maintain records and file reports with the SEC.[4] The SEC may share this information with the FSOC, which may use it to determine whether to designate a private investment fund as "systemically significant" and therefore subject to Federal Reserve supervision, capital requirements, risk controls, pre-packaged liquidation plan requirements, the FDIC's orderly liquidation authority, and other significant and pervasive regulatory requirements that will apply to financial companies so designated under Titles I and II of the Act.[5]

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

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

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

Title V. Insurance

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

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

4 Records and reports to be maintained by an investment adviser include the amount of assets under management; use of leverage, including off-balance sheet leverage; counterparty credit risk exposure; trading and investment positions; valuation policies and practices; types of assets held; side arrangements or side letters, whereby certain fund investors obtain more favorable rights than others; trading practices; and other information that the SEC, in consultation with the FSOC, determines is necessary or appropriate in the public interest or for the assessment of systemic risk.

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

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

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

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

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

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

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

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

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

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

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

- The purchase, sale, acquisition, or disposition of obligations of the United States, Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution; and state or municipal obligations.
- Transactions in connection with underwriting or market-making-related activities, to the extent that any such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.
- Hedging activities designed to mitigate risks associated with individual or aggregated positions.
- Transactions on behalf of customers.

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

- Investments in small business investment companies; investments designed primarily to promote the public welfare; or investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure.
- The purchase, sale, acquisition, or disposition of securities and other instruments by a regulated insurance company for the general account of the company and by any affiliate of such regulated insurance company, subject to certain requirements.
- Organizing and offering a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, provided certain requirements set forth in the law are met. These requirements include that the banking entity provide *bona fide* trust, fiduciary, or investment advisory services; that the fund be organized and offered only in connection with the provision of such services and only to persons that are customers of such services of the banking entity; and that the banking entity not acquire or retain more than a specified *de minimis* ownership interest in the fund.
- Proprietary trading conducted solely outside of the United States by a banking entity pursuant to Section 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, unless the entity is controlled by a banking entity organized in the United States.
- The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund by a banking entity pursuant to Section 4(c)(9) or 4(c)(13) of the Bank Holding Company Act solely outside of the United States, provided that no ownership interest in such hedge fund or private equity fund is offered or sold to United States residents and the banking entity is not controlled by a banking entity organized in the United States.
- Other activity as permitted by regulators.

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

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

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

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

The Act also would, among other things:

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

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

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

Title VII of the Act provides for unprecedented and substantial regulation of the over-the-counter derivatives market, including swaps. In an effort to provide additional "transparency" to financial markets, the Act increases the regulatory requirements imposed on various financial entities that utilize derivatives products. More specifically, the Act regulates "swap dealers" and "major swap participants," whose definitions would likely include banks, large hedge funds, and possibly even large insurance and some finance companies. Requirements imposed on entities that fit within the definition of swap dealers and major swap participants include registration requirements, posting of margin for trades, capital requirements, reporting and recordkeeping requirements, and business conduct standards. Certain "end-user" businesses could be exempt from many of the above requirements if their positions in derivatives are determined to be for hedging and commercial risk mitigation purposes.

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

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

Title VIII. Payment, Clearing, and Settlement Supervision

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

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

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

Securitization Reforms

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

Credit Rating Reforms

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

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

Regulation of Broker-Dealers and Investment Advisers

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

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

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

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

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

The Act directs numerous organizational changes within the SEC. Notably, it directs the SEC's Divisions of Trading and Markets and Investment Management to have their own examination staffs, streamlines and accelerates the process for rule changes by self-regulatory organizations, codifies the establishment of the SEC's Investor Advisory Committee, and creates an Investor Advocate's Office to assist and represent the interests of retail investors.

Executive Compensation and Governance Reforms

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

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

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

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

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

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

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

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

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

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

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

Title X. Bureau of Consumer Financial Protection

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

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

- The Electronic Funds Transfer Act;
- The Equal Credit Opportunity Act;
- The Fair Credit Reporting Act;
- The Fair Debt Collection Practices Act;
- The Real Estate Settlement Procedures Act;
- The Truth in Lending Act;
- The Truth in Savings Act; and
- The Interstate Land Sales Full Disclosure Act (added during conference).

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

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

The regulations issued by the CFPB would apply to any "covered person," which is defined as any person engaged in offering or providing a consumer financial product or service (generally not including otherwise-regulated securities and insurance activities) and an affiliate that acts as a service provider to such a person. However, the Act makes it clear that the CFPB does not have authority over commercial transactions or the sale of nonfinancial goods or services. For example, the CFPB generally may not exercise authority with respect to a merchant, retailer, seller, or broker of nonfinancial goods or services. At conference, payday lenders, money remitters, check cashers, and private student loan providers were explicitly added to the supervision of the CFPB, while motor vehicle dealers were excluded. Pawn shop lenders do not appear to be subject to the supervision of the CFPB. Motor vehicle dealers and their financing operations are exempt to the extent that the source of the motor vehicle dealer's financing is a third party; however, motor vehicle dealers continue to be subject to FTC jurisdiction, and the FTC is given Administrative Procedure Act rulemaking powers over them.

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

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

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

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

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

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

A state attorney general may bring a civil action in the name of the state to enforce regulations that the CFPB issues, but not the provisions of Title X itself, against a federally chartered institution. To that end, the visitorial standard for federally chartered institutions will remain the standard set forth in the 2009 US Supreme Court case *Cuomo* v. *Clearing House Association, L.L.C.* Under that standard, a state attorney general may bring a judicial action against a federally chartered institution to enforce an applicable law.

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

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

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

Title XI of the Act requires the Federal Reserve to establish by regulation policies and procedures governing emergency lending programs. The programs must be of "broad based" applicability and designed to provide liquidity and not to aid a failing financial company. The programs must also be designed to ensure that the security for emergency loans is sufficient to protect taxpayers from losses and that the programs are terminated in a timely and orderly fashion. The Federal Reserve may not establish any emergency lending programs without the prior approval of the Treasury Secretary.

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

Title XII. Improving Access to Mainstream Financial Institutions

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

Title XIV. Mortgage Reform and Anti-Predatory Lending Act

Title XIV creates new standards and prohibitions for residential mortgage lending to be supervised by the CFPB. These standards are designed to prevent the practices that were prevalent during the subprime mortgage crisis. Mortgages will be subject to a federal standard that would require the loans to reasonably reflect a borrower's ability to repay. A consumer may assert a lender's violation of this "ability to repay" standard as a defense to a foreclosure. A mortgage that fits certain qualifications will be presumed to meet this standard. These qualifications include:

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

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

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

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

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Dodd-Frank Act Addresses Systemic Risk

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

The Financial Stability Oversight Council

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

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

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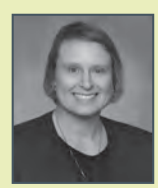

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Financial Regulatory Chart

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

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

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

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

Defining Systemic Risk

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

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

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

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

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

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

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

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

In addition, the Federal Reserve may require a company determined to be of systemic risk to establish such an intermediate holding company to segregate its financial activities. Moreover, the Federal Reserve *must* require that such a company establish an intermediate holding company if the Federal Reserve determines that such action is necessary to monitor appropriately the company's financial activities and to ensure that Federal Reserve supervision does not extend to the company's nonfinancial commercial activities. This intermediate holding company would be supervised by the Federal Reserve and be subject to the prudential standards applicable to nonbank financial companies under Federal Reserve oversight. The Federal Reserve also may promulgate regulations establishing restrictions or limitations on transactions between the intermediate holding company and its affiliates in order to prevent unsafe and unsound practices.

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

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

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

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

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

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

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

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

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

Impact of Systemic Risk Designation

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

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

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

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

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

Early Remediation. In order to minimize the possibility that financial distress at a systemically significant company will lead to insolvency and eventually undermine the country's financial stability, large bank holding companies and nonbank financial companies determined to be of systemic risk may be subject to regulations, promulgated by the Federal Reserve in consultation with the FSOC and the FDIC, that provide for early remediation in the event that such financial distress occurs. Similar to prompt corrective action regulations in place for banking organizations, these remediation regulations must define specific prudential measures for the company to take, such as increasing capital and liquidity, that grow increasingly stringent as the company's financial condition declines. However, the US government is prohibited from providing financial assistance to the company.

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

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

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

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

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

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

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

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

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

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

Implementation

Will the systemic risk determination process and the ability of the Federal Reserve and other federal regulators to intervene proactively in these nonbank companies in order to address material risks to the US financial system avert another economic crisis such as the one that started two years ago? Perhaps not completely, but the regulators now will have at their disposal more tools than the federal government has had in the past to handle a situation with a financial company that is in financial distress. As we have seen in the past two years, at times the federal government has appeared to have only two choices: either infuse massive amounts of taxpayer money into systemically significant companies (such as AIG), or stand by and let such a company file for bankruptcy protection (such as Lehman Brothers). If all the new tools provided under Title I still prove ineffective to deal with a systemically significant yet troubled financial company, Title II of the Act[2] provides for the US government to close and liquidate the troubled company.

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

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

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

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

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

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

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

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

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

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

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

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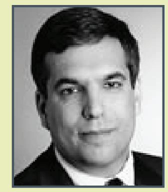

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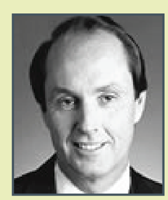

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Financial Regulatory Chart

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Repudiation of Contracts: The FDIC's broad powers to conduct the affairs of the institution include the power to repudiate any contract that it deems burdensome, if repudiating such a contract would promote the orderly administration of the affairs of the company. The FDIC also has the power to avoid fraudulent and preferential transfers, similar to the authority of a debtor-in-possession or trustee in bankruptcy. In fact, with respect to the definitions of fraudulent and preferential transfers, the statute largely mirrors the provisions contained in the Bankruptcy Code. As with bankruptcy proceedings, transfers involving Qualified Financial Contracts (QFCs)—generally meaning securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, or similar agreements as determined by statute and regulation—are not avoidable by the FDIC, except in instances where there was actual intent to hinder, delay or defraud.[1] Although the Act incorporates wholesale certain provisions of the Bankruptcy Code with respect to defenses to various preference actions, it notably omits section 546(e), frequently referred to as the "settlement defense," which is a defense to the avoidance of certain settlement payments. While other language in the Act arguably accomplishes the same result as the omitted provision, it is unclear how this difference will be interpreted in practice.

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

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

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

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

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

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

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

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

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

* * *

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

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

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

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

Historical Role of SLHCs

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

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

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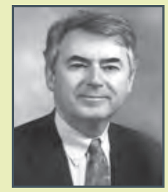

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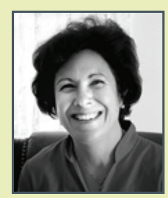

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Financial Regulatory Chart

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

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

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

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

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

The examination and supervision of SLHCs will move to the Federal Reserve. However, SLHCs would continue to operate under the provisions of the HOLA. Those SLHCs that are "grandfathered" for purposes of the HOLA's activity restrictions would remain so grandfathered and thus could continue to engage in any activity. Nevertheless, as the regulator of SLHCs, the Federal Reserve will examine and supervise SLHCs, and it should be expected that the Federal Reserve will be a much more rigorous regulator than the OTS. The Federal Reserve will have authority to assess SLHCs with total consolidated assets of $50 billion or more to recoup the total expenses that the Federal Reserve estimates are necessary or appropriate to carry out its supervisory and regulatory responsibilities with respect to SLHCs.

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

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

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

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

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

- The so-called "source of strength" doctrine is made statutory and applied for the first time to SLHCs, which means that SLHCs will now have to serve as a source of strength to their savings institutions subsidiaries. In addition, the doctrine is expanded to include a requirement that a grandfathered savings and loan holding company also must serve as a source of strength to any intermediate holding company that it directly or indirectly controls.

- All financial companies, including SLHCs, are prohibited from merging or consolidating with, acquiring all or substantially all of the assets of, or otherwise acquiring control of, another company, if the total consolidated liabilities of the acquiring financial company upon consummation of the transaction would exceed 10 percent of the aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction. In this connection, with respect to insurance companies, the term "liabilities" is to be defined by the Federal Reserve by regulation "in order to provide for consistent and equitable treatment of such companies."

There also are additional operational restrictions placed on savings institutions:

- The ability of federal savings institutions to branch interstate, subject to the provisions of Section 5(r) of the HOLA, is preserved. However, so are the multistate multiple savings and loan holding company restrictions in the HOLA—which impose activity restrictions similar to those of a bank holding company on any SLHC if it were to acquire and maintain two savings institution subsidiaries.

- Conversions of charters are prohibited without approval of the regulators if the institution is subject to an enforcement action.

- In interstate transactions, the depository institutions involved must be "well capitalized" and "well managed," a stronger standard than currently in place.

- Federal savings institutions would be subject to national bank lending limits, which are revised (as are Regulation O provisions) to include derivative, repurchase, reverse repurchase, securities lending, and securities borrowing transactions.

- The number of "covered transactions" subject to the restrictions of Section 23A of the Federal Reserve Act would be increased to include:
  - An affiliate's use of debt obligations as collateral;
  - Transactions between a member bank and an affiliate (or a subsidiary) involving the borrowing or lending of securities resulting in credit exposure by the member bank or any subsidiary; and
  - Derivative transactions between a member bank (or its subsidiary) and an affiliate resulting in credit exposure to the member bank or subsidiary.

- Loans issued by member banks on behalf of affiliates, credit exposures resulting from securities lending or borrower transactions and derivative transactions would be required to be secured at all times. The scope of Section 23A also is extended to include investment funds where a member bank or affiliate serves as an adviser.

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

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

In addition to the changes in regulatory regimes and operational standards, SLHCs could be impacted by the systemic risk and resolution authority provisions of the Act. Under the systemic risk provisions of the Act, the Federal Reserve is given the authority to impose additional supervision over large interconnected bank holding companies, as well as over nonbank financial companies that are determined by the new Financial Stability Oversight Council (FSOC) to pose a threat to the financial stability of the United States. These enhanced requirements include increased capital requirements, leverage and concentration limits, liquidity requirements, submission of a resolution plan, credit exposure report requirements, enhanced public disclosures, short-term debt limits, and overall risk management requirements.

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

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

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

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

In addition, the FDIC is given the authority to liquidate SLHCs where a systemic risk determination has been made if the Secretary of the Treasury, upon the recommendation of the FDIC and the Federal Reserve and in consultation with the President, finds that the company is in default or in danger of default, the failure of the company and its resolution under applicable Federal or State law would have serious adverse effects on US financial stability and the appointment of the FDIC would avoid or mitigate such adverse effects.

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

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

Impact of the Volcker Rule on SLHCs and their Subsidiaries

SLHCs also will be subject to the Volcker Rule, which prohibits "banking entities" from engaging in proprietary trading or acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring a hedge fund or a private equity fund. For an SLHC that is, or is owned by, an insurance company, however, the Volcker Rule may have little practical effect.[2]

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

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

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

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

Background

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

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

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

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

1 In general, institutions that function solely in a trust or fiduciary capacity will not be deemed "banking entities."

2 The Act provides that nonbanking financial companies meeting specified criteria can be designated as "systemically significant" and be subject to supervision by the Federal Reserve.

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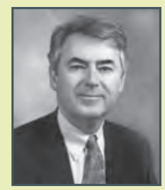

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Financial Regulatory Chart

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

I. Proprietary Trading Restrictions

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

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

- Transactions in government securities, agency securities, and state and municipal obligations;
- Transactions in connection with underwriting or market-making-related activities to the extent they are "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties";
- Risk-mitigating hedging activities designed to reduce specific risks of a firm's individual or aggregated positions or holdings;
- Transactions on behalf of customers;
- Investments in small business investment companies and certain enterprises devoted to the public interest;[3]
- Transactions by any regulated insurance company directly engaged in the business of insurance for the general account of the company or by its affiliates (also for the general account of the company), as permitted by relevant state insurance company investment laws and regulations (subject to additional review by the appropriate Federal banking agencies, after consultation with the Act's new systemic risk council and state insurance commissioners);
- Proprietary trading by a banking entity conducted solely outside of the United States pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act,[4] unless the banking entity is directly or indirectly controlled by a banking entity organized in the United States; and
- Other activity as permitted by regulation.

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

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

4 12 U.S.C. § 1843(c)(9), (13).

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

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

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

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

- Organizing and offering a fund, even to the extent of sponsorship, as long as the fund and entity do not share a name or name variant, and the following conditions are met:
  - — The fund is organized and offered only in connection with the provision of bona fide trust, fiduciary or investment advisory services;
  - — The banking entity may not acquire or retain an equity, partnership or other ownership interest in the fund;
  - — However, "de minimis investments" (as defined by regulators) would be permitted. Such investments would have to be immaterial to a banking entity, could not, in the aggregate, exceed 3 percent of a banking entity's Tier I Capital, and could not exceed 3 percent of the total ownership interests in any one fund. Subject to similar restrictions, a banking entity would also be permitted to make "seed" investments (i.e., initial investments of up to 100 percent of a fund for the purpose of establishing it and providing it with sufficient initial equity for investment to permit it to attract unaffiliated investors). The banking entity would then be required to reduce or dilute its investment to permitted levels within one year after the fund's establishment (with the possibility of a two-year extension).
  - — The banking entity, and its affiliates, comply with restrictions on transactions with such fund under Sections 23A and 23B of the Federal Reserve Act, as described below;
  - — The banking entity may not guarantee the fund, or any fund in which the fund invests, against losses or to a minimum performance;
  - — The banking entity discloses to prospective and actual investors, in writing, that the fund's losses are borne solely by investors and not by the banking entity, and otherwise complies with rules that the regulators may issue to ensure that losses are so borne;
  - — No director or employee of the banking entity may have an ownership interest in the fund, unless they directly provide investment advisory or other services to the fund.
- Acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring, a hedge fund or private equity fund by a banking entity solely outside of the United States pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, provided that no ownership interest in such fund is offered for sale or sold to a US resident and that the banking entity is not directly or indirectly controlled by a banking entity organized in the United States;

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

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

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

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

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

If a nonbank financial company supervised by the Federal Reserve engages in similar activities, it will be subject to additional capital requirements and restrictions to address the same types of conflicts of interest that banking entities would face in such transactions.

IV. Loan Securitization

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

Challenges of Implementation

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

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

5 12 U.S.C. § 371c.

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

7 12 U.S.C. § 371c-1.

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

Special considerations will also apply in the context of international banking. Under Sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act,[8] bank holding companies (including non-US banks regulated as such) may, as permitted by the Federal Reserve, acquire ownership or control of nonbanking companies that do not do business in the United States (except as an incident to their non-US operations), or that are organized outside of the United States and that primarily conduct their business outside of the United States.

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

8 12 U.S.C. § 1843(c)(9), (13).

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

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

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Dodd-Frank Act Mandates Stricter Capital Requirements for Financial Institutions

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

The Collins Amendment

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

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

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

2 *Id.*

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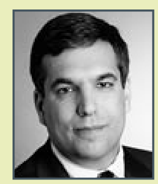

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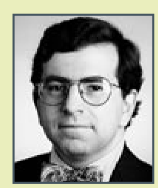

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Financial Regulatory Chart

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

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(1) They may not be less than the leverage and risk-based capital requirements, respectively, established for insured depository institutions; and

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

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

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

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

- Certain small bank holding companies;[3] and
- All federal home loan banks.

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

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

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

3 This exemption applies to small bank holding companies subject to the Small Bank Holding Company Policy Statement of the Board of Governors of the Federal Reserve System. This includes bank holding companies with pro forma consolidated assets of less than $500 million that (i) are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (ii) do not conduct significant off-balance sheet activities; and (iii) do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission.

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

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

Other Provisions on Capital Requirements

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

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

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

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

Required Studies on Capital Requirements

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

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

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

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

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

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

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ADVISORY July 2010

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

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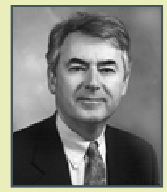

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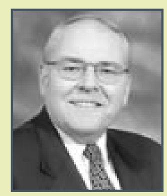

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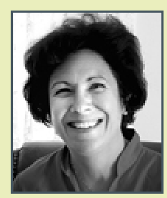

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) tightens the affiliate transaction rules contained in Sections 23A and 23B of the Federal Reserve Act and the related insider lending rules of Section 22(h) of the Federal Reserve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

Affiliate Transaction Rules

Historically, the primary federal statutory provisions governing transactions involving an insured depository institution (including its subsidiaries, collectively referred to as an "institution" below) and its affiliates are Sections 23A and 23B of the Federal Reserve Act, both of which are implemented by Regulation W of the Federal Reserve Board (Federal Reserve). Section 23A defines certain types of transactions as "covered transactions," imposes quantitative limits on an institution's covered transactions with any one affiliate and with all affiliates combined, and requires that certain types of covered transactions of an institution be secured by no less than a certain amount of collateral of specific quality. Section 23B generally requires that certain transactions (which include "covered transactions" and more) involving an institution and its affiliates be on terms and under circumstances that are at least as favorable to the institution as those for comparable transactions with nonaffiliates. By their terms, Sections 23A and 23B apply only to "member banks" (i.e., national banks and state member banks). But Section 18(j)(1) of the Federal Deposit Insurance Act applies these provisions to state nonmember banks, and Section 11(a) of the Home Owners' Loan Act (HOLA) applies them to savings associations.

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

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

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

1. **Definition of Affiliate**. The Act broadens the definition of affiliate to include any investment fund (whether it is a registered investment company or not) for which an institution or any affiliate thereof serves as an investment adviser. As a result, a hedge fund or private equity fund to which an institution or an affiliate of the institution serves as an investment adviser would be an affiliate of the institution.

2. **Covered Transactions**. The Act also broadens the types of transactions covered by the affiliate transaction rules of Section 23A and 23B as follows:

   — An institution's purchase of assets from an affiliate subject to an agreement by the affiliate to repurchase would fall under the "loan or extension of credit" type of covered transaction, which also is subject to the collateral requirements. This likely would affect the types of assets used and the margin required in repurchase transactions between institutions and their affiliates.

   — The Act would clarify that an institution's acceptance of debt obligations issued by an affiliate, even if such obligations are not considered securities, as collateral for an extension of credit to a nonaffiliate would be a covered transaction.

   — A securities lending or borrowing transaction or a derivative transaction with an affiliate would be a covered transaction to the extent that the transaction causes the institution to have credit exposure to the affiliate. Such a covered transaction also would be subject to the collateral requirements. Importantly, the Act clearly eliminates the Federal Reserve's authority to make any distinction between a credit derivatives and other types of derivatives, such as interest rate swaps, because the statutory language itself specifically defines credit exposure arising from derivative transactions with affiliates as a type of covered transaction subject to the quantitative limits and collateral requirements of Section 23A. Of course, issues remain, such as how to quantify the credit exposure arising from a derivative transaction. Presumably, the Federal Reserve would need to issue regulations to resolve these issues.

3. **Collateral Requirements.** The Act tightens the collateral requirements of Section 23A by:
   - Clarifying that debt obligations issued by an affiliate of an institution, even if such obligations are not considered securities, may not be used to meet the collateral requirements for a covered transaction between the institution and any of its affiliates.
   - Providing that the collateral requirements (with respect to both quality and quantity) must be met "at all times," not just "at the time of the transaction." Therefore, if the value of the collateral declines for any reason, additional collateral would need to be provided so that the covered transaction is collateralized in an adequate amount. Under the current statutory language, collateral that is retired or amortized after the time of the transaction must be replaced, but no additional collateral is required if the market value of the collateral posted at the time of the transaction declines to a level lower than that required at the inception of the transaction.
4. **Treatment of Transactions with Financial Subsidiaries.** Under the current statutory language, a financial subsidiary of an institution is treated as an affiliate (whereas other subsidiaries of an institution that are not depository institutions are not so treated), but certain exceptions apply to an institution's covered transactions with a financial subsidiary of the institution. The Act would eliminate these exceptions. As a result, a financial subsidiary of an institution would be treated the same way as any other affiliate. Specifically, there would no longer be an exception that would allow the aggregate amount of covered transactions between an institution and a financial subsidiary of the institution to exceed 10 percent of the institution's capital and surplus, and the retained earnings of the financial subsidiary would no longer be excluded in calculating the institution's investment in securities issued by the financial subsidiary (which is a covered transaction).

   The elimination of these exceptions would appear to have the practical effect of limiting the expansion of any financial subsidiary of an institution. As the retained earnings of a financial subsidiary increases, the value of the parent institution's investment in the financial subsidiary would increase under the amended Section 23A to a level over 10 percent of the parent institution's capital and surplus, unless other business activities of the parent institution also contribute substantially to the growth of its capital and surplus. Therefore, to comply with the 10 percent limit, the financial subsidiary would have to pay out at least some of its net income to the parent institution as dividends instead of reinvesting all of it in the expansion of the financial subsidiary.
5. **Exemptive Authority.** Perhaps one of the most important changes made by the Act is to restrict the ability of the Federal Reserve to issue exemptions from the restrictions of Section 23A. The Act does so in a number of ways:
   - Under the current statutory language, the Federal Reserve may provide for exemptions from Section 23A by regulation or by order. The Act would only allow the Federal Reserve to provide for exemptions by regulation, except that the Federal Reserve could continue to issue exemptive orders with respect to specific transactions of state member banks. In addition, the Act would require the Federal Reserve to provide the Federal Deposit Insurance Corporation (FDIC) with 60 days' notice before issuing any exemptive regulation or order. During the 60-day period, the FDIC could make a written objection to the exemption if it determines that the exemption presents an unacceptable risk to the Deposit Insurance Fund.
   - For certain institutions, the authority to exempt specific transactions from Section 23A by order would be shifted to the Office of the Comptroller of the Currency (OCC), with respect to national banks and federal savings institutions, and the FDIC, with respect to state nonmember banks and state chartered savings institutions. The Federal Reserve's concurrence would be required for any such order issued by the OCC or the FDIC. The same procedures whereby the FDIC could object to the Federal Reserve's exemptive regulations apply

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

— The Federal Reserve could issue regulations or interpretations regarding how a netting agreement may be taken into account in determining the amount of a covered transaction. An interpretation on this issue with respect to a specific institution would need to be issued jointly with the institution's primary federal regulator.

— The Federal Reserve could continue to issue exemptive regulations under Section 23B, subject to the same procedures whereby the FDIC could object to the Federal Reserve's exemptive regulations under Section 23A. No agency would have the authority to issue an order to exempt a specific transaction under Section 23B.

Extensions of Credit to Insiders

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

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

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

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

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

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

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

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

Swap Dealer Definition and its Potential Implications for Banks

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

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

Major Swap Participant Definition and its Potential Implications for Banks

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

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

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

Banks Divesting Certain Swaps Activities

One of the most contentious and important sections of the

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

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

Banks Must be Proactive in the Rulemaking Process

The new legislation of the OTC markets will substantially change the costs associated with trading derivatives products as well as regulatory requirements for participants in OTC transactions. As discussed, the extent to which costs and regulatory requirements will increase will depend on how the CFTC, SEC and federal banking regulators decide to interpret the new legislation. Rulemakings on most of the provisions of Title VII are required to be released by the agencies no later than 360 days after Title VII's enactment. If the agencies determine to take an expansive approach in drafting the rules many participants, including banks, may be required to register with the CFTC or SEC to participate actively in the derivatives market. The costs and ongoing regulatory compliance associated with OTC trades will also likely increase substantially for banks. Therefore, banks would be advised to consider participating in the rulemaking process to help ensure that agencies adopt a reasonable and balanced approach to implementing these new regulatory requirements.

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

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

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

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

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

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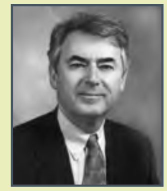

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Preemption of State Law by Federal Consumer Protection Laws, Including the Reform Act Itself

Under the new Act:

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

Clarification of Preemption Standards Under the NBA and HOLA

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

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

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

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

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

Comptroller Determinations of Preemption

- As noted, the Comptroller's decisions on NBA and HOLA preemption are to be made on a "case-by-case" basis. However, there is some leeway in the Act for broader determinations, if the Comptroller involves the CFPB. Specifically, the Comptroller may, in making a preemption finding regarding the state consumer financial law of a particular state, also determine that another state's similar law is similarly preempted, provided that the Comptroller (i) first consults with the CFPB; and (ii) takes its views into consideration.
- The Comptroller's authority to determine that a state consumer financial law is preempted by the NBA or HOLA is also limited by the requirement that there be "*substantial evidence*, made on the record of the proceeding," supporting the finding of preemption under the *Barnett Bank* preemption standard.
- All preemption determinations of the Comptroller will have to be published on a quarterly basis, and must be reviewed periodically. The required reviews will involve a notice-and-comment process which, for each preemption determination, will occur within (i) the first five years after issuance, and (ii) at least once during every subsequent five-year period. The Comptroller will have to report to Congress on whether, based on such reviews, the Comptroller intends to continue, rescind, or propose to amend any of the existing preemption determinations.

Preservation of State Enforcement Authority

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

Implications for National Banks and Federal Savings Banks

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

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

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

On the litigation front, all financial institutions subject to the Act's new consumer protection provisions, including but not limited to national banks and federal savings banks, can expect an increase in aggressive plaintiffs' activities and the advent of broader actions by state Attorneys General. Defending against these actions on grounds of federal preemption will require both a solid understanding of preexisting precedent and the analytical skill to demonstrate that these "clarifying" tests for preemption are met.

* * *

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

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

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

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

Creation of the CFPB

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

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

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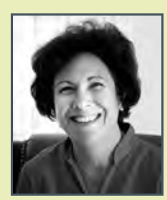

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in a given year, limited only by an annual funding cap.[1] The Director will be responsible for executing the CFPB's purpose of implementing and enforcing consumer financial laws on behalf of consumers, and according to the Act, on behalf of "fair,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

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

Scope of the CFPB's Authority

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

- The Alternative Mortgage Transaction Parity Act of 1982;
- The Consumer Leasing Act of 1976;
- The Electronic Fund Transfer Act;
- The Equal Credit Opportunity Act (ECOA);
- The Fair Credit Billing Act;
- The Fair Credit Reporting Act;
- The Home Owners Protection Act of 1998;
- The Fair Debt Collection Practices Act;
- Subsections (b) through (f) of section 43 of the Federal Deposit Insurance Act, requiring disclosure when a depository institution lacks federal deposit insurance;
- Sections 502 through 509 of the Gramm-Leach-Bliley Act, protecting the disclosure of nonpublic personal information;
- The Home Mortgage Disclosure Act of 1975;
- The Home Ownership and Equity Protection Act of 1994;
- The Real Estate Settlement Procedures Act of 1974 (RESPA);
- The S.A.F.E. Mortgage Licensing Act of 2008;
- The Truth in Lending Act (TILA);
- The Truth in Savings Act;
- Section 626 of the Omnibus Appropriations Act, 2009, mandating a rulemaking on unfair and deceptive mortgage lending practices; and
- The Interstate Land Sales Full Disclosure Act.

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

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

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

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

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

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

- Extending consumer credit and servicing loans;
- Extending or brokering leases of property that are the functional equivalent of purchase finance arrangements;[3]
- Providing real estate settlement services (other than appraisal of real or personal property);
- Engaging in deposit-taking activities, transmitting or exchanging funds, or acting as a custodian of consumer funds;
- Selling, providing, or issuing stored value or payment instruments, unless the seller does not exercise substantial control over the terms and conditions of the stored value;
- Providing check cashing, check collection, or check guaranty services;
- Providing payments or other financial data processing products or services to a consumer by any technological means;
- Providing individual financial advisory services to consumers, including credit counseling or debt management;[4]
- Maintaining or providing consumer credit information to make a decision regarding the offering of a consumer financial product or service;
- Collecting debt related to any consumer financial product or service; and
- Offering any other financial product that is permissible for a bank or financial holding company to offer where the CFPB determines such activity will likely have a material impact on consumers.

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

- Merchants, retailers, and sellers of nonfinancial goods or services;
- Motor vehicle dealers[5] (except for motor vehicle dealers who provide mortgages, or who extend retail credit directly to consumers without assigning that credit to a third party);
- Persons regulated by the Securities and Exchange Commission, Commodity Futures Trading Commission, or state securities commissions;
- Persons regulated by a state insurance regulator;
- Persons regulated by the Farm Credit Administration;
- Real estate agents, brokers, and appraisers;
- Manufactured home retailers;
- Accountants;

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

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

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

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

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

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

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

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

Regulatory Powers of the CFPB

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

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

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

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

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

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

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

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

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

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

Examination Authority of the CFPB

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

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

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

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

Large Depository Institutions. For depository institutions, examination authority for compliance with consumer financial laws will be divided between the primary federal banking regulators, and the CFPB on the basis of the institution's total asset size. Depository institutions with total assets greater than $10 billion (Large Depository Institutions), will be subject to consumer financial compliance examination by the CFPB. The CFPB must coordinate its examination of a Large Depository Institution with examinations conducted by the institution's federal and state banking regulators. If the supervisory determinations of the CFPB and a federal banking regulator are in conflict, then the Large Depository Institution may request a joint statement from the conflicting regulators. If the regulators are unable to resolve the conflict, then the institution may file an appeal with a governing panel consisting of representatives from the CFPB, the conflicting regulator, and a federal banking regulator not involved in the dispute. Through majority vote, the governing panel will provide a final determination to the supervisory conflict.

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

Enforcement Authority of the CFPB

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

Covered Person	Primary Enforcement Authority	Secondary Enforcement Authority
Nondepository Entities	■ CFPB has exclusive authority to enforce federal consumer financial laws, except where the FTC continues to have enforcement authority. ■ CFPB and the FTC will coordinate enforcement actions through a negotiated agreement.	■ Any federal agency authorized to enforce a federal consumer financial law may recommend in writing that the CFPB initiate an enforcement proceeding.
Large Depository Institutions (Total Assets Greater than $10 Billion)	■ CFPB has primary authority to enforce federal consumer financial laws.	■ Any federal agency (other than the FTC) that is authorized to enforce a federal consumer financial law may recommend in writing that the CFPB initiate an enforcement proceeding. ■ If the CFPB does not initiate an enforcement proceeding within 120 days, then that agency may initiate an enforcement proceeding.
Smaller Depository Institutions (Total Assets of $10 Billion or Less)	■ Federal banking regulator of the depository institution shall have exclusive authority to enforce federal consumer financial laws.	■ CFPB shall notify the federal banking regulator in writing when there is reason to believe that a material violation of a federal consumer financial law has occurred.

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

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

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

- Rescission or reformation of contracts;
- Refund of moneys or return of real property;
- Restitution;
- Disgorgement or compensation for unjust enrichment;
- Payment of damages;
- Public notification of the violation;
- Limits on the covered person's activities or functions; and
- Civil money penalties, as follows:
  - First Tier: Up to $5,000 per day for any violation of a law rule, final order, or condition imposed in writing by the CFPB;
  - Second Tier: Up to $25,000 per day for *recklessly* engaging in a violation of a federal consumer financial law; and
  - Third Tier: Up to $1,000,000 per day for *knowingly* violating a federal consumer financial law.

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

Impact of the CFPB

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

It is true that Title X of the Act contains several potential checks against the CFPB that could limit its authority. First, the mandated assessment of all significant federal consumer financial regulations could allow industry commenters to encourage the CFPB to identify and address outdated, unnecessary, or unduly burdensome regulations, which is a stated objective of the agency. Second, in any rulemaking, the CFPB must conduct a cost-benefit analysis of the effects of a rule on both consumers and covered persons, with particular consideration to the reduction of access to consumer financial products. Third, although less likely to be used, the FSOC can set aside a regulation if it places safety and soundness at risk, and federal banking agencies may formally object to CFPB rulemakings that are inconsistent with the agencies' objectives. Finally, each of the dozens of rulemakings that the CFPB must conduct will allow for public comment periods, where industry stakeholders may express their concerns.

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

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

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

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

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

Definition of Fair Lending

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

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Financial Regulatory Chart

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

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

Office of Fair Lending and Equal Opportunity

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

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

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

Amendments to the Equal Credit Opportunity Act

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

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

Amendments to the Home Mortgage Disclosure Act

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

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

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

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

Enforcement of Fair Lending Laws

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

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

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

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

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

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

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

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

General Scope of Provisions

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

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

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

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

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Financial Regulatory Chart

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

New Requirements for Mortgage Originators

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

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

  Yield spread premiums (YSPs) are prohibited if the total amount of direct and indirect compensation from all sources permitted to a mortgage originator would vary based on the terms of the loan (other than the principal amount).
- **Ban on Unfair and Deceptive Practices**. The Act gives the Federal Reserve (but presumably again this is the CFPB) the authority to promulgate regulations to ban acts or practices of mortgage originators that it finds to be unfair, deceptive, abusive, predatory, or necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers.

Minimum Standards for Mortgages

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

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

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

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

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

- **Safe Harbor Rules**. A creditor may presume that any residential mortgage loan it makes meets the "ability to repay" described above if the loan is a "qualified mortgage loan." To be a "qualified mortgage loan," it must possess the following parameters:

  — It must not permit negative amortization or, subject to certain exceptions, deferred principal;

  — Subject to certain exceptions, it must not require any balloon payment (defined as a scheduled payment that is more than twice as large as the average of earlier scheduled payments);

  — The income and assets relied on to qualify the borrower must be verified and documented;

  — Underwriting must be based on full amortization over the loan term;

  — The debt-to-income ratio must not exceed certain guidelines to be set by regulation;

  — Total points and fees must not exceed 3 percent of the total loan amount (with certain exceptions allowed for smaller loans in rural areas); and

  — The loan term must not exceed 30 years, subject to certain exceptions.

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

- **Refinance of Hybrid Loans with Current Lender**. The Act also sets forth factors to consider in determining a borrower's ability to repay when the creditor considers an application for refinancing of an existing hybrid loan made by the creditor into a standard loan. Under this provision, if there would be a reduction in monthly payment and the borrower has not been delinquent on any payment on the existing hybrid loan, the creditor, in determining the borrower's ability to repay, may: (i) consider the borrower's good standing on the existing mortgage; (ii) consider if the extension of new credit would prevent a likely default should the original mortgage reset and give such concerns a higher priority; and (iii) offer rate discounts and other favorable terms to such borrower that would be available to new customers with high credit ratings. It appears that the Act would allow the creditor to consider the borrower's ability to repay with a standard loan relative to the borrower's ability to repay under the existing hybrid loan, although the statutory language does not specifically say so.

- **Limits on Prepayment Penalties**. The Act also provides that no prepayment penalty may be allowed on a loan that is not a qualified mortgage loan. A prepayment penalty may be imposed on a qualified mortgage, but it would be subject to limits decreasing over a three year period from 3 percent of the loan balance to 1 percent of the loan balance. Moreover, a creditor may not offer a residential mortgage loan with a prepayment penalty without also offering one without a prepayment penalty.

- **Prohibition on Single Premium Credit Insurance**. No creditor may finance, with respect to any residential mortgage loan or any HELOC secured by a consumer's principal dwelling, credit insurance paid as a lump sum, except for certain credit unemployment insurance sold by unaffiliated third parties.

- **Limitation on Arbitration**. No residential mortgage loan or open-end loan secured by a consumer's principal dwelling may include terms requiring arbitration or any other non-judicial procedure for resolving disputes. However, a consumer may agree to such a resolution method after a dispute arises.
- **Disclosures Regarding Negative Amortization**. Negative amortization loans secured by a dwelling, whether closed-end or open-end, would require additional disclosures regarding the impact of negative amortization.
- **Disclosures Regarding Anti-Deficiency Laws**. If a residential mortgage loan is protected by state anti-deficiency laws (i.e., state laws that provide that, in the event of foreclosure on the residential property of a consumer securing a mortgage loan, the consumer is not liable for any deficiency between the sale price obtained on such property through foreclosure and the outstanding loan balance), the creditor or mortgage originator must provide notice of such protection, and if a refinancing would cause the borrower to lose such protection, the creditor or mortgage originator in the refinancing must provide notice of such loss of protection.
- **Reset of Hybrid Adjustable Rate Mortgages**. Six months' notice is required for changing from a fixed rate to a floating rate on a hybrid adjustable rate mortgage. Similar notices also may be required by regulation for non-hybrid adjustable rate mortgages.
- **More Disclosure Requirements**. The Act also requires certain new disclosures to be provided at the closing of a mortgage loan and on periodic statements (or coupon books).
  - — New information that must be provided at the closing include:
    - Information regarding settlement charges, including the aggregate amount of such charges, and the amount included in the loan and that to be paid at the closing;
    - The approximate wholesale rate of funds in connection with the loan;
    - Mortgage originator compensation;
    - Total interest payments over the loan term as a percentage of the loan principal; and
    - Certain monthly payment information for variable rate loans with escrow accounts.
  - — New information that must be provided on periodic statements to be provided during each billing cycle include:
    - The amount of the loan principal;
    - The current interest rate;
    - The date on which the interest rate may reset or adjust;
    - Any prepayment fee;
    - Any late fee;
    - A phone number and an email address the borrower may use to obtain information on the loan;
    - Information on credit counseling agencies; and
    - Any other information required by regulation.
- **Lender Rights**. One provision in the Act favoring lenders is that if a borrower has been convicted of obtaining a residential mortgage loan by actual fraud, the lender may not be held liable for any violations of the Truth in Lending Act (TILA) with respect to that loan.

New Provisions Relating to High-Cost Mortgages

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

- **Definition of High-Cost Mortgage Expanded**. Under the Act, a high-cost mortgage is redefined to be a loan (whether closed-end or open-end) that is secured by the consumer's principal dwelling and that fits under any of the following:

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

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

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

Creation of Office of Housing Counseling

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

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

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

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

New Provisions Relating to Mortgage Servicing

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

■ **Mandatory Escrow Account**. A creditor is required to establish an escrow account for the payment of taxes, insurance premiums, and other required assessments with respect to a closed-end loan secured by a first lien on the principal dwelling of a consumer, if:

- Federal or state law requires such an escrow account;
- The loan is made, guaranteed, or insured by a state or federal governmental lending or insuring agency;
- The APR on the loan exceeds the average prime

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

— Any regulation requires such an escrow account.

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

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

Appraisal Activities

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

- **Appraisal Required for Higher Risk Loans**. The Act prohibits creditors from making a "higher risk" (which is a wording change from "subprime") mortgage loan to any consumer without obtaining a written appraisal of the property to be mortgaged in accordance with the following requirements:

  — The appraisal is performed by a qualified appraiser who conducts a physical property visit of the interior of the property; and

  — A second appraisal is performed if the loan is to finance the purchase of the mortgaged property from a person who purchased the property at a price lower than the current sale price less than 180 days earlier.

  For this purpose, a qualified appraiser is defined as one that is licensed by the state and conforms with the applicable rules. A higher risk loan is defined as a residential mortgage loan secured by a principal dwelling with an APR that exceeds the average prime offer rate for a comparable transaction by at least 1.5 percentage points in the case of a first lien loan having an original principal amount not exceeding the applicable conforming loan limit, or by at least 2.5 percentage points for a first lien loan exceeding the applicable conforming loan limit, or by at least 3.5 percentage points for a subordinate lien loan.
- **Unfair and Deceptive Practices**. Certain practices compromising appraisal independence are considered unfair and deceptive under the Act, including:

  — A person with an interest in the credit transaction,

— compensating or otherwise influencing the appraiser; and
— Mischaracterizing or inducing any mischaracterization of the appraised value of the mortgaged property.

- **Conflict of Interests Prohibited**. The Act prohibits an appraiser from being involved in appraising the principal dwelling of a consumer offered as security for a consumer loan if the appraiser has an interest in the property or transaction.
- **Mandatory Reporting of Appraiser Violation**. If a person involved in a mortgage transaction, such as a mortgage broker, mortgage lender, or real estate broker, has a reasonable basis to believe that the appraiser failed to comply with applicable laws or standards, that person must report such failure to the applicable state licensing agency. The Act also prohibits a creditor from extending credit on the basis of an appraisal that fails to meet certain independence standards.
- **Regulation of Appraisal Management Companies**. The Act regulates appraisal management companies (i.e., companies that oversee more than 15 certified or licensed appraisers in a state or 25 or more nationally in a year), requiring them to be registered and supervised by a state appraiser certifying and licensing agency. A company that is a subsidiary of an insured depository institution will be regulated by the federal regulator for the parent institution.
- **Automated Valuation Models**. Automated valuation models must adhere to quality control standards designed to:
  — Ensure a high level of confidence in the estimates produced by the models;
  — Protect against the manipulation of data;
  — Seek to avoid conflicts of interest; and
  — Require random sample testing and reviews performed by a licensed appraiser.
- **Broker Price Opinions**. A broker price opinion (i.e., an estimate prepared by a real estate broker, agent, or sales person that details the probable selling price of a particular piece of real estate property) may not be used as the primary basis to determine the value of a consumer's principal dwelling for the purpose of originating a residential mortgage loan secured by that dwelling.
- **Copy of Appraisal to Borrower**. Finally, the Act amends the Equal Credit Opportunity Act to require that each creditor furnish to an applicant a copy of any written appraisal and valuation developed in connection with the applicant's application for a loan secured by a first lien on a dwelling promptly upon completion, but no later than three days prior to the loan closing (if the loan does go to closing). Currently, the creditor is required to furnish a copy of the appraisal only at the applicant's request.

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

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

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

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

Title I. Financial Stability

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

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

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

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

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

The Act expands the scope of the Federal Deposit Insurance Corporation's (FDIC's) existing back-up enforcement authority over insured depository institutions under Section 8(t) of the FDI Act to encompass back-up enforcement authority over depository institution holding companies. The Act provides that if the FDIC determines that the conduct or threatened conduct of a depository institution holding company that is not in a sound condition threatens the Deposit Insurance Fund, the FDIC may take an enforcement action, provided that the appropriate federal banking agency did not act within 60 days of receiving a recommendation by the FDIC to take an enforcement action.

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

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

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

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

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

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

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

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

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

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

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

B. Restriction on Bank Conversions

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

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

Title X. Bureau of Consumer Financial Protection

A. CFPB's Enforcement Authority over Nondepository Covered Persons

Title X of the Act creates the CFPB and provides it with examination and enforcement authority over nondepository covered persons who are (i) mortgage originators, brokers, or servicers; (ii) payday lenders; (iii) private education lenders; (iv) larger participants of a market for consumer financial products; or (v) are found to engage in conduct that poses risks to consumers. The CFPB is required to issue regulations, after consulting with the Federal Trade Commission (FTC), to further define the nondepository covered persons who are subject to the CFPB's examination and enforcement authority within one year of the Transfer Date. The Act provides the CFPB with "exclusive" enforcement authority to enforce federal consumer financial laws against these nondepository covered persons.[2] The effective date of this provision is the date of enactment of the Act.

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

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

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

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

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

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

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

D. Interagency Dispute-Resolution Process

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

E. CFPB's Enforcement Powers

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

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

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

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

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

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

F. Preservation of State Enforcement Powers

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

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

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

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ARNOLD & PORTER LLP

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Whistleblower Incentives and Protections in the Financial Reform Act

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

Financial "Bounties" for Employees to Disclose Information

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

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

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Financial Regulatory Chart

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

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

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

Prohibition on Reprisal for Employee's Disclosure of Alleged Wrongdoing

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

Under the Act, employees who have been discharged or discriminated against are given a private right of action to sue their employers for retaliation. Unlike the SOX whistleblower provisions, the Act does not require the exhaustion of administrative remedies. While the precise type of violation necessary to trigger the statute of limitations lacks clarity in the Act's language, the Act appears to permit an employee who alleges that he or she suffered an adverse employment action based on providing information to or assisting the SEC or CFTC to file a complaint directly in federal court if the employee reported the alleged violation (1) to the CFTC, for a period of up to two years after the alleged retaliatory act transpired; or (2) to the SEC, the later of (a) six years after the alleged retaliatory act, (b) three years after the employee reasonably should have discovered the retaliatory act, or (c) no later than 10 years after the alleged violation of the securities laws. These limitations periods are significantly longer than provided for in the SOX whistleblower provisions.

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

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

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

Consumer Financial Services Employee's Protection from Retaliation

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

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

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

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

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

In addition to creating its own new protections for whistleblowers, the Act also reinforces whistleblower provisions of SOX. SOX contains a provision providing whistleblower protection from retaliation for employees of publicly traded companies who have provided the SEC with information relating to securities fraud. The new legislation confirms those protections extend to the employees of subsidiaries "whose financial information is included in the consolidated financial statements of [a publicly] traded company" rather than merely direct employees of the publicly traded companies.

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

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

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ARNOLD & PORTER LLP

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

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

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

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

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

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

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Financial Regulatory Chart

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

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Title IV. The Private Fund Investment Advisers Registration Act

Amendments to Impose Advisers Act Requirements on Advisers to Private Funds

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

Exemptions from Advisers Act Registration

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

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

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

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

Federal and State Jurisdiction

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

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

Record-Keeping, Reporting, and Registration Requirements

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

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

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

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

Information Sharing

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

Protection of Confidential and Proprietary Information

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

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

Confidential Client Information

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

Custody of Adviser Client Accounts

The Act requires registered investment advisers to take such steps to safeguard client assets over which the adviser has custody, including verification of such assets by an independent public accountant, as the SEC may prescribe by rule. The SEC recently adopted amendments to Advisers Act custody and recordkeeping rules, effective March 12, 2010.[9]

Definition of the Term "Client"

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

Joint SEC/CFTC Rulemaking

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

Adjustment to the "Accredited Investor" Standard

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

Adjustment to the Qualified Client Standard

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

Studies

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

Other Provisions of Interest to Private Funds

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

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

To carry out these functions, Title II creates an "Orderly Liquidation Fund" (OLF), to be funded by FDIC obligations issued to the Treasury and then repaid with proceeds from the liquidated firm's assets. If necessary, however, assessments could be charged to "eligible financial companies," including, potentially, private funds and advisers supervised by the Federal Reserve, and any bank holding company with total consolidated assets of $50 billion or more. Assessments will be imposed on a graduated basis, with financial companies having greater assets and risk being assessed at a higher rate. Further information on Title II is available in our advisory, "Dodd-Frank Act Creates New Resolution Process for Systemically Significant Institutions."[16]

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

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

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

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

— Extends the jurisdiction of US courts in actions or proceedings brought or instituted by the SEC or the United States alleging a violation of the antifraud provisions of the federal securities laws to cover (i) securities transactions outside the United States, where conduct within the United States constitutes "significant steps in furtherance of the violation;" or (ii) conduct occurring outside the United States that has a "foreseeable substantial effect" within the United States.

— Clarifies that controlling person liability under Section 20(a) of the Exchange Act applies in SEC enforcement actions, not only in private actions.

— Amends the Exchange Act and the Advisers Act to give the SEC authority to bar offenders from associating with a broad range of SEC-regulated entities (e.g., investment advisers, brokers, dealers, municipal securities dealers, municipal advisers, transfer agents, and nationally recognized statistical rating organizations). Previously, offenders barred for securities law violations in one type of regulated entity could find work in another part of the securities industry.

— Gives the SEC authority to subpoena witnesses located anywhere in the United States in civil actions filed in federal court.[19]

— Gives SEC staff 180 days after giving a Wells Notice to any person to file an enforcement action against such person or provide notice to the Director of the Division of Enforcement of its intent to not file an action. In addition, gives the SEC staff 180 days after completing an onsite examination or receiving all requested records, whichever is later, to request corrective action or provide written notice that the examination has concluded. Both deadlines are subject to additional 180-day extensions by the SEC in complex cases with notice to (and for the subsequent extensions, approval of) the SEC.

- **Broader CFTC Enforcement Powers.** Title VII of the Act significantly increases the enforcement powers of the CFTC:

— The Act broadens the CFTC's enforcement authority with regard to commodity futures contracts and swaps by including fraud liability provisions that parallel Section 10(b) of the Exchange Act with respect to securities. Specifically, the Act achieves this by amending Section 4b of the Commodity Exchange Act and adding language that prohibits derivatives participants from: employing any device, scheme, or artifice to defraud; making any untrue statement of material fact or omitting any statement of material fact necessary in order to make the statements made misleading; or engaging in any act, practice or course of business which operates as a fraud or deceit upon any person.

— The Act also provides the CFTC with enforcement authority over market participants that engage in "disruptive practices." The Act defines such disruptive practices to include: activities violating bids or offers; intentional or reckless disregard for the orderly execution of transactions during the closing period of a market; and "spoofing" (bidding or offering with the intent to cancel the bid or offer before execution).

— The Act also expands the CFTC's anti-manipulation authority, and broadens the types of activities that are considered manipulation. For instance, it reduces the scienter requirement for manipulation in the reporting context by changing the standard of such conduct to include acting in *reckless* disregard of the fact that such report is false, misleading, or inaccurate.

- **Miscellaneous Provisions.** Title IX also:

— Authorizes the SEC to require earlier filing of beneficial ownership reports required by Section 13(d) of the Exchange Act (current law requires reporting "within ten days of acquisition") and eliminates requirements to send related notices to the issuer and exchanges. A similar accelerated time frame would be allowed for "short swing" reporting under Exchange Act Section 16.

— Requires the SEC to issue rules within one year after enactment of the Act to disqualify felons and other "bad actors" from participating in exempt offerings of securities made under Rule 506 of Regulation D.

— Requires persons who have custody or use of securities, deposits or credits of a registered investment company or of clients of registered investment advisers to comply with recordkeeping requirements as the SEC may prescribe and subjects such records to examinations.

— Gives the SEC authority to prohibit or impose conditions or limitations on the use of mandatory pre-dispute arbitration agreements with customers of brokers, dealers, municipal securities dealers and investment advisers.

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

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(Endnotes)

1 The Act defines a "private fund" as an issuer that would be an investment company under the Investment Company Act of 1940 (Investment Company Act) but for the exceptions provided in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. Section 3(c)(1) excludes from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 investors and which is not making a public offering. Section 3(c)(7) excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers," and which is not making a public offering. The term "qualified purchasers" is defined in Section 2(a)(51) of the Investment Company Act and includes institutions with $25 million or more in investments and individuals and family companies with $5 million or more in investments.

2 In prescribing regulations for advisers to such "mid-sized" private funds, the SEC must take into account the size, governance, and investment strategy of the funds to determine whether they pose systemic risk, and must provide for registration and examination procedures for the advisers of these funds that reflect the level of systemic risk posed by the funds.

3 The exemption applies to investment advisers who solely advise small business investment companies that are licensed under the Small Business Investment Act of 1958; entities that have received from the Small Business Administration notice to proceed to qualify for a license, which notice or license has not been revoked; or applicants affiliated with one or more licensed small business investment companies that have applied for another license, which application remains pending.

4 The enumerated categories of investors include:

(A) Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who:

(i) have invested with the family office before January 1, 2010; and

(ii) are accredited investors, as defined in Regulation D under the Securities Act or, as the SEC may prescribe by rule, the successors-in-interest thereto;

(B) Any company owned exclusively and controlled by members of the family of the family office, or as the SEC may prescribe by rule;

(C) Any investment adviser registered under the Advisers Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represent, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice.

5 Many high net worth families operate offices to manage the personal and financial affairs of family members. For smaller families, the old "fewer than 15" clients exemption in Section 203 of the Advisers Act, and SEC rules which defined relatives living in a single household as one "client" for this purpose, have provided an exemption from Advisers Act registration for these "family offices." Since the 1940s, however, the SEC has issued individual orders exempting from the Advisers Act certain family offices on a case-by-case basis (typically offices of larger, multi-generational families). The SEC in the past took the view that it did not have statutory authority to grant these exemptions by rule of general applicability, but only by individual orders.

6 Section 203(b)(1) of the Advisers Act exempts from registration any investment adviser all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange.

7 "Proprietary information" includes sensitive, non-public information regarding the investment adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and any additional information that the SEC determines to be proprietary.

8 Section 210(b) of the Advisers Act generally prohibits the SEC and its staff from disclosing the existence of any examination under the Advisers Act or the results of or any facts ascertained during any such examination.

9 *See* Release IA-2968, Custody of Funds or Securities of Clients by Investment Advisers, Dec. 30, 2009, *available at:* http://www.sec.gov/rules/final/2009/ia-2968.pdf.

10 The term "accredited investor," as defined in Rule 501(a) of Regulation D under the Securities Act for purposes of certain exempt offerings, includes:

- Individuals who have a net worth, or joint worth with their spouse, above $1 million, or have income above $200,000 in each of the last two years (or joint income with their spouse above $300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, executive officers or general partners of the issuer of the securities or its general partner; and
- Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than $5 million in assets; and qualified employee benefit plans and trusts with more than $5 million in assets.

11 The SEC has issued an interpretation that the amount of any associated mortgage and other indebtedness secured by the primary residence up to its fair market value may be excluded in determining an individual's net worth. Any excess liability should be deducted from the investor's net worth. *See* Compliance Disclosure and Interpretation (CDI) 179.01 (or identical CDI 255.47).

12 The SEC may undertake an initial review of the definition of an "accredited investor," as the term applies to natural persons, to determine whether the definition, excluding the requirement relating to the net worth standard described above, should be adjusted or modified, and following completion of the review, may make adjustments to the definition (except as to the net worth standard requirement) after notice and comment rulemaking. The SEC is required to conduct a review, not earlier than four years after enactment and not less frequently than every four years thereafter, of the definition of "accredited investor" in its entirety as defined in Rule 215 of the Securities Act. Upon completion of this review, the SEC may make adjustments to the definition of "accredited investor" as defined in Rule 215 after notice and comment rulemaking. (The Act does not require a review of the definition of an "accredited investor" in Rule 501(a) of Regulation D every four years. Rather, this review is only required with respect to the definition of an "accredited investor" for purposes of Rule 215, which affects the Section 4(6) exemption from registration under the Securities Act.)

13 Rule 205-3 generally defines a "qualified client" as one of the following:

(1) A natural person or company that has $750,000 under the management of the adviser; or

(2) A natural person or company whom the adviser reasonably believes has (a) a net worth of more than $1.5 million; or (b) is a "qualified purchaser" as defined in Section 2(a)(51) of the Investment Company Act; or

(3) An executive officer, director, trustee, or general partner of the adviser, or an employee that participates in the investment activities of the adviser with at least 12 months investment experience.

14 Section 205(e) of the Advisers Act permits the SEC to exempt any person or transaction from the Advisers Act limitations on incentive fees set forth in Section 205(a)(1) if the SEC determines such person does not need this protection on the basis of financial sophistication, net worth, knowledge of and experience in financial matters, and certain other factors.

15 *Available at:* http://www.arnoldporter.com/public_document.cfm?id=16151&key=17B3.

16 *Available at:* http://www.arnoldporter.com/public_document.cfm?id=16155&key=12F3.

17 *Available at:* http://www.arnoldporter.com/public_document.cfm?id=16138&key=26I2.

18 In addition to the rulemaking on short sale reporting and disclosure, the SEC is required to conduct a study of the feasibility, benefits and costs of requiring reporting of short sale positions to the public, or alternatively, only to the SEC and the Financial Industry Regulatory Authority. A separate study is required on the state of short selling, with consideration given to the impact of recent rule changes and failures to deliver.

19 Previously, the applicable federal rule of civil procedure placed a geographical limit on how far a witness could be required to travel, which meant that juries in federal court cases often watched videotaped depositions rather than live testimony. However, nationwide service of process will now be available to defendants in SEC federal court cases as well. The SEC currently has nationwide subpoena authority in administrative proceedings.

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

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

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

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

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

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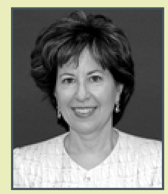

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vote on the compensation of executive officers (as disclosed under Item 402 of Regulation S-K), as well as a separate resolution to determine whether future "say-on-pay" votes should occur on an annual, biannual, or triennial basis. Companies must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

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

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

Companies should consider undertaking a comprehensive review of executive compensation with a view toward gaining shareholder support. This review should include the new executive compensation requirements added by the Act (discussed below), as well as a fresh look at the executive compensation disclosures included in last year's proxy statement. Companies also should strive to make their presentation of executive compensation clearer and more persuasive, providing compelling reasons for compensation decisions and analysis in the Compensation Disclosure & Analysis (CD&A) section of the proxy statement.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The "new" requirement in the Act that companies disclose in their proxy statement the relationship between executive compensation paid and the company's financial performance taking into account any change in its stock price takes us back to an "old" SEC rule that required companies to include a stock performance graph in their proxy statements. The SEC repealed this requirement in 2006, noting that stock performance information is widely available and that the executive compensation disclosure contained in CD&A is intended to encourage broader discussion than just the relationship of compensation to company performance as reflected in its stock price.[5] Currently, a performance graph is required only in the company's annual report to shareholders.[6]

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

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

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

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

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

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

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

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

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

The SEC must issue rules not later than 360 days after enactment. The rules of the SEC must provide for appropriate procedures for an issuer to cure any defect that would be the basis for a listing prohibition. The SEC rules must permit a national securities exchange to exempt a category of issuers. In determining appropriate exemptions, the exchanges must take into account the potential impact of the requirements on smaller reporting issuers.

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

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

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

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

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

- *Disclosure Regarding Use of Compensation Consultants.* A listed company will be required to disclose in the proxy statement for an annual meeting occurring one year or more after enactment of the Act whether (1) the compensation committee retained or obtained the advice of a compensation consultant; and (2) any conflicts of interest arise from the consultant's work and, if so, the nature of the conflict and how it is being addressed.
- *Authority to Engage and Oversee Independent Compensation Consultants, Counsel and Other Advisers.* The compensation committee of a listed company must be granted authority, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel, and other advisers and be directly responsible for their oversight.
- *Funding of Compensation Consultants and Other Advisers.* Listed companies must provide for appropriate funding, as determined by the compensation committee, for payment of "reasonable compensation" to compensation consultants, independent legal counsel, or other advisers to the committee.

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

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

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

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

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

11 *See, e.g.,* Kara Scannell, "SEC Enters Overdrive to Prepare for Overhaul," *Wall Street Journal*, July 12, 2010, *available at:* http://online.wsj.com/article/SB100014240527487047996045753573224 07593694.html (noting that agency officials are committed to completing proxy access).

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

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

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

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

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

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

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

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

14 The term "accredited investor," as defined in Rule 501(a) of Regulation D under the Securities Act for purposes of certain exempt offerings, includes:

- Individuals who have a net worth, or joint worth with their spouse, above US$1 million or have income above US$200,000 in each of the last two years (or joint income with their spouse above US$300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, executive officers or general partners of the issuer of the securities or its general partner; and
- Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than US$5 million in assets; and qualified employee benefit plans and trusts with more than US$5 million in assets.

15 The SEC has issued an interpretation that the amount of any associated mortgage or other indebtedness secured by the primary residence up to its fair market value may be excluded in determining an individual's net worth.

16 The SEC may undertake an initial review of the definition of an "accredited investor," as the term applies to natural persons, to determine whether the definition, excluding the requirement relating to the net worth standard described above, should be adjusted or modified, and following completion of the review, may make adjustments to the definition (except as to the net worth standard requirement) after notice and comment rulemaking. The SEC is required to conduct a review, not earlier than four years after enactment and not less frequently than every four years thereafter, of the definition of "accredited investor" in its entirety as defined in Rule 215 of the Securities Act. Upon completion of this review, the SEC may make adjustments to the definition of "accredited investor" as defined in Rule 215 after notice and comment rulemaking. (The Act does not require a review of the definition of an "accredited investor" in Rule 501(a) of Regulation D every four years. Rather, this review is only required with respect to the definition of an "accredited investor" for purposes of Rule 215, which affects the Section 4(6)

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

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

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

Enhanced Disclosure and Reporting of Compensation Arrangements by Covered Financial Institutions with US$1 Billion or More in Assets; Prohibition on Certain Compensation Arrangements. Not later than nine months after the date of enactment, appropriate federal regulators[18] must jointly prescribe regulations or guidelines that:

(1) Require "covered financial institutions" to disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements sufficient to determine whether the compensation structure provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or could lead to material financial loss to the covered financial institution; and

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

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

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

exemption from registration under the Securities Act.)

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

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

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

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

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

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

1 Pub. L. No. 111-203 (2010).

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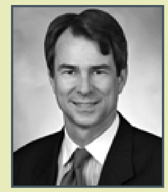

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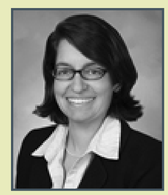

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Section 1502: Conflict Mineral Due Diligence

To help address the long-running international concern about the exploitation of certain minerals from the DRC and neighboring countries to help fund armed conflicts, Section 1502 of the Act amends the Securities Exchange Act of 1934 (Exchange Act) to require covered companies that use certain minerals in their products to disclose annually whether those minerals originate from the DRC or adjoining countries[2] if the use of the minerals is "necessary to the functionality of production of a product manufactured."[3] The "conflict minerals" that are covered under Section 1502 include columbite-tantalite (coltan), cassiterite (tin ore), gold, wolframite, or any of their derivatives, or any other mineral determined by the Secretary of State to be financing conflict in the DRC or adjoining countries.[4] Minerals described in the Act are commonly found in electronic devices such as cell phones, computers, digital cameras, and DVD players, although not all minerals used in these devices come from this region of the world.

The SEC is required to issue regulations implementing Section 1502 no later than April 17, 2011 (within 270 days of enactment of the Act). The Act provides limited guidance as to the specific information that a company must disclose, and the SEC will therefore need to clarify the disclosure requirements in its regulations. The Act obligates covered companies to describe "products manufactured or contracted to be manufactured" that are not "DRC conflict free,"[5] disclose the facilities used to process the conflict minerals, the country of origin of the conflict minerals, and efforts to determine the mine or location of origin with "the greatest possible specificity."[6] Moreover, it provides that when a covered company discloses that its products contain conflict minerals that originate from the DRC or adjoining countries, it must disclose due diligence undertaken to discover the source and chain of custody of the mineral. Finally, the section mandates that the report submitted to the SEC must be reviewed by an independent private sector auditor.

Section 1504: Disclosure of Payments to Foreign Governments

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

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

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

3 *Id.*

4 *Id.*

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

6 *Id.*

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

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

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

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

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

Implications

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

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

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

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

11 *Id.*

12 *Id.*

13 *Id.*

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

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

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

The disclosure requirement could raise another FCPA issue. The DOJ and SEC both have consistently encouraged companies to voluntarily disclose illegal payments, often rewarding companies that voluntarily disclose potentially covered payments with deferred prosecution agreements or mitigation of civil and criminal penalties.[15] If a company fails to disclose information required by the Act, and the DOJ and/or SEC subsequently learn about a resource extraction issuer's FCPA violations through cooperation with foreign governmental authorities or a whistleblower, the SEC and/or DOJ may take a harder line toward prosecution and enforcement under the FCPA, in addition to the SEC opening an investigation and bringing suit for failure to make such disclosures pursuant to Section 1504.[16] In addition, any violations of Section 1504, when ultimately disclosed to investors, could provide a new basis for shareholder class action or derivative lawsuits, including actions for fraud brought pursuant to Section 10(b) of the Exchange Act.

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

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

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

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

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

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

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

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

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

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

Title I. Financial Stability

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

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

- The FSOC must adopt rules necessary for the FSOC's conduct of business, including rules of organization, procedure, or practice.
- The FSOC may recommend to the federal banking agencies that they apply new or heightened standards and safeguards for a financial activity or practice, and it must provide notice to the public and an opportunity to comment on any such recommendation. In turn, the federal banking agencies must impose the recommendations or explain in writing why they will not. No timeframe is specified either for the FSOC to recommend or for the federal banking agencies to impose the recommendations, but if the federal banking agencies choose to reject the recommendations they must do so within 90 days.
- The Board of Governors of the Federal Reserve System (Federal Reserve) must issue, no later than 18 months after the Transfer Date, rules establishing prudential standards applicable to nonbank financial companies supervised by the Federal Reserve and bank holding companies with total consolidated assets equal to or greater than $50 billion in order to prevent or mitigate risks to financial stability.
- The Federal Reserve must promulgate, no later than 18 months after the Transfer Date, rules regarding resolution plans and credit exposure reports, leverage limitations, early remediation of financial distress, the establishment of intermediate holding companies, and exemptions from its supervision.
- The Federal Reserve must prescribe limits on credit exposures of nonbank financial companies supervised by the Federal Reserve or a bank holding company with total consolidated assets of $50 billion or more. This rulemaking must occur no later than 18 months after the Transfer Date, but the regulations may not take effect until three years after the Transfer Date, which restriction is extendable an additional two years by the Federal Reserve.
- The Federal Reserve must promulgate rules regarding the establishment of risk committees no later than one year after the Transfer Date, to take effect no later than three months after that.
- The Federal Reserve may issue, no later than 18 months after the Transfer Date, regulations regarding contingent capital, periodic public disclosures, short-term debt limits, and transactions between an intermediate holding company or a nonbank financial company supervised by the Federal Reserve and its affiliates.
- The federal banking agencies must promulgate regulations regarding stress tests and establishing leverage and risk-based capital requirements for certain financial institutions. No timeframe is specified for this rulemaking.
- The OFR, in consultation with the Chairperson of the FSOC (the Treasury Secretary), must issue rules, regulations, and orders to the extent necessary to collect and provide data to the FSOC and member agencies, standardize the types and formats of data reported and collected, and assist member agencies in determining the types and formats of data authorized by the Act to be collected by member agencies.

Title II. Orderly Liquidation Authority

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

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

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

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

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

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

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

Title III splits the rulemaking authority of the abolished OTS prospectively between the Federal Reserve and the OCC. The Federal Reserve is required under this title to issue regulations applicable to savings and loan holding companies and their nonbank subsidiaries, including regulations governing transactions between savings and loan holding companies and their affiliates, as well as regulations supervising tying arrangements and credit extensions to executives, directors, and principal shareholders under the Home Owners' Loan Act. The OCC is required under this title to issue regulations applicable to savings associations, and must also amend the term "assessment base" with respect to insured depository institutions under the Federal Deposit Insurance Act. No deadlines for the rulemakings required under this title have been specified.

Title IV. Regulation of Advisers to Hedge Funds and Others

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

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

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

Title V. Insurance

Title V establishes a Federal Insurance Office (FIO), and gives the Treasury Secretary the authority to issue orders, regulations, policies, and procedures to carry out the functions of the FIO, to facilitate the collection of information from insurers and affiliates, and to preempt certain state insurance measures. Title V also provides that the states adopt nationwide uniform requirements regarding the payment and allocation of premium taxes. We note that, generally, many of the provisions in Title V became effective on July 22, 2010, while some of the Title V provisions will become effective July 22, 2011.

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

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

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

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

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

In addition, Title VI sets forth, for example, the following permissive rulemakings:

- The Federal Reserve may issue regulations or interpretations concerning the manner in which a netting agreement between a member bank or a subsidiary and an affiliate may be taken into account in determining the amount of an inter-affiliate “covered transaction” under Section 23A of the Federal Reserve Act, including the extent to which a netting agreement may be taken into account in determining whether a covered transaction is fully secured under Section 23A (there is no specific timeframe for this rulemaking, but the rulemaking may not be effective any earlier than one year after the Transfer Date);

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

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

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

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

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

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

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

Title VIII. Payment, Clearing, and Settlement Supervision

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

The Federal Reserve is authorized to prescribe rules that:

- Authorize a Federal Reserve Bank to establish an account for and provide assistance (including discount and borrowing privileges) to a designated institution similar to the assistance provided to depository institutions under the Federal Reserve Act; and
- Impose recordkeeping requirements, upon majority vote by the FSOC, on systemically important clearing entities or on financial institutions engaged in designated activities that are subject to risk management standards prescribed by the Federal Reserve pursuant to this title.

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

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

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

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

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

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

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

Title X. Bureau of Consumer Financial Protection

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

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

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

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

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

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

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

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

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

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

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

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

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

Title XII. Improving Access to Mainstream Financial Institutions

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

Title XIV. Mortgage Reform and Anti-Predatory Lending Act

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

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

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

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

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

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

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

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Foreign Banks and Nonbank Financial Companies Also Face Challenges from Dodd-Frank

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Foreign banks and nonbank financial companies (jointly, foreign financial companies) that are engaged in activities in the United States, whether or not through a direct office or subsidiary, are affected in significant ways by provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), Public Law 111-203.[1] Some provisions in the Act affect specific activities in which the foreign financial company might be engaged in the United States in the same manner and to the same extent as a US financial company. Other provisions of the Act specifically exempt foreign financial companies or treat them in a different or alternative manner than US financial companies. The Act leaves many areas unclear, including areas of importance to foreign financial companies, with details left to the regulatory agencies to sort out in the hundreds of regulations, studies and regulatory guidance that either are required or made necessary by the Act. These regulations, studies and guidance will be issued or conducted by the US Department of the Treasury, the new Consumer Financial Protection Bureau, and federal banking, housing, and securities regulators.[2] This Advisory will discuss some of the important provisions in the Act that may directly or indirectly affect foreign banks and foreign financial companies.

Title I—Financial Stability

Financial Services Oversight Council

The Act establishes the Financial Stability Oversight Council (Council), chaired by the Secretary of the Treasury, as an overseer of US financial system stability. The Council's 10 voting members are representatives from the various federal government agencies

1 For a general discussion of Dodd-Frank, please see the Arnold & Porter Advisory "Congress Finalizes Landmark Financial Regulatory Reform Legislation," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16134&key=2E2. In addition, Arnold & Porter has prepared a compendium of several Arnold & Porter Advisories on aspects of Dodd-Frank, *available at:* http://www.arnoldporter.com/public_document.cfm?id=16170&key=15A2.

2 Please see the Arnold & Porter Advisory "The Rulemakings Process Has Begun: The Dodd-Frank Act Requires More Than 180 Rulemakings" [http://www.arnoldporter.com/resources/ documents/Advisory-The_Rulemakings_Process_Has_Begun_The_Dodd-Frank_Act_Requires_More_Than_180_Rulemakings_80210.pdf].

responsible for regulation of financial services and an individual who is experienced in the insurance industry. Among its many functions, the Council is required to monitor the financial markets for trends affecting systemic risk. In addition, the Council has the authority to identify US or foreign nonbank financial companies that are considered to pose a threat to the stability of the US financial system and require those companies to be subject to supervision and regulation by the Board of Governors of the Federal Reserve System (Federal Reserve) and be subject to heightened prudential requirements, such as more stringent capital, liquidity, leverage, and risk management requirements.[3] Large bank holding companies (those with total consolidated assets of more than US$50 billion as of January 1, 2010), including foreign banks that are treated as bank holding companies under the Bank Holding Company Act, also will be subject to these heightened prudential requirements.

As defined in the Act, a "foreign nonbank financial company" is any company that is organized under the laws of a country other than the United States (other than a foreign bank that is treated as a bank holding company under the Bank Holding Company Act, (BHC Act)), and derives 85 percent or more of its annual gross revenues from, or has 85 percent of its consolidated assets related to, financial activities as defined in section 4(k) of the BHC Act (primarily banking, insurance, securities, and merchant banking activities).

Generally, it is expected that only the US activities of the foreign nonbank financial company, whether through a direct office or a subsidiary, would become subject to the heightened prudential requirements under Title I. This is because the Act provides that references to a ''company'' or a ''subsidiary'' when referring to a foreign nonbank financial company (except with respect to its designation as systemically significant) include only the US activities and subsidiaries of such foreign nonbank financial company, except as otherwise provided.

3 For a more in-depth discussion of Title I of the Act and provisions designed to address systemic risk, please see the Arnold & Porter Advisory "Dodd-Frank Act Addresses Systemic Risk," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16151&key=17B3.

The Council is required to consult with both the home country regulator of a foreign nonbank financial company, if any, in making a systemically significant determination regarding that company, and, with "appropriate foreign regulatory authorities" in generally exercising its duties with respect to foreign nonbank financial companies.

The definition of a foreign nonbank financial company excludes a foreign company that is, or is treated in the United States as, a bank holding company under the BHC Act. Under the International Banking Act (IBA), a foreign bank that maintains a branch, agency, or commercial lending company in the United States, and any company controlling that bank, is treated as if it were a bank holding company with respect to its US activities. However, as noted above, large foreign banks (that is, those with total consolidated assets of more than US$50 billion as of January 1, 2010), also will be subject to Title I's heightened prudential requirements to the same extent as a U.S. bank holding company. It should be noted that the Act is silent on whether only US assets will be considered when calculating this US$50 billion asset threshold.

In imposing Title I's heightened prudential requirements on foreign companies, the Council and the Federal Reserve are to take a number of factors into consideration, including the amount and nature of the US activities of the company, particularly whether it owns an insured depository institution; whether the particular company is subject to comprehensive supervision on a consolidated basis in its home country at a level similar to that provided to US financial companies; and whether "due regard" has been given to "the principle of national treatment and equality of competitive opportunity" in developing the Prudential Requirements. Exactly what will constitute "due regard" and how the various factors will be weighed by the Council are unclear at this point, pending the issuance of key regulations and additional guidance from the Council and the regulatory agencies. Foreign financial companies are encouraged to monitor the regulatory rulemaking process and participate by submitting comments to the regulatory agencies on these areas of importance to non-US financial companies.

Establishment or Termination of US Offices of Foreign Banks

Title I of the Act also amends the IBA to require the Federal Reserve to take into account additional factors relating to systemic risk when either reviewing the application of a foreign bank to establish a US branch, agency or commercial lending company in the United States, or when it is considering terminating a foreign bank's authority to maintain a branch, agency or commercial lending company in the United States.

The additional factor for consideration when reviewing an application by a foreign bank that has been determined to be a risk to the stability of the US financial system for approval to establish the branch, agency, or commercial lending company is whether the home country of a foreign bank has adopted, or is making demonstrable progress towards adopting, an appropriate system of financial regulation for the financial system of such home country to mitigate such risk.

The Federal Reserve also will be able to terminate the authority of such a bank to operate a branch, agency or commercial lending company in the United States if it determines that the bank's home country has not in fact adopted an appropriate system of financial regulation or made demonstrable progress towards doing so.

Enhanced Capital Requirements

The so-called "Collins Amendment" (named after Senator Susan Collins of Maine) of Title I requires the federal banking agencies to establish minimum leverage capital and risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies (that is, bank holding companies and savings and loan holding companies), and nonbank financial companies supervised by the Federal Reserve.[4] In addition, the Collins Amendment terminates the ability of holding companies to use hybrid capital instruments such as trust-preferred securities as part of Tier 1 capital for all such securities issued on or after May 19, 2010. For those securities issued prior to that date, use of these securities is phased out over a period of time for depository institution holding companies that maintained total assets of at least US$15 billion as of December 31, 2009.

These new capital requirements will be applicable to any US-based depository institution or depository institution holding company owned by a foreign bank, but not to the parent foreign bank itself. Under Federal Reserve Supervisory Letter 01-1, issued January 5, 2001, current US bank holding company capital standards are not applicable to US bank holding companies that are owned by foreign banks that qualify as financial holding companies under section 4 of the BHC Act. Under the Collins Amendment, intermediate US holding companies will no longer be able to rely on Supervisory Letter 01-1 and will have to meet the new minimum capital requirements, effective five years after the date of enactment of the Act (*i.e.*, July 2015).

Title II—Resolution Authority

Title II of the Act gives the Secretary of the Treasury, upon the recommendation of the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC), the authority under certain extraordinary circumstances to circumvent the US bankruptcy process and place any bank holding company or nonbank financial company that is in default or in danger of default into receivership to be liquidated by the FDIC under a new expedited resolution process being developed by the FDIC.[5] The Act provides for special rules for dealing with liquidating insurance companies and broker dealers pursuant to the new Title II resolution authority. The provisions of Title II, however, are only applicable to US companies. Thus, the US bank holding company or savings and loan holding company subsidiary of a foreign financial company potentially could be subject to Title II's resolution provisions. The FDIC will continue to use the provisions of the Federal Deposit Insurance Act with respect to the receivership of insured depository institutions.

4 For additional analysis of the Collins Amendment, please see the Arnold & Porter Advisory, "Dodd-Frank Act Mandates Stricter Capital Requirements for Financial Institutions" *available at:* http://www.arnoldporter.com/public_document.cfm?id=16152&key=23C0.

5 For further information on Title II, please see the Arnold & Porter Advisory, "Dodd-Frank Act Creates New Resolution Process for Systemically Significant Institutions," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16155&key=12F3.

Title III—Transfer of OTS Authority

Regulatory Redistribution

Title III of the Act will be of particular interest to those foreign financial companies that own a US savings institution and thus are savings and loan holding companies under the Home Owners Loan Act (HOLA). The Treasury Department's Office of Thrift Supervision (OTS) regulates savings and loan holding companies and charters and regulates federal savings associations. Title III abolishes the OTS within a year to 18 months of the date of enactment of the Act and redistributes its supervisory authorities. Chartering and supervision of federal savings associations is given to the Treasury Department's Office of the Comptroller of the Currency (OCC), and the Federal Reserve will take over the supervision of savings and loan holding companies, using HOLA instead of the BHC Act. HOLA has enough flexibility to allow the Federal Reserve to tighten up supervision of savings and loan holding companies to a level that is more similar to its supervisory reach under the BHC Act.[6] In general, the Federal Reserve's supervision and regulation of bank holding companies is viewed as being more rigorous and pervasive than OTS supervision and regulation of savings and loan holding companies. Foreign financial companies that are savings and loan holding companies may need to make significant adjustments as the regulation of holding companies is shifted from the OTS to the Federal Reserve.

Increase in Minimum Deposits at US Branches of Foreign Banks

A provision in Title III also makes permanent the change from US$100,000 to US$250,000 in the federal standard maximum deposit insurance amount (SMDIA) that had originally been instituted in 2009 as a temporary measure and would have expired on December 31, 2013. Why should this matter to a foreign bank that has an uninsured branch in the United States and does not own a US bank that carries federal deposit insurance? Subject to certain exceptions, an uninsured state-licensed US branch of a foreign bank now may only establish accounts for customers who make an initial deposit of at least US$250,000. The initial deposit amount had been set at US $100,000 for many years until the FDIC issued regulations in 2009 pegging the initial deposit amount to the SMDIA, thus temporarily raising it to US$250,000. When the US$250,000 SMDIA was scheduled to go back to the US$100,000 SMDIA on January 1, 2014, the minimum deposit required to open an account at an uninsured state-licensed US branch of a foreign bank also would have gone back to US$100,000. The permanent increase in the SMDIA under the Act thus results in a permanent increase in the initial minimum deposit amount required to open a deposit account at an uninsured state-licensed US branch of a foreign bank.

To complicate the matter, this required minimum deposit is not applicable to the few foreign banks that maintain US-insured branches (the authority of a US branch of a foreign bank to obtain federal deposit insurance ended in December 1991). It also is not applicable to US branches of foreign banks that have licenses issued by the OCC (federal branches). When the FDIC amended its regulations in 2009, the OCC did not follow suit and thus OCC regulations still require only a minimum deposit of at least US$100,000 for federal branches.

Title IV—Increased Regulation of Investment Advisers

Title IV of the Act contains amendments to the US securities laws that would increase regulation of investment advisers by eliminating certain exceptions from the required registration with the Securities & Exchange Commission (SEC) for certain investment advisers to private funds. For example, the Act repeals the exemption from registration for investment advisers with fewer than 15 clients. However, certain currently exempt foreign-based investment advisers will continue to remain exempt provided that they meet certain conditions.[7]

6 For more information on the effect of the Act on savings associations and their holding companies, please see the Arnold & Porter Advisory, "Savings and Loan Holding Companies and their Subsidiaries Will Be Subject to New Regulatory Regimes under the Dodd-Frank Act," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16144&key=4E0.

7 For further information on the provisions of Title IV that affect investment advisers, please the Arnold & Porter Advisory, "Private Fund Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16196&key=26G0.

Title VI—Regulatory Enhancements

Moratorium on Certain New Charters

Many foreign financial companies have established banking subsidiaries in the United States that have not caused the foreign financial company to be required to register as a bank holding company with the Federal Reserve and as a result become subject to the restrictions on bank holding companies under the BHC Act. As noted above, neither savings and loan holding companies nor owners of certain other specified categories of banking institutions such as industrial banks, credit card banks, and limited purpose trust banks, subject to the provisions of the BHC Act. The Act imposes a three-year moratorium on applications by commercial firms for deposit insurance for, and most acquisitions of, industrial banks, credit card banks, and limited purpose trust banks. A firm is a "commercial firm" if its annual gross revenues, and those of its affiliates, derived from financial activities and, if applicable, from the ownership or control of one or more insured depository institutions, represent less than 15 percent of the consolidated annual gross revenues of the particular company.

Title VI also requires the General Accountability Office (GAO) to conduct a study to determine if most of the BHC Act exemptions, including those for savings associations, industrial banks, credit card banks, and limited-purpose trust banks, should be eliminated completely. Foreign financial companies that own or control banking organizations currently exempt from having to register as bank holding companies need to remain cognizant of future developments regarding these BHC Act exemptions. If the exemptions are abolished, senior management at foreign financial companies owning a now non-exempt banking organization will have to analyze the increased costs and compliance burdens resulting from the loss of such exemptions and assess whether maintaining the banking charter can continue to be justified in light of such regulatory changes.

Merchant Banking Activities

Since the enactment of the Gramm-Leach-Bliley Act of 1999, many foreign banks have qualified under the BHC Act to be treated as if they are financial holding companies. Prior to the Act, aside from needing prior approval to purchase a savings association, financial holding companies did not need prior approval to engage in most nonbanking financial activities, including merchant banking activities (which are passive investments of limited duration in nonfinancial companies). The Act amends the BHC Act to require that a financial holding company obtain prior Federal Reserve approval to make a merchant banking acquisition if the total consolidated assets of the target exceed US$10 billion.

Lending Limits and Affiliate Transactions

The Act also amends the limitations on loans that a national bank may make to one borrower. This change in national bank lending limits is relevant to foreign banks with US branches and agencies because the IBA makes the lending limits for national banks applicable to both state-licensed and federally licensed branches and agencies of foreign banks. Among other provisions, the definition of "loan" for purposes of the lending limit restrictions has been broadened to include credit exposure to a person arising from a derivative transaction, repurchase (or reverse repurchase) agreement, or securities lending or borrowing transaction between the bank and the borrower.

The Act also expands the restrictions on transactions between affiliates in Section 23A of the Federal Reserve Act to include credit exposure arising from derivative transactions and securities borrowing or lending transactions with affiliates, thus subjecting those transactions to the quantitative and qualitative restrictions on affiliates required by Section 23A. Foreign banks should remember that the restrictions of Section 23A apply to transactions by a US insured depository institution subsidiary of a foreign bank with the head office of its foreign parent. In addition, Section 23A is applicable to transactions by the US branch, agency or commercial lending company of a foreign bank with an affiliate engaged in certain activities in the United States, such as securities and insurance underwriting.[8]

8 For more information regarding the changes made by the Act to lending limits and affiliate transactions, please see the Arnold & Porter Advisory " Financial Regulatory Reform: Tightening the Regulation of Affiliate Transactions, Extensions of Credit to Insiders, and Lending Limits," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16147&key=22H3.

Volcker Rule

Under the so-called "Volcker Rule," named for former Federal Reserve Chairman Paul Volcker, pursuant to regulations to be issued by the federal banking, securities and commodities regulators and subject to certain exceptions, a "banking entity" is prohibited from engaging in proprietary trading in most securities and financial instruments or sponsoring or investing in hedge funds or private equity funds. The term "banking entity" is defined for purposes of the Volcker Rule as an insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of the IBA, and any subsidiary or affiliate of the foregoing. As defined, the term would capture foreign banks that maintain branches and agencies in the United States because, as noted above, such foreign banks are treated as bank holding companies pursuant to the IBA. The definition also captures foreign nonbank financial companies that own or control an insured depository institution such as an industrial bank that does not otherwise cause the owner thereof to become a bank holding company or savings and loan holding company. Even if it does not own an insured depository institution, a systemically significant nonbank financial company that engages in proprietary trading or sponsors or invests in hedge funds or private equity funds will be subject, by regulation, to additional capital requirements for, and additional quantitative limits with regards to, such proprietary trading and hedge fund/ private equity fund sponsorship or investment.

Permitted proprietary trading and fund-related activities include activities conducted solely outside the United States under Sections 4(c)(9) and 4(c)(13) of the BHC Act by a banking entity that is not directly or indirectly controlled by a US-organized banking entity. However, offering interests in the funds held under this exemption to US residents is prohibited. What will be required in order to meet the "solely outside the United States" requirement for these exemptions is not yet known. Sections 4(c)(9) and 4(c)(13) of the BHC Act do not require that the foreign bank's activities take place wholly outside the United States, and the Federal Reserve has implemented and interpreted these BHC Act provisions to allow for some incidental activities in the United States. In contrast, the Volcker Rule exception tied to these two sections of the BHC Act requires that the transaction be conducted solely outside the United States. The Federal Reserve and the other regulatory agencies with responsibility to draft regulations to implement the Volcker Rule will have to clarify the applicability of these exemptions through such regulations. Foreign companies that are not subject to the BHC Act but are covered by the Volcker Rule due to their ownership of insured depository institutions such as industrial banks do not appear to be covered by the exemptions, and the ability of the regulators to expand the exemption to include such companies is not clear.[9]

The Volcker Rule has a protracted implementation period. It must be implemented in accordance with joint regulations issued by the US federal banking, securities and commodities regulators. Prior to the rulemaking, however, the Council must undertake a study (to be completed within six months after the Act's enactment) regarding, among other things, limitations on an insured depository institution's activities that pose a risk of undue losses, and provide recommendations to the regulators issuing the regulations. Regulations must be adopted within nine months of the completion of the Council's study. The effective date of the Volcker Rule is the earlier of 12 months after the date of the issuance of the regulations or two years after the date of enactment of this section (i.e., July 21, 2012). Even then, there is a two-year conformance/divestiture period, with three one-year extensions possible, and a special extended transition period for illiquid funds.

Title VII—Over the Counter Derivatives

The Act also creates a comprehensive new regulatory regime for most derivative transactions that were previously deregulated by the Commodities Futures Modernization Act of 2000. Among the most significant

9 For more information on the Volcker Rule, please see the Arnold & Porter Advisory "Banking Entities, Other Significant Financial Service Companies to Face Significant Restrictions Under New "Volcker Rule," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16129&key=1J1.

aspects of Title VII's provisions regarding regulation of derivatives are (i) new categories of regulated market participants (including "swaps dealers" and "major swaps participants"); (ii) mandatory clearing through regulated clearing organizations and mandatory trading through regulated exchanges or execution facilities; and (iii) the requirement that banks push out many swaps activities to affiliates. In order to foster global uniformity in the swaps area, US regulators are required to consult and coordinate with foreign regulatory authorities on the establishment of "consistent international standards" regarding the regulation (including fees) of swaps, entities engaging in swaps activities, and futures and options contracts.[10]

Under the Act, "swaps entities," which could include banks and US branches and agencies of foreign banks, will be prohibited from receiving any "federal assistance" with respect to their activities. "Federal assistance" includes access to the Federal Reserve Bank discount window for purposes of obtaining a loan. US banks and US branches and agencies of foreign banks maintain accounts at Federal Reserve Banks, and may from time to time borrow money from the Federal Reserve Bank backed by collateral in its collateral account at the Federal Reserve Bank.

The Act exempts insured depository institutions from this prohibition if their hedging and other similar risk-mitigating activities are directly related to the insured depository institution's activities or they are engaging in swaps related to assets that are permissible investments for a national bank, such as loans and other extensions of credit, foreign currency, bullion (including gold, silver, and certain other precious metals), and US government and agency securities. However, as the Act is written, US branches and agencies of foreign banks, most of which are uninsured, will not be able to take advantage of that exemption. This gap in equitable treatment for US branches and agencies of foreign banks was acknowledged as inadvertent in a colloquy on the floor of the United States Senate during the debate on the Act, so action at some point to correct this gap is expected.

Foreign banks are typically involved in foreign exchange activities, often through their US offices, so it is important to note the Act's significant provisions regarding the regulatory treatment of foreign exchange swaps and forwards. The Act provides that foreign exchange swaps and forwards will be considered to be swaps (and thus subject to jurisdiction of the Commodities Futures Trading Commission) unless the Treasury Secretary grants an exemption by making a written determination that either or both types of foreign exchange derivatives (i) should not be regulated as swaps; and (ii) are not structured in a manner so as to evade application of the Act. On October 29, 2010, the Treasury Department published a request for public comment on questions relating to the determination as to whether foreign exchange swaps and forwards should be exempted from the new regulations contemplated under Title VII of the Act. Treasury will accept written comments through November 29, 2010.

Title IX—Investor Protection and Securities Regulation[11]

Title IX of the Act is aimed at, among other issues, improvements for investors in securities and commodities, executive compensation, and Securities and Exchange Commission (SEC) governance.

In addition, pursuant to an amendment to the Securities Exchange Act of 1934, under regulations jointly issued by federal regulators (including the federal banking agencies and the SEC), persons who securitize assets, and those who originate assets to be used in a securitization, will be required to retain an economic interest in a portion of any asset that the securitizer transfers, sells, or conveys to a third party through the issuance of an asset-backed security. The term "securitizer" means an issuer of an asset-backed security

10 For additional information on Title VII of the Act, please see the Arnold & Porter Advisory "Dodd-Frank Wall Street Reform and Consumer Protection Act to Significantly Impact Derivatives Trading of Banks," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16138&key=26I2.

11 For additional information on some of the topics addressed in Title IX of the Act, please see the Arnold & Porter Advisories "The Corporate Governance and Executive Compensation Provisions in the Dodd-Frank Act—What to Do Now," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16195&key=20F3.

or a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer; the term "originator" means a person who through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and sells an asset directly or indirectly to a securitizer. Foreign financial companies, including US branches and agencies of foreign banks, could fall within the definition of either originator or securitizer depending upon their particular activities in connection with securitization transactions.

The Act requires that the regulations include certain mandatory requirements that will:

- Prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset;
- Prescribe a general credit retention requirement of 5 percent of the value of the asset in question, with the percentage being greater or lesser under certain circumstances;
- Specify the permissible forms and minimum duration of the required risk retention;
- Be applicable regardless of whether the securitizer is an insured depository institution;
- Provide specified criteria for risk retention with respect to securitization of commercial mortgages and collateralized debt obligations; and
- Provide for certain exemptions, such as with respect to securities issued or guaranteed by the United States (Fannie Mae and Freddie Mac are ineligible for this exemption).

Title IX also provides for increased information sharing by the SEC with US and foreign authorities and extends the jurisdiction of US courts in actions or proceedings brought or instituted by the SEC or the United States alleging a violation of the anti-fraud provisions of the US federal securities laws to cover securities transactions outside the United States where conduct inside the United States constituted "significant steps in furtherance of the violation" or conduct occurring outside the United States that has a "foreseeable substantial effect" within the United States.

Conclusion

The Act imposes significant new regulatory requirements and obligations on foreign banks and nonbank financial companies operating in the United States. The full scope of the new challenges faced by foreign financial companies under the Act ultimately will be determined over the coming months by the regulatory agencies through the regulatory rulemaking process. Foreign financial companies should actively engage in the rulemaking process in order to ensure that the regulatory agencies fully consider their concerns as the regulations to implement these and other important provisions of the Act are written.

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

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SEC Proposes Rules to Implement Dodd-Frank Provisions Relating To Registration and Reporting By Investment Advisers

The US Securities and Exchange Commission (SEC) recently proposed a series of rules and rule amendments designed to clarify the registration and reporting obligations for certain categories of investment advisers in the aftermath of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that amended the Investment Advisers Act of 1940 (Advisers Act). Among other things, the proposed rules provide guidance to certain "mid-sized" SEC-registered investment advisers concerning the process for transition to state regulation from SEC regulation; define the reporting obligations that certain advisers would need to undertake even if they are exempt from registration; and enhance public reporting by registered investment advisers and other reporting advisers, including significant new mandated disclosures concerning private funds advised by such investment advisers. The proposed rules, disseminated in a November 19, 2010 release (Proposing Release) are designed to implement provisions of Title IV of the Dodd-Frank Act. Among other things, Title IV of the Dodd-Frank Act: (a) reallocated responsibility for regulatory oversight of certain advisers with assets under management of between $25 million and $100 million (mid-sized advisers) to the states from the SEC; (b) repealed the Section 203(b)(3) exemption from Advisers Act registration historically relied upon by many advisers to private funds, including hedge funds, private equity funds, and venture capital funds (Private Fund Adviser Exemption); and (c) created several more narrowly tailored exemptions for certain categories of investment advisers, including, family offices, advisers solely to venture capital funds, advisers solely to private funds with assets under management of less than $150 million, foreign private advisers, and commodity trading advisers registered with the Commodity Futures Trading Commission. These exemptions are discussed in more detail in a separate advisory that can be found at http://www.arnoldporter.com/public_document.cfm?id=17125&key=3F1.

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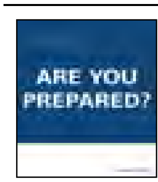

I. Advisers Act Registration

A. Deregistration of Certain Investment Advisers

Historically, Section 203A of the Advisers Act has prohibited an investment adviser, that is regulated by a state in which it has its principal office and place of business, from registering with the SEC unless it has at least $25 million in assets under management. An adviser with $30 million or more in assets under management has been required to register as investment adviser with the SEC. The Dodd-Frank Act amended Section 203A of the Advisers Act to generally prohibit an investment adviser from registering with the SEC if it is registered as an investment adviser with the state in which it maintains its principal office and place of business and has less than $100 million in assets under management. Congress enacted this amendment in an effort to shift responsibility for regulating certain "mid-sized advisers" with between $25 million and $100 million in assets under management to the states. A mid-sized adviser, however, would not be subject to this prohibition if: (a) it is not required to register with the state in which it maintains its principal office and place of business, (b) if registered with that state, the adviser would not be subject to examination as an investment adviser by that state, or (c) the investment adviser would be required to register as an investment adviser with 15 or more states. These exceptions from the prohibition would not be available to advisers with less than $25 million in assets under management. In addition, mid-sized advisers that advise registered investment companies and business development companies (as defined in the Investment Company Act of 1940 (Company Act)) would be required to register with the SEC despite the prohibition.

The SEC estimates that approximately 4,100 advisers currently registered with the SEC would need to deregister with the SEC and register with the states in which they have their principal office and place of business. To facilitate this process, the SEC has proposed Rule 203A-5 under the Advisers Act which would require advisers currently registered with the SEC to amend Part I of their Form ADV by August 20, 2011, in order to report their assets under management to be determined within 30 days of the filing date. This filing would provide the SEC and state regulatory authorities with information necessary to determine whether an adviser would still be eligible for registration with the SEC. Advisers that would no longer be eligible for registration with the SEC would be required to deregister with the SEC by filing Form ADV-W by October 19, 2011. The SEC has proposed this transition period for deregistration to provide an adviser time to arrange for state registration and, if applicable, to ensure that its associated persons register as investment adviser representatives (which could include taking an examination). The SEC notes that the timing of these transition periods may be impacted by the need to reprogram the Investment Advisory Registration Depository (IARD) system through which investment advisers file Form ADV.

The SEC has also proposed to grant relief from registration for certain state-registered advisers that would otherwise have to register with the SEC before July 21, 2011 because they would have between $30 million and $100 million in assets under management before implementation of the new higher SEC-registration threshold. This will allow such advisers to avoid the regulatory burdens of having to register with the SEC (as they cross the $30 million assets threshold) only to deregister once the new $100 million registration threshold becomes effective. Advisers would be permitted to take advantage of this relief if: (a) they are able to report on Form ADV that they have between $30 million and $100 million in assets under management between January 1, 2011 and October 19, 2011 and (b) the adviser is registered with the state where it has its principal office and place of business, and it reasonably believes it is required to be registered with and is subject to examination as an investment adviser by that state.

B. Assets Under Management

The SEC has also modified the method for calculating an adviser's assets under management to determine an adviser's eligibility to register with the SEC. This new measure, which would be known as an adviser's "regulatory assets under management" would also be used to determine an adviser's eligibility for various exemptions from Advisers Act registration including: (a) the exemption for advisers that advise only private funds and have less than $150 million in assets under management and (b) certain "foreign private advisers" with fewer than 15 US clients and investors in private funds and less than $25 million in assets under management from US clients and investors in private funds.

Section 203A(a)(2) of the Advisers Act defines "assets under management" as the "securities portfolios" with respect to which an adviser provides "continuous and regular supervisory or management services." The instructions to Form ADV provide further clarification on the calculation of assets under management and include a list of certain types of assets that advisers are permitted but not required to include in such a calculation. These include proprietary assets, assets managed without compensation, and assets of foreign clients. The SEC has proposed amending the instructions to Form ADV to require all advisers to include such assets in their calculations of regulatory assets under management. In addition, an adviser would neither be permitted to subtract outstanding indebtedness nor accrued but unpaid liabilities that are in a client's account managed by the adviser.

In addition, the SEC is also amending the instructions to Form ADV to provide guidance on how to calculate the regulatory assets under management of "private funds" managed by the adviser. Advisers would be required to include the value of any private fund over which the adviser exercises continuous and regular supervisory or management services. Sub-advisers, however, would only be required to count those assets of a private fund for which they actually provide sub-advisory services, as opposed to the total assets of the private fund. In addition, an adviser would be required to include capital that has been committed by investors to a private fund but has not yet been called for contribution by the adviser. An adviser would also be required to value private fund assets at fair value instead of being permitted to value such assets at cost. The SEC noted that it has proposed this method of calculation to ensure more consistent calculation of assets among investment advisers and to deter advisers from understating their assets to avoid registration.

For the purpose of determining eligibility to register with the SEC based on its assets under management, an adviser would only be required to make such a determination once a year based on its assets under management disclosed on its annual updating amendment to Form ADV. However, for the purpose of determining whether an adviser is eligible for the exemption from Advisers Act registration for advisers to private funds with less than $150 million in assets, an adviser would be required to value its private fund assets at fair value on a quarterly basis as opposed to an annual basis.

The SEC recognized that an adviser's regulatory assets under management, as disclosed in Part I of its Form ADV, would likely differ from the assets under management reported by an adviser in Part II of Form ADV.

III. Exempt reporting Advisers

As noted above, the Dodd-Frank Act repealed the Private Fund Adviser Exemption which was relied on by many advisers to private funds, including hedge funds, private equity funds, and venture capital funds. While advisers solely to venture capital funds and advisers to private funds with less than $150 million in assets under management would be eligible for exemption from Advisers Act registration, they would nonetheless be subject to reporting requirements proposed by the SEC in the Proposing Release. Such advisers would be known as "exempt reporting advisers."

The SEC has proposed a new rule, Rule 204-4 under the Advisers Act, which would require an exempt reporting adviser to file reports with the SEC by completing a subset of information required by Form ADV, which would be filed through the IARD and become available to the public. Specifically, the SEC is proposing that exempt reporting advisers complete the following items in Form ADV along with corresponding information required by Schedules A, B, C, and D: (a) Item 1, which requires basic identifying information about an adviser, including its contact information; (b) Item

2.C., which requires an exempt reporting adviser to indicate the exemption from Advisers Act registration on which it is relying as an exempt reporting adviser; (c) Item 3, which requires an adviser to indicate its form of organization; (d) Item 6, which requires an adviser to delineate its other business activities; (e) Item 7, which requires an adviser to provide information about its related persons as well as detailed information about private funds it advises; (f) Item 10, which requires an adviser to provide information about its direct and indirect owners; and (g) Item 11, which requires an adviser to disclose certain disciplinary information about itself and its employees. An exempt reporting adviser would not be required to provide other information required by other items in Part I or to complete and file Part II of Form ADV. Rule 204-1 under the Advisers Act would also be amended to require an exempt reporting adviser to file annual updating amendments to Form ADV within 90 days of the end of its fiscal year or other amendments "promptly" if certain material information becomes inaccurate. Also, as proposed, Rule 204-4 under the Advisers Act would require an exempt reporting adviser to amend its Form ADV to indicate that is no longer an exempt reporting adviser when it ceases to be an exempt reporting adviser. Proposed amendments to the instructions to Form ADV would also make it clear that those exempt reporting advisers that no longer qualify as exempt reporting advisers, because they must register with the SEC, must simultaneously file their last report on Form ADV as an exempt reporting adviser and their first Form ADV as a registrant. Exempt reporting advisers would be required to file their first reports on Form ADV by August 20, 2011.

IV. Amendments to Form ADV

The SEC has also proposed general amendments to Form ADV designed to enhance disclosures about the private funds advised by an investment adviser as well as additional information about an adviser's employees, clients, advisory activities, non-advisory business activities, financial industry affiliations, business practices, and related persons.

A. Information about Private Fund Clients

To begin with, registered advisers and exempt reporting advisers would be required to provide more detailed information about private funds that they advise in Item 7.B. and Schedule D of Form ADV. However, such advisers would not be required to include information about private funds advised by their related persons, which would likely be reported in a separate Form ADV by the related persons. Sub-advisers would not be required to provide information about a private fund if such information is already being provided by another adviser. Also, advisers to funds established as a master-feeder structure could complete a single Schedule D for the master fund and all of the feeder funds. Also, advisers with a principal office and place of business outside of the United States would not be required to provide information about a private fund organized outside of the United States that is not offered to or owned by "United States persons."

The SEC is proposing to require advisers to report information about a private fund, including information concerning the fund's organizational and investment characteristics, assets, investors, and service providers.

An adviser would generally be required to provide identifying information about a private fund client, including the name of the private fund, provided that an adviser could withhold the name of the client if it maintained the identity of the private fund client in code in its records to identify the private fund listed in Schedule D using the same code. With respect to a private fund's organizational characteristics, the SEC has proposed that an adviser provide information about: (a) the state or country where the private fund is organized; (b) the name of its general partner, directors, trustees, or persons occupying similar positions; (c) whether the fund is established as a master-feeder structure; and (d) the regulatory exclusions and exemptions relied on by the fund. Thus, an adviser to a fund that relies on any of the exclusions found in Section 3(c)(1) or Section 3(c)(7) from Company Act registration and a fund that relies on the exemption found in Regulation D under the Securities Act of 1933 (Securities Act) , with respect to its offerings of securities, would be required to indicate that the fund relies on any such exclusions or exemptions. With respect to a fund's investment characteristics, an adviser would be required to indicate the type of investment strategy employed by the fund by choosing among seven broad categories of strategies. With respect to the fund's assets, an adviser would be required to provide: (a) the gross and net assets of the fund (to facilitate the SEC's evaluation of any leverage utilized by the fund) and (b) a breakdown of the fund's assets and liabilities by class and categorization in the fair value hierarchy established under US generally accepted accounting principles (GAAP). This could prove to be burdensome where a fund does not prepare its financial statements in accordance with GAAP. With respect to the fund's investors, the adviser would be required to indicate the number and type of investors in the fund and the minimum investment required. To identify conflicts of interest, an adviser would be required to indicate whether its clients are solicited to invest in the fund and what percentage of the adviser's other clients have invested in the fund.

With respect to a fund's primary service providers, (including its auditors, prime brokers, custodians, administrators, and marketers) an adviser to a fund would be required to disclose: the service provider's name and location; whether it is a related person of the adviser; information about the services it provides to the fund; and certain identifying information (such as its registration status). With respect to a fund's auditors, an adviser would be required to disclose whether the auditor is an independent auditor; whether the auditor is registered with and subject to supervision by the Public Company Accounting Oversight Board; and whether audited statements are delivered to fund investors. With respect to a prime broker, an adviser would be required to disclose whether the prime broker is an SEC-registered broker-dealer and whether it acts as custodian for the private fund. With respect to the custodians of a private fund, the adviser would be required to disclose whether the custodian is a related person of the private fund. With respect to the fund's administrators, the adviser would be required to disclose whether the administrator prepares and sends account statements to fund investors and what percentage of the private fund's assets are valued by the administrator or another person that is not a related person of the adviser. With respect to marketers, an adviser would be required to disclose whether the marketer is a related person of the adviser, its SEC file number, and the address of any website the marketer uses to market the private fund. The SEC noted that the proposed new disclosures are designed to improve the SEC's ability to assess conflicts and potential risks, identify private funds with service provider arrangements that raise a red flag, and identify firms for examination.

As proposed, an adviser to a private fund would also be required to indicate whether it is subject to foreign regulatory authorities and whether it is a primary adviser or sub-adviser to the fund. In addition, an adviser to a private fund would be required to list all of the advisers to the private fund as well as their SEC file numbers.

Because this information about private funds would be filed on an adviser's Form ADV, such public disclosures raise the question of whether private funds can continue to rely on the exemption from registration of their securities found in Regulation D under the Securities Act, which prohibits a private fund from engaging in "general solicitation and advertising" in offering its securities. The SEC did not address this issue in the Proposing Release.

B. Information about an Adviser's Employees, Clients, and Advisory Activities

The SEC has proposed expanding existing questions in Item 5 of Form ADV which ask about an adviser's employees, clients, and advisory activities. First, the SEC would require an adviser to disclose the number of its employees that are registered investment adviser representatives or insurance agents in addition to the current mandated disclosure related to the number of employees that are registered representatives of a broker-dealer. In addition, the SEC has proposed requiring an adviser to provide a numerical approximation of the number of its employees instead of checking a box corresponding to a range of numbers of employees.

With respect to client and advisory activity disclosures, an adviser is currently required to "check the box" if it advises certain categories of clients or engages in certain types of advisory activities. The SEC has proposed expanding these categories of clients and advisory activities to gain more insight into an adviser's client base and advisory activities. With respect to clients, the SEC has proposed adding business development companies, insurance companies, and other investment advisers as new categories of clients and to distinguish pensions and profit-sharing plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) from those that are not subject to ERISA. The SEC has also proposed requiring that an adviser estimate the percentage of its total regulatory assets under management that are represented by each client type. Also, the SEC has proposed requiring advisers to indicate the approximate percentage of its clients that are not United States persons

With respect to advisory activities, the SEC has proposed expanding the list of advisory activities to include portfolio management for pooled investment vehicles, other than registered investment companies, and educational seminars or workshops. In addition, the SEC would mandate a new disclosure that would require an adviser to indicate the types of investments for which the adviser provided investment advice during a fiscal year.

C. Other Amendments to Form ADV

The SEC also proposed amendments to Items 6 and 7 of Form ADV which require an adviser to indicate whether it or one of its related persons provides certain types of financial services to the adviser's clients. The SEC noted that these amendments are designed to identify any conflicts of interests or risks that could be created by the provision of these services to an adviser's clients. The SEC has also proposed requiring advisers to disclose the name under which they engage in other business activities. In addition, the SEC has also proposed expanding the information an adviser would be required to disclose with respect to its related persons, including identifying information; how the adviser and the related person are related; whether the related person is registered with a foreign financial regulatory authority; and how the adviser and related person share personnel and confidential information.

The SEC also proposed amending Item 8 which discusses the adviser's participation in client transactions. Notably, the SEC has proposed requiring an adviser to indicate whether broker-dealers used by the adviser are related persons of the adviser. Also, an adviser that indicates that it receives soft-dollar benefits would be required to report whether those soft-dollar benefits qualify for the safe harbor provided in Section 28(e) of the Securities Exchange Act of 1934 (Exchange Act) as "eligible research or brokerage services." Also, an adviser would be required to disclose whether it or a related person receives compensation for client referrals.

Also, the SEC would require an adviser to indicate on Form ADV whether it had $1 billion or more in assets under management (as measured by the total assets on the adviser's balance sheet) as of the last day of the adviser's most recent fiscal year. The SEC is interested in identifying such advisers because Section 956 of the Dodd-Frank Act tasks the SEC to work with certain other federal regulators to adopt rules or guidelines addressing excessive incentive-based compensation arrangements, including those for advisers with $1 billion or more in assets under management.

Because of the amendments to the Dodd-Frank Advisers Act registration requirements, the SEC has also proposed conforming changes to Item 2, which requires an adviser to indicate the basis for its SEC registration.

The SEC has also proposed additional amendments to Form ADV, including requiring an adviser to indicate: (a) contact information for its chief compliance officer in Item 1; (b) whether the adviser or any of its control persons is a public-reporting company under the Exchange Act in Item 1; and (c) the number of persons that act as qualified custodians for the adviser's clients.

V. Amendments to the Pay to Play Rule and Other Amendments to the Advisers Act

In the Proposing Release, the SEC also proposed other amendments to the Advisers Act, including amendments to the recently adopted pay-to-play rule found in Rule 206(4)-5 under the Advisers Act, which prohibits an adviser from engaging in certain pay-to-play practices, including paying third party marketers that are not "regulated persons" (i.e. registered investment advisers or broker-dealers subject to rules of a registered national securities association, that restricts its members from engaging in pay to play activities) to solicit government entities on the adviser's behalf.

The rule, as adopted, was designed to cover those investment advisers that were registered with the SEC as well as those investment advisers that relied on the Private Fund Adviser Exemption. Because the Dodd-Frank Act repealed the Private Fund Adviser Exemption, the SEC proposes to amend Rule 206(4)-5 to cover not only registered advisers, but also exempt reporting advisers and foreign private advisers.

In addition, the SEC has proposed amendments to Rule 206(4)-5 to prohibit advisers from paying third party marketers unless they are "regulated municipal advisors", (as opposed to "regulated persons"). "Regulated municipal advisors" would be defined under the Advisers Act as persons that are registered pursuant to Section 15B of the Exchange Act and subject to pay-to-play rules adopted by the Municipal Securities Rulemaking Board (MSRB). The Dodd-Frank Act created a new category of persons called "municipal advisors" that are defined as persons that undertake a solicitation of a municipal entity. These persons include third party solicitors, including registered investment advisers and broker-dealers, that seek business on behalf of an investment adviser from a municipal entity, including a pension fund. These municipal advisors are subject to MSRB rules. The SEC believes that the MSRB will adopt pay-to-play rules that will apply to these municipal advisors.

In addition to amendments to the Advisers Act pay-to-play rule, the SEC is also proposing to amend Rule 204-2 under the Advisers Act, which requires registered advisers to keep certain delineated books and records, including performance-related records. The SEC is proposing to exempt certain advisers that would be required to register with the SEC because of the repeal of the Private Fund Adviser Exemption by the Dodd-Frank Act from having to maintain certain performance-related records as long as the adviser did not voluntarily register with the SEC while it was still eligible for the Private Fund Adviser Exemption. The SEC has also adopted other technical and conforming amendments to the Advisers Act relating to client-counting, the keeping of books and records, and various definitions under the Advisers Act.

VI. Conclusion

The SEC will accept comments on the rule proposals throughJanuary 24, 2011. Comments may be sent via the SEC's internet comment form, which can be found at http://www.sec.gov/rules/proposed.shtml or by sending an email to rule-comments@sec.gov with a subject line of "File Number S7-36-10".

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys.

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SEC Proposes New Rules to Implement Dodd-Frank Exemptions for Certain Categories of Investment Advisers

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In several recent releases, the US Securities and Exchange Commission (SEC) has proposed a series of rules and rule amendments designed to clarify whether certain categories of investment advisers including "family offices"; advisers that advise only "venture capital funds; advisers that advise only "private funds" and manage less than $150 million in assets; certain "foreign private advisers"; and registered commodity trading advisers are eligible for exemption from the registration and other requirements of the Investment Advisers Act of 1940 (Advisers Act). The proposed rules are designed to implement the statutory exemptions created for these categories of investment advisers by the Dodd- Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) which President Obama signed on July 21, 2010.

Historically, many family offices as well as advisers to many private funds (such as hedge funds, private equity funds, and venture capital funds) relied on an exemption from Advisers Act registration found in Section 203(b)(3) of the Advisers Act (Private Fund Adviser Exemption). The Private Fund Adviser Exemption exempted from registration an investment adviser that advised fewer than 15 clients (with each private fund being counted as a single client) in any rolling twelve-month period, that did not hold itself out generally to the public as an investment adviser, and that did not advise registered investment companies. In addition, advisers exempt from registration under the Private Fund Adviser Exemption were not subject to reporting or record-keeping provisions of the Advisers Act and were not subject to periodic examination by the SEC.

The Dodd-Frank Act repealed the Private Fund Adviser Exemption in an attempt to obtain more transparency and regulatory oversight over such advisers, and replaced it with a series of more narrowly tailored exemptions for "family offices"; advisers that advise only "venture capital funds; advisers that advise only "private funds" and manage less than $150 million in assets; certain "foreign private advisers"; and registered commodity trading advisers. The proposed rules, among other things, provide important definitions to terms

such as "family office " and "venture capital funds," which are critical to determining whether an investment adviser is eligible for an exemption. In addition, the proposed rules introduce new reporting obligations for certain categories of advisers, including advisers to venture capital funds and advisers to private funds with less than $150 million in assets under management, even though such advisers would be exempt from Advisers Act registration. Such advisers could also potentially become subject to the Advisers Act's record-keeping requirements and periodic examination of their books and records by the SEC in the future. The following provides a brief overview of each of the exemptions and the rules proposed by the SEC relating to each exemption.

I. Family Offices

Generally, "family offices" are entities established by wealthy families to manage the family's wealth and to provide financial, tax, and estate planning advice and other services to the family members. Historically, family offices relied on the Private Fund Adviser Exemption or applied for an order from the SEC indicating that the requesting family office is not an "investment adviser" as defined in Section 202(a)(11) of the Advisers Act. In light of the repeal of the Private Fund Adviser Exemption, Congress adopted Section 202(a)(11)(G) of the Advisers Act which excludes a "family office" from the definition of an investment adviser. Qualifying family offices generally will not be subject to any provisions of the Advisers Act (including the registration, reporting, and record-keeping provisions) and will not be subject to periodic examination by the SEC staff.

On October 12, 2010, the SEC issued a release (October Release), in which it proposed Rule 202(a)(11)(G)-1 under the Advisers Act, designed to define a "family office." Generally speaking, the proposed definition of a "family office" would be restricted to entities that (a) restrict investment advice about securities to certain "family clients," (b) are wholly-owned by family members, and (c) do not hold themselves out to the public as investment advisers. The SEC reasoned that such entities are in a better position to protect their interests and are not as likely to be in a position to need the protection of the federal securities laws. In proposing the "family office" definition, the SEC seeks to generally exclude entities that provide investment advice to persons that are not affiliated with a family (other than certain family-office employees), as such arrangements would be more likely to resemble those of a typical commercial investment adviser. Therefore, entities that provide investment advice to multiple families would not fall within the definition of a "family office." Nonetheless, entities that do not qualify under the "family office" definition may nonetheless apply for exemptive relief from the SEC as they have been permitted to do in the past.

A. Key Definitions

As defined in the proposed rule, a "family client" would include any: (a) family member; (b) key employee of the family office; (c) charitable foundation, charitable organization, or charitable trust, in each case established and funded exclusively by one or more family members or former family members; (d) trust or estate existing for the sole benefit of one or more family clients; (e) entity wholly owned and controlled exclusively by, and operated for the sole benefit of, one or more family clients; and (f) former family member or former key employee—provided that the family office can only advise such former family member or former key employee with respect to assets already invested (or committed to be invested) by the family office at the time such person becomes a former family member or former key employee and such former family member or former key employee is not permitted to make additional investments (other than those already contractually obligated to be made at the time such person becomes a former family member or former key employee).

The rule proposal would generally define a "family member" to include: (a) the founders of the family office (including their spouses and spousal equivalents), their lineal descendants (including by adoption and stepchildren), and such lineal descendants' spouses or spousal equivalents; (b) the parents of the founders; and (c) the siblings of the founders and such siblings' spouses or spousal equivalents and their lineal descendants (including by adoption and stepchildren) and such lineal descendants' spouses or spousal equivalents. A "key employee" of the family office would include any natural person (including any person who holds a shared ownership interest with that person's spouse or spousal equivalent) who is an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or any employee of the family office (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office, provided that such employee has been performing such functions and duties for or on behalf of the family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.

The SEC proposes to include key employees that are not family members as "family clients" to incentivize highly skilled advisory employees to work for family offices. The SEC further proposes to allow family offices to advise former family members and former key employees with respect to assets already under management at the time such persons become former family members or former key employees to avoid triggering adverse investment or tax consequences for such former family members and former key employees.

B. Involuntary Asset Transfers

In the October Release, the SEC also addressed involuntary transfers of assets managed by a family office (such as transfers through bequests) noting that if such assets are transferred to a person that is not a "family client," the family office generally may not continue to render investment advice with respect to such assets without becoming an investment adviser subject to Adviser Act regulation. However, the family office can continue to render investment advice with respect to such assets for up to four months from the date of the involuntary transfer to permit the family office to transition the management of such assets to another adviser, seek exemptive relief, or restructure its activities to comply with the family office exclusion.

C. Grandfathering Provision

The SEC has also proposed a grandfathering provision for certain advisers that were not registered or required to be registered as of January 1, 2010 solely because they rendered investment advice to the following types of clients: (a) natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010, and are accredited investors, as defined in Regulation D under the Securities Act of 1933 (Securities Act); (b) any company owned exclusively and controlled by one or more family members; or (c) any investment adviser registered under the Advisers Act who provides investment advice and identifies investment opportunities to the family office, invests in such transactions on substantially the same terms as the family office invests, does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than five percent of the value of the total assets as to which the family office provides investment advice. However, entities that qualify for the grandfathering provision would still be treated as investment advisers for purposes of (and therefore be subject to) certain anti-fraud provisions contained in the Advisers Act, including Sections 206(1), (2), and (4).

II. Advisers to Venture Capital Funds

Broadly speaking, venture capital funds are privately offered funds that make investments in private companies that are expanding with the goal of either taking companies public or selling the companies in the future. As with family offices, advisers to venture capital funds have generally relied on the Private Fund Adviser Exemption. In light of its repeal, the Dodd-Frank Act enacted Section 203(l) of the Advisers Act which creates a new exemption from Advisers Act registration for advisers that advise only venture capital funds with the apparent goal of promoting capital-raising for early stage companies. Although such advisers would be exempt from Advisers Act registration, they could nonetheless be subject to other requirements under the Advisers Act including reporting and record-keeping obligations. In addition, such advisers could also become subject to periodic examination of their books and records by the SEC.

On November 19, 2010, the SEC issued a release (November Release) in which it proposed Rule 203(l)-1 under the Advisers Ac, which is designed to define a venture capital fund and to define the parameters of the exemptive relief to be granted to advisers to such funds. Pursuant to proposed Rule 203(l)-1, a venture capital fund would be defined as a private fund that: (a) invests in equity securities of certain "qualifying portfolio companies" in order to provide operating and business expansion capital and acquires at least 80 percent of such equity securities directly from the qualifying portfolio company; (b) directly, or through its investment advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; (c) does not borrow or otherwise incur leverage (other than limited short-term borrowing); (d) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (e) represents itself as a venture capital fund to investors; and (f) is not registered under the Investment Company Act of 1940 (Company Act) and has not elected to be treated as a business development company.

A. Qualifying Investments

To qualify as a venture capital fund, a fund generally would be permitted to invest only in the equity securities of qualifying portfolio companies (or hold cash, cash equivalents, and US Treasury securities with maturities of less than sixty days to fund anticipated investments and redemptions). A "qualifying portfolio company" would generally be defined as a company that: (a) at the time of investment, is not publicly traded; (b) does not incur leverage in connection with the investment by the private fund; (c) uses the capital provided by the fund for operating or business-expansion purposes rather than to buy out other investors; and (d) is not itself a fund (i.e., is an operating company). The SEC clarified that qualifying portfolio companies need not be US companies. In addition, the SEC clarified that if the securities of a qualifying portfolio company become publicly traded after the venture capital fund invests in the company, the venture capital fund may continue to hold the publicly offered securities or sell them on public markets (so as to permit the venture capital fund to exercise its business judgment with respect to the timing of investment dispositions). In addition, the SEC has also noted that it would consider a bridge financing in the form of debt convertible into the common or preferred securities of a qualifying portfolio company in a later round of investment to be an investment in the "equity securities" of the qualifying portfolio company.

In defining a venture capital fund, the SEC seeks to distinguish between traditional venture capital funds and buyout funds. Therefore, the definition of a venture capital fund requires that at least 80 percent of the qualifying portfolio company's securities acquired by the venture capital fund be acquired directly from the company itself (as opposed to the company's founders, angel investors, or other equity holders). Also, to qualify as a venture capital fund, a company in which the venture capital fund invests, cannot obtain leverage in connection with the venture capital fund's investment, which many buyout funds arrange for in connection with an investment in a portfolio company. Nonetheless, portfolio companies may use leverage in the ordinary course of business (for instance, to finance equipment, fund payroll, or otherwise manage cash flow) and still qualify as qualifying portfolio companies.

B. Managerial Assistance

A qualifying venture capital fund must also either control the qualifying portfolio companies in which it invests or have an arrangement under which it offers to provide them significant guidance and counsel concerning the management, operations or business objectives, and policies of the portfolio companies (and actually provide such managerial assistance if the offer to provide such services is accepted by a qualifying portfolio company). The SEC noted that it believes that venture capital funds typically provide significant managerial expertise to their portfolio companies as both an integral component of their investments and also as a significant driver of value in such portfolio companies. The SEC noted that managerial assistance can take many forms, such as active involvement in the company's day-to-day affairs or less active involvement through board representation or exercise of delineated voting rights. Nonetheless, the SEC declined to denote what specific activities would constitute significant managerial assistance pointing to the evolving needs of portfolio companies over time.

The SEC also addressed funds investing as a group noting that each fund in a group must offer (and if accepted, provide) managerial assistance to or exercise control over a qualifying portfolio company to qualify as a venture capital fund.

C. Leverage

To qualify as a venture capital fund, the fund would not be permitted to borrow money, issue debt obligations, provide guarantees, or otherwise incur leverage in (each case) excess of 15 percent of the fund's capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee, or leverage must be for a non-renewable term not to exceed 120 calendar days. The SEC notes that it has established this limit to address perceived concerns that financial leverage utilized by venture capital funds could contribute to systemic risk.

D. No Redemptions

To qualify as a venture capital fund, a fund would not be permitted to grant investors a redemption right except in extraordinary circumstances. However, the fund would be permitted to make *pro rata* distributions to investors as investments mature and are realized. While the November Release did not designate what would constitute "extraordinary circumstances," it does point to several examples of "foreseeable but unexpected" circumstances where redemptions could be permitted, including changes in laws or regulations that impact an investor's investment in a fund.

E. Represents Itself as a Venture Capital Fund

The November Release notes that a venture capital fund would include only those private funds that represent themselves as venture capital funds to investors and prospective investors. The SEC noted that a venture capital fund could represent itself as being a venture capital fund by describing its investment strategy as venture-capital-investing or describing itself as a fund that is managed in compliance with the elements of the proposed rule. The SEC proposes to include this requirement because other types of funds, including multi-strategy hedge funds, may be able to satisfy the other elements of the rule but may not otherwise be engaged in activities typical of most venture capital funds.

F. Private Fund

The November Release notes that only private funds (as defined in the Advisers Act by the Dodd-Frank Act) would qualify as venture capital funds. Section 202(a)(29) of the Advisers Act defines a private fund as an issuer that would be an investment company, as defined in Section 3 of the Company Act but for Sections 3(c)(1) or 3(c)(7) of the Company Act. This definition is designed to exclude registered investment companies, mutual funds, and companies electing to be treated as business development companies from being considered as private funds.

G. Grandfathering Provision

In the November Release, the SEC includes certain "grandfathered" funds as venture capital funds if such funds (a) represented themselves as venture capital funds to investors and potential investors at the time the fund offered its securities; (b) sold securities to one or more investors prior to December 31, 2010; and (c) does not sell any securities to, or accept any additional capital commitments from, any person after July 21, 2011. The SEC seemed to suggest in the text of the November Release, that a fund that has accepted capital commitments on or before the dates specified above would qualify as a venture capital fund even if the capital is called after the specified dates; however, this point is not clear from a reading of the text of the proposed rule. The SEC believes that most funds previously sold as venture capital funds would qualify as grandfathered funds.

III. Advisers to Private Funds

With the repeal of the Private Fund Adviser Exemption, an investment adviser would be subject to Advisers Act registration and regulation if it has at least $100 million in assets under management. However, the Dodd-Frank Act created a new exemption from the Advisers Act registration (found in Section 203(m) of the Advisers Act) for advisers that advise only private funds (as defined in Section 202(a)(29) of the Advisers Act), and have less than $150 million in assets under management. Section 203(m) would not limit the number of private funds that could be managed by an adviser. Although such advisers would be exempt from Advisers Act registration, they could nonetheless be subject to other requirements under the Advisers Act including reporting and record-keeping obligations. In addition, such advisers could also become subject to periodic examination of their books and records by the SEC.

A. Advisers Solely to Private Funds

In the November Release, the SEC affirmed that US advisers would not be eligible for the Section 203(m) exemption if they manage assets of clients that are not private funds. However, foreign advisers that advise other non-private fund clients would still be eligible for the exemption as long as their clients that are United States persons are all qualifying private funds. For purposes of the exemption, the SEC proposes to use the definition of "United States person" found in Regulation S under the Securities Act (which generally uses the residence of an individual and the place of organization for entities) as the basis for determining whether a person or entity is a United States person. The SEC noted one exception from the definition of a United States person stating that discretionary accounts established offshore for the benefit of United States persons would be treated as United States persons.

B. Assets Under Management

As noted above, an adviser must aggregate its assets under management to determine whether it will qualify for the Section 203(m) exemption. The SEC has proposed a new method for calculating assets under management which will be known as an adviser's "regulatory assets under management." The regulatory assets under management will likely be calculated differently from an adviser's actual assets under management. As proposed, an adviser would need to include as part of its regulatory assets under management proprietary assets, assets managed without compensation, and assets of foreign clients. In addition, the SEC has proposed new guidance for calculating the assets under management of private funds. Advisers would be required to count capital commitments made by investors even if such capital had not been called for contribution by the adviser. In addition, advisers would be required to value private fund assets at fair value as opposed to valuing such assets at cost. Sub-advisers to private funds would be required to report only those assets of private funds for which they provide sub-advisory services as opposed to the total assets of the private fund.

An adviser with its principal office or place of business in the United States must count all of its assets under management towards the $150 million threshold. Advisers that do not have a principal office or place of business in the United States need only count those assets managed from a place of business in the United States. For purposes of this exemption, the SEC considers an adviser's principal office and place of business as the location where the adviser controls, or has ultimate responsibility for, the management of private fund assets (i.e., the place where all the advisers' assets are managed, although day-to-day management of certain assets may also take place at another location).

C. Transition Rule

The SEC noted that advisers could unexpectedly cross the $150 million threshold in the course of day-to-day fluctuations in the value of their assets under management. As a result, the SEC has proposed giving an adviser three months from the date it crosses the $150 million threshold to register with the SEC and to adopt compliance policies and procedures required by the Advisers Act. This transition period would only be available to advisers that are in compliance with all applicable SEC reporting requirements.

IV. Exempt Reporting Advisers

Although advisers that advise only venture capital funds and advisers that advise only private funds and have less than $150 million in assets under management would be exempt from Advisers Act registration, the SEC has proposed that such advisers would nonetheless be subject to certain reporting requirements and be known as "exempt reporting advisers." In a companion release issued on November 19, 2010, the SEC proposed that exempt reporting advisers report a subset of the information required by Form ADV, relating to the investment advisory firm and its affiliates, their respective principals, advisory employees, potential conflicts of interest, and any disciplinary actions taken against the firm, its affiliates or its personnel. Forms ADV filed by an exempt reporting adviser would be filed with the SEC and would be available to the general public. For a more in-depth discussion of the proposed reporting regime for exempt reporting advisers, please see "SEC Proposes Rules to Redefine Registration and Reporting Obligations of Investment Advisers," *available at*: http://www.arnoldporter.com/public_document.cfm?id=17124&key=26E0.

V. Sub-Advisory Relationships

The SEC recognized that some sub-advisers render services directly to primary advisers of venture capital funds and private funds as their clients, instead of having venture capital funds and private fund as direct clients. The SEC has noted that if the services rendered to primary advisors of venture capital funds and private funds by sub-advisors solely relate to venture capital funds or private funds, the sub-adviser would be permitted to rely on the exemptions provided in Section 203(l) and Section 203(m) of the Advisers Act respectively.

VI. Foreign Private Advisers

The Dodd-Frank Act also created another exemption from Advisers Act registration for certain "foreign private advisers" that do not advise many US clients and investors or have many assets under management from US clients and investors. This exemption would be found in a new Section 203(b)(3) of the Advisers Act which replaces the Private Fund Adviser Exemption. As a result, those advisers that qualify as "foreign private advisers" would be eligible for exemption not only from the Advisers Act's registration requirement, but also from its reporting and record-keeping requirements. In addition, foreign private advisers would not be subject to periodic examination of their books and records by the SEC.

Pursuant to the Dodd-Frank Act, a "foreign private adviser" is defined in Section 202(a)(30) of the Advisers Act as an adviser that: (a) has no place of business in the United States; (b) has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the investment adviser; (c) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million; and (d) does not hold itself out generally to the public in the United States as an investment adviser. The SEC has proposed Rule 202(a)(30)-1 which defines certain key terms designed to facilitate implementation of the foreign private adviser exemption.

A. Place of Business in the United States

In determining whether a foreign adviser has a place of business in the United States, the SEC has proposed to define a "place of business" as any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities. In addition, the SEC proposes to use the definition of "in the United States" based on the definition of "United States" provided in Regulation S under the Securities Act.

B. Counting US Clients and Investors in Private Funds

As noted above, to qualify for the foreign private adviser exemption, an adviser would not be permitted to have more than fifteen clients in the United States and investors in the United States in private funds advised by the adviser.

Proposed Rule 202(a)(30)-1 under the Advisers Act would define a "client" to include: (a) a natural person and: (i) that person's minor children (whether or not they share the natural person's principal residence), (ii) any relative, spouse, or relative of the spouse of the natural person who has the same principal residence, (iii) all accounts of which the natural person or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries, and (iv) all trusts of which the natural person or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries; (b) a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the organization's investment objectives; and (c) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries. Advisers would need to count clients regardless of whether they receive compensation from such clients.

Proposed Rule 202(a)(30)-1 would define an "investor" in a private fund as any person who would be included in determining the number of beneficial owners of the outstanding securities of a private fund under section 3(c)(1) of the Company Act, or whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under section 3(c)(7) of the Company Act. The SEC proposed this "investor" definition to ensure that advisers would not structure nominee and similar relationships to circumvent the limitation on the number of investors in a private fund to do indirectly what it is not permitted to do directly. The SEC's rule proposal would require an adviser to look through feeder funds in a master-feeder structure to count the holders of securities in the feeder fund as investors. In addition, where the risk of investing in a private fund is transferred from a record-owner to another person through an instrument such as a total return swap, the person that holds such an instrument would be considered the "investor" in the fund.

In addition, advisers would be required to count knowledgeable employees as "investors" even if they do not need to be counted as beneficial owners of a section 3(c)(1) fund or need to qualify as qualified purchasers in a section 3(c)(7) fund. Holders of the short-term paper issued by a private fund would also be counted as "investors" because the private fund's losses would impact such holders.

Nonetheless, to avoid double-counting, investors in the United States that invest in more than one fund need not be counted twice towards the total count. In addition, an adviser need not count a private fund as a client if that adviser has already counted any investor in that private fund as an investor.

In determining whether a "client" or "investor" in a private fund is "in the United States," the SEC proposes to make such a determination based on whether the client or investor is a "United States person" as defined in Regulation S under the Securities Act, except that (a) any discretionary account or similar account that is held on behalf of a person in the United States by a non-US dealer or other professional fiduciary is deemed "in the United States" if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption. In addition, as proposed, the determination as to whether a person would be deemed to be "in the United States" would only be required to be made at the time the person becomes a client or the person invests in the securities of the private fund. This would eliminate the need for advisers to continually monitor the whereabouts of their clients and investors.

C. Assets Under Management

For purposes of determining eligibility for the foreign private adviser exemption, an adviser would need to calculate its assets under management based on the SEC's proposed measure of "regulatory assets under management" described above.

VII. Conclusion

With respect to the family office exemption, the SEC requested comments through November 18, 2010. With respect to the exemptions relating to advisers to venture capital funds, advisers to private funds with assets under management of less than $150 million, and foreign private advisers, the SEC will accept comments on the rule proposals through January 24, 2011. Comments may be sent via the SEC's internet comment form, which can be found at http://www.sec.gov/rules/proposed.shtml or by sending an email to rule-comments@sec.gov with a subject line of "File Number S7-37-10."

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys.

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New CRA Rule Amendments Encourage Institutions to Provide Foreclosure Relief

On December 20, 2010, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the Agencies) published a joint final rule (Final Rule) expanding the category of community development activities that qualify for Community Reinvestment Act (CRA) credit to include loans, investments, and services that support, enable, or facilitate projects or activities under a recent federal program designed to address the home mortgage and foreclosure crisis. The Final Rule becomes effective on January 19, 2011.

As financial institutions know, the CRA requires the Agencies to assess the record of each insured depository institution in helping to meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of the institution, and to take that record into account when evaluating various expansion activities by the institution. Among other things, financial institutions may receive credit in their CRA examinations for community development loans, qualified investments, and community development services which have a primary purpose of "community development." As summarized further below, the Final Rule expands what can count as "community development" activities.

Summary of Final Rule's Expansion in Community Development Activities

Recognizing the need to provide emergency assistance to communities affected by the high level of foreclosures, Congress established the Neighborhood Stabilization Program (NSP) in 2008. The program initially provided emergency funds for the redevelopment of abandoned and foreclosed homes, totaling nearly $4 billion, to states and localities with the greatest need for such funds. In 2009, an additional $2 billion in NSP funding was provided not only to states and local governments, but also to non-profit organizations through a competitive bidding process administered by the United States Department of Housing and Urban Development (HUD).

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More NSP funds, totaling $1 billion, were set aside in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). HUD has established a formula for deciding how to allocate the additional funds. It determines the states and localities with the greatest need based on the number and percentage of home foreclosures, the number and percentage of homes financed by a subprime mortgage-related loan, and the number and percentage of homes in default or delinquency in each state or unit of local government. On September 8, 2010, HUD announced the allocation of $970 million in funds to 283 grantees nationwide.

The Final Rule allows institutions to receive CRA credit for supporting, enabling, or facilitating NSP-eligible activities in the geographic areas targeted in approved NSP plans. NSP-eligible activities are projects or activities that use the NSP funds to:

1. Establish financing mechanisms for purchase and redevelopment of foreclosed upon homes and residential properties;
2. Purchase and rehabilitate homes and residential properties that have been abandoned, or foreclosed upon, in order to sell, rent, or redevelop such homes and properties;
3. Establish and operate land banks for homes and residential properties that have been foreclosed upon;
4. Demolish blighted structures; and
5. Redevelop demolished or vacant properties.

The Dodd-Frank Act requires that at least 25 percent of the NSP funds received by each grantee must be used with respect to low-income individuals and families, and that NSP funds *may not be* used with respect to upper-income individuals and families. However, unlike most CRA activities, the community development activities covered by the Final Rule can benefit *middle-income* individuals and geographies in addition to low- and moderate-income individuals and geographies. The CRA regulations define “middle-income” as “an individual income that is at least 80 percent and less than 120 percent of the area median income or a median family income that is at least 80 percent and less than 120 percent in the case of a geography.”

Thus, under the revised definition of “community development,” a financial institution will receive favorable CRA consideration, for example, for a donation of other real estate owned properties to non-profit housing organizations in eligible middle-income, as well as low- and moderate-income geographies. Additionally, institutions will receive favorable CRA credit, for example, if they provide financing for the purchase and rehabilitation of foreclosed, abandoned, or vacant properties in targeted areas.

Finally, under the current CRA regulations, an institution is evaluated under the current CRA rules primarily on how it helps meet the credit and community development needs of its CRA assessment area(s). The Final Rule provides that an institution that has adequately addressed the community development needs of its assessment area(s) may receive favorable CRA consideration for NSP-eligible activities that are *outside* of its assessment area(s).

While most CRA activities do not have termination dates, the Final Rule provides that NSP-eligible activities will receive favorable consideration if conducted no later than two years after the last date that funds appropriated for the program are required to be spent by the grantees. The Agencies have not set forth a specific termination date; however, they indicated that they will provide reasonable advance notice to institutions in the Federal Register regarding termination of the rule once a specific date has been determined.

The rule, in its proposed form, was welcomed by commenters because it provides a CRA incentive for institutions to engage in activities that stabilize communities affected by foreclosures. This incentive works together with the funding provided by the NSP towards the goal of helping to revive areas that have been devastated by the foreclosure crisis.

Furthermore, we are likely to see further changes to the CRA rules in the near future. The preamble to the Final Rule notes that the Agencies have begun a regulatory review of the CRA rules generally, and that during that process they will carefully consider any comments received that may recommend further changes to, among other things, the definition of "community development." In addition, the Agencies have indicated that they will consider issuing additional guidance in connection with a future revision of the Interagency Questions and Answers Regarding Community Reinvestment or examination procedures to the extent that additional guidance may be needed regarding the provision of CRA credit for activities outside an institution's assessment area(s).

Arnold & Porter LLP is available to respond to questions raised by the Final Rule. We can assist you in determining how the Final Rule may affect your business and industry. For further information, please contact your Arnold & Porter attorney or:

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SEC Proposes Permanent Rules for Registration of Municipal Advisors

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On December 20, 2010, the US Securities and Exchange Commission (SEC or Commission) proposed rules (proposed rules) to provide a permanent registration regime for "municipal advisors" and to delineate the books and records required to be created and maintained by such municipal advisors. These proposed rules are designed to implement Section 975 of the Dodd- Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) which amended Section 15B of the Securities Exchange Act of 1934 (Exchange Act) to require municipal advisors to register with the SEC by October 1, 2010. In addition to the new registration requirement, the Dodd-Frank Act subjects municipal advisors to SEC reporting obligations, an obligation to create and maintain certain books and records specified by SEC rules, fiduciary duties and a duty to deal fairly with their municipal entity clients, and SEC examinations and administrative enforcement authority. The Dodd-Frank Act defines the term "municipal advisor" generally to mean a person (who is not a municipal entity or an employee of 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, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues or (b) undertakes a solicitation of a municipal entity. The statutory definition includes financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders, and swap advisors, if such persons engage in the activities described above.

To meet the October 1, 2010 registration deadline, the SEC proposed an interim temporary final rule to mandate registration by municipal advisors on Form MA-T. The proposed rules are designed to replace the temporary registration regime by December 31, 2011 and to provide further clarification with respect to various statutory provisions, including key terms such as "municipal advisor."

The SEC's rulemaking release (proposing release) accompanying the proposed rules has raised significant concerns about the SEC's broad interpretation of the statutory term "municipal advisor" and related terms and narrow readings to the exemptions for broker-dealers and investment advisers (discussed below) accompanying those registration requirements, which together could have the effect of subjecting a much broader range of persons and entities to municipal advisor registration and regulation. Of particular significance, the proposing release suggests that a person need not receive any compensation for municipal advice in order to trigger municipal advisor registration and that this requirement could be triggered by as little as a single instance of providing advice (which suggests that a variety of innocuous informational and marketing or public outreach activities might trigger municipal advisor registration obligations). For instance, activities such as serving as a bond trustee to a municipal issuer; having the trust department of a bank serve as an advisor to a municipal entity; receiving deposits on behalf of a municipal entity; serving as an escrow agent with respect to the proceeds of municipal securities offerings; serving as an unelected, non-employee appointed member of an advisory board of a municipal entity; or even simply responding to a request for proposals (RFP) that includes a discussion of the products and services that can be made available, may constitute municipal advice. The proposing release interprets the terms "municipal entity" and "obligated persons" broadly to include not only state and local governments and their pension plans, but also self-directed 529 college savings plans, 457 plans and 403(b) plans, as well as private entities that are obligors on revenue bonds (for example, businesses, private schools, universities, or hospitals that raise money through tax-favored bond offerings). The proposing release also requests comments on whether a bank that provides information to municipal entities about deposits is a "municipal advisor."

Financial services firms that are not registered as municipal advisors will, as a practical matter, need to assess whether they currently are triggering municipal advisor registration requirements and find a way to continue to monitor this issue on an on-going basis to avoid inadvertently triggering the municipal advisor registration and other requirements. For firms that become registered as municipal advisors, similar monitoring may be required to determine what parts of the firm's operations and relationships are subject to the regulatory requirements that apply to municipal advisors. Because the proposing release suggests that municipal advisor registration and regulation may be triggered by fairly innocuous, uncompensated activities not involving a regular trade or business, and not necessarily involving entities that most people would think of as municipal government entities, this may be a difficult task.

I. Interim Temporary Final Rule and Temporary Registration Regime

To meet the October 1, 2010 registration deadline, the SEC adopted, on September 1, 2010, Interim Final Temporary Rule 15Ba2-6T (interim temporary rule) to establish a stop-gap registration regime for municipal advisors. The interim temporary rule (and the adopting release accompanying it) did not add much gloss to the statutory terms and essentially requires "municipal advisors" to register with the SEC on temporary Form MA-T and be subject to new and future SEC and Municipal Securities Rulemaking Board (MSRB) rules governing the activities of municipal advisors. Form MA-T requires a municipal advisor to indicate the purpose for which it is submitting the form (i.e., initial application, amendment, or withdrawal), provide certain basic identifying and contact information concerning its business, indicate the nature of its activities, and supply information about its disciplinary history and the disciplinary history of its associated municipal advisor professionals. Form MA-T is required to be filed electronically via the SEC's website and is available to the general public. However, Interim Final Temporary Rule 15Ba2-6T will expire on December 31, 2011, and a municipal advisor's temporary registration by means of Form MA-T will expire on the earliest of: (a) the date the SEC accepts or rejects the municipal advisor's registration pursuant to a permanent registration regime, (b) the date on which the SEC rescinds the municipal advisor's temporary registration, and (c) December 31, 2011. As a result, on December 20, 2010, the SEC proposed new rules to replace the temporary registration regime.

II. The Proposed Permanent Rules

The proposed rules provide further clarification as to who is a "municipal advisor" for purposes of the Dodd-Frank Act, provide new registration forms to be completed by registering municipal advisors, and define the record-keeping obligations to be undertaken by registering municipal advisory firms.

A. Definition of a Municipal Advisor and Related Terms

In addition to defining the term "municipal advisor" (as described above), the Dodd-Frank Act also defines certain terms used in the definition of "municipal advisor", including the terms "municipal entity," "obligated person," "municipal financial products," and "solicitation of a municipal entity or obligated person." In the proposed rules, the SEC provides further clarification regarding the scope of these definitions.

Generally, the term "municipal entity" includes state and local governmental entities (but not federal or foreign governmental entities) as well as the pension plans and other plans sponsored by such governmental entities. The Dodd-Frank Act defines the term "municipal entity" to include any state, political subdivision of a state, or municipal corporate instrumentality of a state, including: (a) any agency, authority, or instrumentality of the state, political subdivision, or municipal corporate instrumentality, (b) any plan, program, or pool of assets sponsored or established by the state, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof, and (c) any other issuer of municipal securities. To provide additional clarification with respect to clause (b) of the definition of "municipal entity", the SEC explained that the definition of "municipal entity" includes, but is not limited to, public pension funds, local government investment pools and other state and local governmental entities or funds, as well as participant-directed investment programs or plans such as 529, 403(b), and 457 plans, and public school systems (including charter schools).

The Dodd-Frank Act defines the term "obligated person" to include any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person, committed by contract or other arrangement to support the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities. "Obligated persons" apparently include businesses and non-profits that access municipal revenue bond offerings to finance projects, such as through municipal conduit issuers. Determining the applicability of municipal advisor requirements in the context of business or non-profit issuers that access municipal bond financing may be particularly complicated. Through the proposed rules, the SEC has exercised its exemptive authority to clarify that the term "obligated persons" would exclude providers of municipal bond insurance, letters of credit, or other liquidity facilities.

The Dodd-Frank Act defines the term "municipal financial products" to include municipal derivatives, guaranteed investment contracts, and investment strategies. The Exchange Act defines the term "investment strategies" to include "plans or programs for the investment of the proceeds of municipal securities that are not municipal derivatives, guaranteed investment contracts, and the recommendation of and brokerage of municipal escrow investments." The SEC interprets the term "investment strategies" to include plans, programs, or pools of assets that invest funds held by or on behalf of a municipal entity which would include 529 college savings plans, local government investment plans, or public pension plans, even if the source of the funds was not a bond offering.

Importantly, however, the term would not include pooled investment vehicles in which a municipal entity invests alongside other investors that are not municipal entities. Thus, if a municipal entity invests in a collective investment fund, mutual fund, private equity fund, or hedge fund, and other non-municipal issuers are also investors in the fund, the fund itself is not treated as a municipal entity. Rendering investment advice to such a fund would not trigger municipal advisor registration. However, third-party placement agents and solicitors that participate in the offer and sale of securities in the fund to a municipal entity (for example a state pension plan) may be subject to municipal advisor registration and regulation as a result of acting as the fund's placement agent.

The SEC also clarified that even where the proceeds of a municipal securities offering are comingled with the general funds or operating funds of a municipal entity, they do not lose their character as proceeds of a municipal securities offering. As a result, it would be important for an advisor with respect to the general funds or operating funds of a municipal entity to determine whether they include proceeds of a municipal securities offering.

The Dodd-Frank Act defines the term "solicitation of a municipal entity or obligated person" to mean "a direct or indirect communication with a municipal entity or obligated person made by a person, for direct or indirect compensation, on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser (as defined in section 202(a)(11) of the Investment Advisers Act of 1940 (Advisers Act)) that does not control, is not controlled by, or is not under common control with the person undertaking such solicitation for the purpose of obtaining or retaining an engagement by a municipal entity or obligated person of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with municipal financial products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity. As a result of this definition, the Commission notes that, unless an exclusion applies, any third-party solicitor that seeks business on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser from a municipal entity must register as a "municipal advisor." For example, a third-party solicitor that seeks business on behalf of an investment adviser from a municipal pension fund or a local government investment pool must register as a municipal advisor. The SEC, however, clarified that the term would not apply to solicitations by a person on behalf of affiliated entities of the solicitor that are controlling, controlled by, or under common control with the solicitor. The proposing release suggests that a single referral can trigger the registration requirement and that a person does not need to be compensated for the referral in the ordinary sense to be subject to registration.

B. Exclusions from the Definition of a Municipal Advisor

The Dodd-Frank Act excludes from the definition of a "municipal advisor": (a) a broker, dealer, or municipal securities dealer serving as an underwriter; (b) any investment adviser registered under the Investment Advisers Act of 1940 (Advisers Act), or persons associated with such investment advisers who are providing "investment advice;" (c) any commodity trading advisor registered under the Commodity Exchange Act or persons associated with a commodity trading advisor who are providing advice related to swaps; (d) attorneys offering legal advice or providing services that are of a traditional legal nature to their municipal entity client; and (e) engineers providing engineering advice. There is not a "bank" exemption from municipal advisor registration requirements (which the SEC interprets as intentional, indicating that Congress meant to subject banks to registration).

In addition, the definition of "municipal advisor" does not exclude newspapers or other publishers, unlike the Advisers Act and the Commodity Exchange Act which exclude newspapers and publishers from the definitions of "investment advisers" and "commodity trading advisors" respectively). The SEC does not discuss this omission in the proposing release, but in light of First Amendment jurisprudence involving the Advisers Act, it may need to create such an exemption by rule or interpretation in order to preserve its regime of municipal advisor registration and regulation from constitutional challenge. Moreover, there is no overt exclusion or exemption for federal employees, self-regulatory organizations, trade associations or their employees, or employees of another state or local government entity that is not the municipal entity being advised, from municipal advisor registration requirements. Given the SEC's position stated in the proposing release that compensation of the municipal advisor, or more than one instance of providing advice, are not required to trigger registration obligations, unless the SEC amends the proposal to contain some common-sense exemptions, the net cast by the municipal advisor regulatory regime may be far broader than even the SEC intended.

In the proposed rules, the SEC attempts to clarify the scope of these exclusions and generally narrows the coverage of these exclusions. For instance, to qualify for the first exclusion, a broker, dealer, or municipal securities dealer must be acting as an underwriter on behalf of a municipal entity or obligated person in connection with the issuance of municipal securities. In addition, the SEC notes that a broker, dealer, or municipal securities dealer acting as an underwriter would not qualify for the exclusion if it otherwise engages in municipal advisory activities, such as advising municipal entities with respect to the investment of bond proceeds or acting as a placement agent for a private equity fund soliciting municipal entities to invest in the fund. The SEC also clarified that even if the broker, dealer, or municipal securities dealer was not compensated for engaging in such municipal advisory activities, the broker, dealer, or municipal securities dealer would not be eligible for the exclusion.

With respect to the exclusion for federally-registered investment advisers,[1] the SEC has proposed that the exclusion would be available to the registered investment adviser and its associated persons as long as the registered investment adviser did not engage in municipal advisory activities that would not be investment advice that is subject to the Advisers Act. Generally speaking, this means that an investment adviser interested in qualifying for the exclusion must limit the coverage of its advisory services to rendering advice relating to the investment of funds on behalf of the municipal entity. The SEC provided the example that an investment adviser that provides advice with respect to the structuring or issuance of municipal securities would not be eligible to claim the exclusion. Activities that are not subject to the Advisers Act (for example rendering investment advice on investments in non-securities financial products such as swaps and deposits, or acting as a non-advisory solicitor for advice or products provided by a third party), would seem to subject a registered investment adviser to municipal advisor registration requirements.

Similarly, commodity trading advisors that engage in municipal advisory activities other than advising with respect to swaps would not be eligible to claim the exclusion.

Also, professionals such as accountants, attorneys, and engineers that engage in municipal advisory activities outside the scope of their professional responsibilities would not be exempt from registration as municipal advisors. The proposing release accompanying the rule places a number of conditions on the attorney, accountant, and engineer exemptions that may limit the exemptions' availability in many common contexts. The proposed registration forms and instructions contain sections specifically designed and labeled for the registration of law firms, accounting firms, and engineers as municipal advisors, suggesting that the SEC anticipates that law firms, accounting firms, and engineers may be required to register as municipal advisors in many instances.

Additionally, although the Dodd-Frank Act makes clear that employees of a municipal entity are excluded from the definition of a municipal advisor, the SEC also clarified that elected officials of a governing body as well as appointed members that are ex-officio members of a governing body by virtue of holding elective office are included as employees of a municipal entity. However, appointed officials who are not municipal entity employees (for example volunteer advisory board members of a municipal entity) and who are not elected by the public would have to register as municipal advisors.

C. The Proposed Registration Regime

To facilitate registration by municipal advisors, the SEC is proposing to introduce several new registration forms. Municipal advisory firms (which include all entities as well as sole proprietorships) would be required to register by completing and submitting Form MA while natural person municipal advisors (including employees of municipal advisory firms as well as sole proprietors) would be required to register by completing Form MA-I. Non-resident municipal advisors,[2] non-resident general partners, or managing

1 The SEC asks in the proposing release whether the investment adviser exemption, which by its terms only applies to federally-registered investment advisers, should be expanded to cover state-registered investment advisers.

2 A municipal advisor or the general partner or managing agent of a municipal advisor would be deemed to be a "non-resident" where (a) in the case of an individual, the person resides in or has a principal office and place of business in any place not in the United States and (b) in the case of a corporation, the corporation is incorporated in or has a principal office and place of business in any place not in the United States.

agents of municipal advisors would also be required to provide a consent and irrevocable power of attorney to the SEC to appoint an agent for service of process by filing Form MA-NR. Firms or persons that are no longer considered to be "municipal advisors" would file Form MA-W to withdraw their registration as municipal advisors. These forms would be electronically filed on the SEC's website by applicants, and the information would become available to the general public. The SEC believes that these new mandated disclosures provide the public with important information about municipal advisors, assist the SEC in understanding the businesses of these municipal advisors, and allow the SEC to provide important information to the MSRB to better inform its regulation of municipal advisors. The SEC is currently considering whether municipal advisors should be charged for filing these forms. In addition, because these forms would be considered "reports" for certain provisions under the Exchange Act, it would become unlawful for a municipal advisor to make (or cause to be made) a willful misstatement of a material fact or an omission of a material fact in such forms.

Form MA and Form MA-I, which are modeled on Part I of Form ADV which is completed by registering investment advisers, both include a series of fill-in-the-blank, multiple choice, and check-the-box questions about a registering municipal advisor's business. Form MA would require significant disclosures, including, among other things, the following types of information: (a) basic information about an applicant, including name, contact information, and other identifying information (Item 1); (b) the applicant's form of organization (Item 2); (c) information as to whether the applicant is succeeding to the business of a registrant (Item 3); (d) information (and in some instances identifying information) relating to the applicant's employees, clients, and firms that solicit municipal advisory clients on the applicant's behalf as well as the types of municipal advisory activities engaged in by the applicant (Item 4 and Schedule D); (e) information about an applicant's other business activities (Item 5), (f) information about an applicant's associated persons and the types of activities in which they are engaged (Item 6); (g) information about participation by the applicant or its associated persons in the transactions of its municipal advisory clients (Item 7); (h) information about the persons directly or indirectly controlling or controlled by the applicant (Item 8 and Schedules A and B); (i) information about the disciplinary history of the applicant and its associated persons (Item 9); and (j) information about an applicant to determine whether the applicant is a small business (Item 10). The execution page for Form MA would require the applicant to certify that, among other things: (a) the books and records required to be maintained by the applicant will be preserved and available for inspection; (b) the applicant and any natural person associated with the applicant has met or will meet the qualification standards set by the SEC, the MSRB, or any other self-regulatory organization; and (c) the applicant has conducted a review to determine that the applicant can comply with and has complied with its regulatory obligations under the federal securities laws, the rules of the MSRB, or the rules of any other self-regulatory organization, and has documented this review process.

Persons registering as natural person municipal advisors (including employees of municipal advisory firms) would be required to supply the following information on Form MA-I: (a) basic information about the applicant and its relationship with a municipal advisory firm if applicable (Items 1 and 2); (b) information about the applicant's residential history for the last five years (Item 3); (c) information about the applicant's employment history for the past ten years (Item 4); (d) information about the applicant's other business activities (Item 5); and (e) information about the applicant's disciplinary history (Item 6). Applicants completing Form MA-I would also be required to certify that, among other things: (a) they are qualified to carry out their designated functions; (b) they will meet qualification standards required by the SEC, the MSRB, or any other self-regulatory organization; and (c) they have the necessary understanding of all of their applicable regulatory obligations and the ability to comply with such obligations.

Within 45 days of the filing of an application on Form MA or Form MA-I, the SEC must either grant such an application or institute proceedings to determine whether the application should be denied.

Once registered, a municipal advisor that has filed Form MA must update the information in Form MA and provide another self-certification (as described above) at least annually within 90 days of the end of the applicant's fiscal year, and if the applicant is a sole proprietorship, within 90 days of the end of the calendar year. In some cases, Form MA would be required to be amended more frequently. A municipal advisory firm registrant would be required to update Form MA promptly if: (a) any information contained in Items 1, 2, or 9 becomes inaccurate in any way; and (b) if any information contained in Items 3, 7, or 8 becomes materially inaccurate. A natural person municipal advisor would not be required to update Form MA-I annually. Rather, a natural person municipal advisor registrant would only be required to update Form MA-I promptly if any information contained in Form MA-I becomes inaccurate. Nonetheless, the natural person municipal advisor registrant would be required to provide an annual self-certification (as described above) within 90 days of the end of the calendar year. A non-resident municipal advisor or non-resident general partner or managing agent of a municipal advisor must amend Form MA-NR if any information becomes inaccurate. Also, if the appointed agent of such persons is discharged by the municipal advisor, its general partner, or managing agent or the agent refuses to accept service of process on behalf of the registrant, the registrant must appoint a new agent and amend Form MA-NR.

Similar to its approach with registered investment advisers, the SEC has also proposed a new rule that permits the successor to a registrant to continue to rely on its predecessor's registration as a municipal advisor for a limited period of time to avoid interruptions in the successor's business.

D. New Record-Keeping Requirements

The proposed rules would require all registered municipal advisory firms (but not natural person municipal advisors) to keep certain books and records relating to their municipal advisory activities, including: (a) all communications received and sent relating to their municipal advisory activities regardless of the format; (b) all checkbooks, bank statements, cancelled checks, and cash reconciliations of the municipal advisor; (c) a copy of the municipal advisor's policies and procedures for the past five years; (d) a copy of documents material to making recommendations to municipal entities or obligated persons or documents that memorialize the basis for that recommendation; (e) written agreements with municipal entities, employees of municipal entities, or obligated persons or agreements otherwise related to the business of the municipal advisor; (f) names of persons that were associated persons of the municipal advisor for the past five years; (g) identifying and contact information relating to persons that the municipal advisor compensates or is compensated by in connection with the solicitation of business from municipal entities, employees of municipal entities, or obligated persons; and (h) a record of the initial or annual review (as applicable) conducted by the municipal advisor in connection with its self-certification on Form MA. Most books and records must be kept for at least five years, and for the first two years, in an easily accessible place. A municipal advisory firm's organizational documents, including partnership articles, articles of incorporation, charters, minute books, or stock certificate books must be kept in the municipal advisor's principal place of business for at least three years after the termination of the municipal advisor's business or its withdrawal from registration as a municipal advisor. Books and records can be kept in electronic form. These books and records provide the SEC with a roadmap for examinations of municipal advisory firms.

E. SEC Examination and Administrative Enforcement Authority

The Dodd-Frank Act also amended Sections 15B(c) and 17(a) of the Exchange Act to grant the SEC authority to examine municipal advisors (including municipal advisors that are banks), to bring administrative enforcement actions against municipal advisors and to discipline municipal advisors.

III. Conclusion

The SEC will accept comments on the rule proposals through February 22, 2011. Comments may be sent via the SEC's internet comment form, which can be found at: http://www.sec.gov/rules/proposed.shtml or by sending an email to rule-comments@sec.gov with a subject line of "File Number S7-45-10".

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys.

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ADVISORY

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Federal Reserve Proposes Rule to Define the Nonbank Financial Companies It Could Supervise

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The Board of Governors of the Federal Reserve System (Board) published for comment on February 11, 2011, a proposed rule (Proposed Rule) establishing the criteria for defining a "nonbank financial company" that could be subject to the supervision of the Board, upon the determination of the Financial Stability Oversight Council (FSOC). The Proposed Rule implements Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which requires the FSOC to determine "nonbank financial companies" that could pose a threat to the financial stability of the United States, and subject these designated companies to supervision by the Board (Systemic Importance Determination). A nonbank financial company subject to the Board's supervision must adhere to prudential standards, reporting, and disclosure requirements.[1]

Under the Proposed Rule, a nonbank financial company would be a company predominantly engaged in financial activities (as defined by the Bank Holding Company Act), such that for *either* of the past two years, that company derived 85 percent or more of its annual gross revenues or consolidated assets from financial activities. In addition, under the Proposed Rule, the FSOC will consider a nonbank financial company's transactions with other nonbank financial companies and bank holding companies, with total assets of US$50 billion or more, in its Systemic Importance Determination.

In January 2011, the FSOC proposed the criteria for a Systemic Importance Determination of a nonbank financial company. The Board's Proposed Rule subsequently provides tests for determining which companies are nonbank financial companies, and thus eligible to be subject to a Systemic Importance Determination. The Board has issued this Proposed Rule to allow the FSOC to promptly engage in Systemic Importance Determinations upon the FSOC's final adoption of its determination criteria, likely during the second quarter of 2011.

1 A summary of the Dodd-Frank Act requirements for nonbank financial companies supervised by the Board has been provided through a recent advisory (*See* "Dodd-Frank Act Addresses Systemic Risk," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16151&key=17B3).

The Board has requested that comments on the Proposed Rule be received by *March 30, 2011*. The provisions of the Proposed Rule are summarized below.

Tests for Determining a Nonbank Financial Company

Under the Dodd Frank Act, a "nonbank financial company" is defined by the extent to which the company is predominantly engaged in activities that are financial in nature. A company is predominantly engaged in activities that are financial in nature if, according to the Dodd Frank Act:

- The *annual gross revenues* derived by the company and all of its subsidiaries from activities that are financial in nature and, if applicable, from the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated annual gross revenues of the company; or
- The *consolidated assets* of the company and all of its subsidiaries related to the activities that are financial in nature and, if applicable, related to the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated assets of the company.[2]

Section 110(b) of the Dodd-Frank Act authorizes the Board to establish by regulation the requirements for determining if a company is predominantly engaged in financial activities. Under this authority, the Board has proposed two alternative tests for determining that a company is "predominantly engaged" in financial activities and therefore classified as a nonbank financial company.

- The first test, described as the Two-Year Test, examines the above criteria from the Dodd Frank Act for *either* of the two most recently completed fiscal years. Thus, if a company's annual gross revenues or consolidated assets are financial in nature by 85 percent or more in either of the two most recently completed fiscal years, then that company is a nonbank financial company.
- The second test is a case-by-case determination by the Board. The Board may use the facts and circumstances of a company to subjectively determine whether 85 percent or more of a company's annual gross revenues or consolidated assets are financial in nature.

In determining whether a company is predominantly engaged in financial activities, the Proposed Rule has also provided additional considerations. First, if a company has an equity investment in another company but the two companies do not issue consolidated financial statements, then the investor company must consider its equity investment to be financial in nature if the investee company itself is predominantly engaged in financial activities under the Two-Year Test. This consideration reduces a company's obligation to calculate the exact percentage of an investee company's financial activities, but it may also force an investor company to consider the entire revenues or asset value of the equity investment as financial in nature. Second, the Proposed Rule permits a company to treat as nonfinancial the revenues and assets derived from de minimis equity investments. This consideration is subject to conditions limiting the amount of the equity investment, and the permissible investee company types.

Accounting Standards for the Nonbank Financial Company Tests

The Board proposes to allow companies to use their consolidated, year-end financial statements as the basis for determining annual gross revenues and consolidated assets. The financial statements may be prepared according to generally accepted accounting principles (GAAP), or International Financial Reporting Standards. Also, the Board would allow a company to use an alternative accounting standard upon the Board's approval and determination that the alternative accounting standard would be likely to ensure a fair and accurate presentation of the company's revenues and assets in a manner similar to GAAP. This alternative would potentially allow the Board to evaluate the financial statements of foreign companies using customary accounting methods, and domestic insurance companies using statutory accounting methods.

2 12 U.S.C. § 5311(a)(6).

Activities Designated as Financial in Nature

The Board has clarified in its Proposed Rule that the list of activities that are financial in nature are those activities determined to be financial in nature under the Bank Holding Company Act[3] and listed in Regulation Y.[4] These activities, among others, include:

- Activities closely related to banking activities such as:
  - — credit extension and debt collection activities;
  - — real estate appraising;
  - — asset management;
  - — credit bureau services; and
  - — check cashing and check guaranty activities.
- Activities determined by the Board to be usual in connection with the transaction of banking or other financial operations abroad such as:
  - — management consulting services;
  - — travel agency operations; and
  - — the organization, sponsorship, and management of a mutual fund.
- Activities defined as financial in nature by the Gramm-Leach-Bliley Act such as:
  - — insurance or annuity services provided in a principal or agent capacity;
  - — securities underwriting, or making a market in securities; and
  - — merchant banking activities used to control nonfinancial companies.

Similar to Regulation Y, the Proposed Rule also permits a company to request a determination of the Board as to whether a specific activity is financial in nature.

Significant Nonbank Financial Companies

Finally, and most significantly for many nonbank companies, the Proposed Rule also defines the term "*significant* nonbank financial company." The Board has defined the term as:

- Any nonbank financial company supervised by the Board; and
- Any other nonbank financial company that had US$50 billion or more in total consolidated assets as of the end of its most recently completed fiscal year.

In addition, the Board has proposed the term "significant bank holding company" to mean any bank holding company with US$50 billion or more in total consolidated assets at the end of the most recently completed calendar year.

The Dodd-Frank Act uses the term "significant nonbank financial company" as a classification for FSOC determination and reporting purposes. First, the extent and nature of a nonbank financial company's transactions with significant nonbank financial companies and significant bank holding companies are factors in the FSOC's consideration of a Systemic Importance Determination. Second, a nonbank financial company subject to a Systemic Importance Determination must submit a periodic credit exposure report that describes the nature and extent to which the supervised company has credit exposure to significant nonbank financial companies and significant bank holding companies.

* * * *

The Board has requested comments by *March 30, 2011* on the Proposed Rule. In particular, the Board requests comments on the appropriateness of the Proposed Rule, and any other provisions that should be included. Arnold & Porter LLP is available to respond to questions raised by the Proposed Rule or to provide any assistance in drafting comments. We also can assist in determining how these rule changes may affect your business and in ensuring that your business is compliant when the Proposed Rule is finalized.

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3 12 U.S.C. § 1843(k).

4 12 C.F.R. Pt. 225.

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Consumer Financial Protection Bureau Seeks Comment on Definition of "Larger Participants" for Nonbank Supervision Program

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Last week, on June 23, 2011, the new Consumer Financial Protection Bureau (CFPB) issued its first notice and request for comment (Notice). The Notice requested input on how the CFPB should define "larger participants" for purposes of its supervision of nondepository entities that provide consumer financial products and services. These nondepository providers are for the first time subject to federal supervision by the CFPB under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act). While certain entities, including nonbank mortgage companies, private education lenders, and payday lenders are subject to this supervision regardless of size, other providers of nonbank financial services are generally only subject to CFPB supervision if they are deemed to be a "larger participant" in a financial market.[1] The Notice solicits comments on how those "larger participants" are to be identified.

The Act requires that the CFPB issue an initial rule to define the entities that are "larger participants of a market for other consumer financial products or services."[2] A variety of consumer financial products and services offered by nondepository entities could potentially be subject to supervision by the CFPB under the "larger participant" rule. The Notice identifies the following markets for possible inclusion in the initial rule: (1) debt collection; (2) consumer reporting; (3) consumer credit and related activities; (4) money transmitting, check cashing, and related activities; (5) prepaid cards; and (6) debt relief services. These markets are consistent with the CFPB's public statements as to its priorities. The Notice solicits comment on whether these categories should be covered by

1 The CFPB also has the authority to supervise any covered person that it "has reasonable cause to determine, by order, after notice and a reasonable opportunity to respond" that such covered person "is engaging, or has engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services." Act § 1024(a)(1)(C).

2 *See* Act §§ 1024(a)(1)(B) and 1024(a)(2).

How does the Dodd-Frank Act affect your business? The 2,300-page act requires or permits the creation of more than 250 new regulations. Read our: Compendium of Advisories, Rulemakings Weekly Update, and Rulemakings Chart.

the initial rule, whether each category consists of a single market or multiple markets, whether other markets should be addressed by the rule, how the markets included in the rule should be defined, and whether all such markets should be national in scope or whether the CFPB should consider regional or other geographic markets.

Comments on the Notice are due by August 15, 2011. The Notice states that the CFPB will draft and issue a proposed rule for public comment after considering the comments it receives on the Notice and other relevant information. The CFPB must issue the initial rule no later than July 21, 2012 (i.e., one year after the designated transfer date), after consultation with the Federal Trade Commission. The Notice states that although the CFPB anticipates including certain specified markets in an initial rule, additional markets may be added through subsequent rulemakings.

The "larger participant" rule supposedly does not create any new substantive consumer protection requirements to be imposed upon nondepository entities. Rather, the rule will provide the CFPB with authority to supervise larger participants in certain markets by conducting periodic examinations and requiring reports for purposes of assessing compliance with the requirements of federal consumer financial laws, obtaining information about the activities and compliance systems or procedures of such person, and detecting and assessing risks to consumers and to markets for consumer financial products and services. As defined in the Act, the "federal consumer financial laws" include nearly every existing federal consumer financial statute, as well as new consumer financial protection mandates prescribed by the CFPB under the Act, such as the new mortgage loan standards set forth in Title XIV. The federal consumer financial laws include, for example, the Truth in Lending Act, the Fair Debt Collection Practices Act, the Equal Credit Opportunity Act, and the Fair Credit Reporting Act.

The Notice solicits public comment on the (1) criteria and thresholds, (2) data sources, and (3) measurement dates and supervision timeframes that the CFPB should use to define a "larger participant." Specifically, the Notice seeks comment on whether a larger participant should be defined based on the relative size of the participants within a market, or rather based upon an absolute threshold. The Notice states that examples of potential criteria that could be used to define larger participants of a market include one or a combination of the following: (1) annual number of transactions in the market; (2) annual value of transactions (e.g., total loan volume); (3) annual receipts or revenue; (4) geographic coverage (e.g., number of states where engaged in business); (5) asset size; and (6) outstanding loan balances. Comment is also solicited on whether the CFPB should use more than one criterion to define a larger participant and whether the same criteria and thresholds should be used to define a larger participant for every market.

The Notice also solicits public comment on the types of reliable data sources that are available and suitable for the CFPB to use in its larger participant determinations. The Notice states that the type of data that could be used in connection with an initial rule might include: (1) public data from sources such as the Securities and Exchange Commission's online EDGAR database and state and federal licensing and registration records; (2) nonpublic state or federal supervisory or other data; (3) commercial data, such as proprietary industry market analyses; and (4) data obtained directly from market participants.

The Act also provides that the CFPB may establish registration requirements for certain covered persons.[3] The Notice states that the CFPB is considering the establishment of such requirements through a future rulemaking and solicits public comment concerning the type of data that it should collect through such a registration process to use in its larger participant determinations.

With respect to measurement dates and supervision timeframes, the Notice seeks comments on: (1) the

3 *See* Act § 1024(b)(7).

timeframe during which the market participant's size should be measured (e.g., the previous year, two years, or more); (2) the factors the CFPB should consider in the event of a merger of market participants; and (3) the length of time for which a market participant should be subject to supervision once it meets the applicable threshold.

Arnold & Porter LLP is available to assist you in preparing comments on the Notice or in determining how the Notice or the Act may affect your business. For further information, please contact your Arnold & Porter attorney or:

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FDIC Finalizes Dodd-Frank Act Living Will Requirements for Systemically Important Companies

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On September 13, 2011, the Federal Deposit Insurance Corporation (FDIC) approved a Final Rule that requires certain bank holding companies, foreign banks or companies, and systemically important nonbank financial companies, to periodically submit resolution plans, or "living wills," describing how they can be resolved in an orderly manner under the Bankruptcy Code in the event of material financial distress or failure. Once approved by the Board of Governors of the Federal Reserve System (FRB), the Final Rule will be issued jointly by the FDIC and the FRB (collectively, the "Agencies"). Implementing Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Final Rule establishes rules and requirements regarding the submission and content of a resolution plan, as well as procedures for review of the plan by the Agencies. In April 2011, the Agencies released for public comment a proposed version of the resolution plan rules (Proposed Rule). The Final Rule reflects a number of significant changes that were largely prompted by comments submitted by banking organizations, industry groups, and other interested parties.[1]

The Dodd-Frank Act required that the Agencies jointly issue final rules no later than January 21, 2012. The FDIC staff proposed to the Board of Directors of the FDIC that the effective date of the Final Rule be 30 days after its publication in the Federal Register. The Final Rule will likely become effective prior to the statutory deadline.

I. Who is "Covered" By the Final Rule?

The following companies are required to submit resolution plans under the Final Rule (collectively, the "Covered Companies"):

- Nonbank financial companies that have been designated by the Financial Stability Oversight Counsel (FSOC) as being systemically important under Section 113 of the Dodd-Frank Act and therefore are supervised by the FRB;[2]

1 As a complement to the Final Rule, the FDIC also approved on September 13 an Interim Final Rule that requires each US insured depository institution with $50 billion or more in total assets to submit a plan for the resolution by the FDIC, as receiver, of such institution in the event of the institution's failure. Currently, 37 insured depository institutions are covered by the Interim Final Rule. Comments on the Interim Final Rule are due on November 21, 2011.

2 The FSOC has not yet finalized the regulations which establish the standards for designation as a

- Bank holding companies that have US$50 billion or more in total consolidated assets; and
- Foreign banks or companies that are, or are treated as, bank holding companies under Section 8(a) of the International Banking Act of 1978, *and* that have US$50 billion or more in total consolidated assets.

The Agencies have estimated that there are 124 companies that would be subject to the Final Rule. To mitigate the possibility of balance sheet manipulation to escape the Final Rule's coverage, the Final Rule provides that once a bank holding company becomes a Covered Company, it will remain so until it has less than US$45 billion in total consolidated assets, as determined based on the most recent annual or, as applicable, the average of the four most recent quarterly reports. Such a company may become a Covered Company once again if it reports US$50 billion in total consolidated assets on its most recent annual report or, as applicable, the average of its four most recent quarterly reports.

II. Timeframe for Submission

The Final Rule provides Covered Companies with more time to prepare and submit resolution plans than would have been provided under the Proposed Rule. Under the Proposed Rule, resolution plans for all Covered Companies would have been due 180 days following the effective date of the rule. Under the Final Rule, each Covered Company is required to submit its initial resolution plan on a staggered basis depending on the size of the company's US-based nonbank operations as of the effective date of the Final Rule. A Covered Company must submit its initial resolution plan in accordance with the following schedule:

- By **July 1, 2012** if it has **US$250 billion or more** in total nonbank assets (or, in the case of a foreign-based company, in total US nonbank assets);
- By **July 1, 2013** if it has **US$100 billion or more** in total nonbank assets (or, in the case of a foreign-based company, in total US nonbank assets);
- By **December 31, 2013** if it has **less than US$100 billion** in total nonbank assets (or, in the case of a foreign-based company, in total US nonbank assets).

A company that becomes a Covered Company after the effective date of the final rule must submit its resolution plan by the July 1 following the date it becomes a Covered Company, provided that it has been a Covered Company for at least 270 days. While the Final Rule is unclear on this point, it appears that if a company has become a Covered Company less than 270 days before July 1, such company would be expected to file its initial resolution plan by the end of the 270 day period. For example, with respect to a company that becomes a Covered Company with US$100 million or more in total nonbank assets on May 1, 2013, it appears that such company would be expected to file its initial resolution plan by January 27, 2014.

The Final Rule requires each Covered Company to submit updated resolution plans annually on or before the anniversary of its initial submission date. The Agencies may jointly modify the date for an initial or annual submission so long as they provide written notice of such determination no later than 180 days prior to the date upon which they are requiring the resolution plan to be submitted. In addition to the initial and annual submissions of resolution plans, each Covered Company is required to provide the Agencies with notice no later than 45 days after any event or change in circumstances that results in, or could reasonably be foreseen to have, a "material effect" on the resolution plan, unless its annual resolution plan is due within 90 days. The notice must describe the material event and explain why it may require changes to the resolution plan. The material event must be addressed in the Covered Company's next resolution plan.

III. Informational Content of a Resolution Plan

A Covered Company domiciled in the United States is required to provide detailed information outlined in the Final Rule with regard to both its US operations and its foreign operations. A foreign-based Covered Company is required

systemically important nonbank financial company. Therefore, no such designations have been made to date. Recent comments by FRB Governor Daniel Tarullo suggest that a relatively small number of companies will be so designated.

to provide such information regarding its US operations, an explanation of how resolution planning for its US operations is integrated into its overall resolution planning, and a description of the interconnections and interdependencies among its US operations and its foreign-based operations.

Specifically, each resolution plan must include the following components:

Executive Summary. An executive summary must summarize the key elements of the Covered Company's strategic plan, material changes from the most recently filed plan, and any actions taken by the Covered Company to improve the effectiveness of the plan, or remediate or mitigate any material weaknesses or impediments thereto.

Strategic Analysis. A resolution plan must include a detailed and comprehensive strategic analysis describing the Covered Company's plan for rapid and orderly resolution in the event of material financial distress or failure of the Covered Company. The strategic analysis must include any key assumptions and supporting analysis for the resolution plan, and it must address a number of areas set forth in the Final Rule.

Corporate Governance. This component must include a detailed description of how resolution planning is integrated into the corporate governance structure of the company, including identification of the senior management official(s) primarily responsible for overseeing the plan.

Organizational Structure. The resolution plan must include detailed information about the Covered Company's organizational structure, including a hierarchical list of all material entities (including ownership, jurisdiction, and management information on each entity), critical operations and core businesses, financial statements, capital and cash flows, liabilities, off-balance sheet exposures, trading and derivatives activities, hedging activities, major counterparties, and trading systems.

Management Information Systems. This component must include a mapping of the key management information systems and applications to the material entities, critical operations, and core business lines of the company. The plan must also describe the process for supervisory and regulatory agencies to access such systems and applications.

Interconnections and Interdependencies. The resolution plan must identify the interconnections and interdependencies among the company and its material entities, critical operations, and core business lines, including shared resources, funding arrangements, credit exposures, and cross-entity arrangements.

Supervisory and Regulatory Information. The resolution plan must identify all the federal, state, or foreign agencies with supervisory authority or responsibility over the Covered Company and its material entities, critical operations, and core business lines.

IV. Tailored Resolution Plans

In response to comments on the Proposed Rule, the Final Rule permits smaller, less complex bank holding companies and foreign banking organizations that predominately operate through one or more insured depository institutions (or, in the case of a large number of foreign banking organizations subject to the rule, one or more branches or agencies) to elect to file a "tailored" resolution plan that focuses only on resolution of the company's nonbank operations and business lines subject to the Bankruptcy Code, and the interconnections of such operations with those of its US insured depository institution(s) and, in the case of a foreign banking organization, its branches and agencies. A Covered Company may elect to file a tailored resolution plan if, as of the end of the prior calendar year, it had less than US$100 billion in total nonbank assets (or, in the case of a foreign-based company, in total US nonbank assets), and total insured depository assets comprise 85 percent or more of the company's total consolidated assets (or, in the case of a foreign-based company, the assets of its US insured depository institution operations, branches, and agencies comprise 85 percent or more of its US total consolidated assets).

A Covered Company must submit written notice of its intent to submit a tailored resolution plan no later than 270 days prior to its required submission date. Within 90 days of receiving such notice, the Agencies will determine whether the Covered Company will be allowed to submit a tailored resolution plan or whether it must nonetheless submit the full resolution plan.

V. Agency Review Process and Consequences of Noncompliance

The Final Rule requires the Agencies to review a resolution plan within 60 days of submission and determine jointly whether the resolution plan is incomplete or that additional information is necessary to facilitate review. If the resolution plan is incomplete, the Covered Company will have 30 days to submit a revised plan. If the Agencies determine that the resolution plan is not credible or would not facilitate an orderly resolution of the Covered Company under the Bankruptcy Code, then they will notify the Covered Company that the plan is deficient and such company must submit a revised plan addressing the deficiencies within 90 days of receipt of such notice. The Final Rule permits the Agencies to extend these timeframes on their own initiative or in response to an extension request.

The preamble to the Final Rule states that the Agencies do not anticipate that initial resolution plans will be found to be deficient, but rather that such plans will serve as a foundation for more robust annual resolution plans over the next few years. Recognizing that resolution plans will vary by company, the Agencies have stated that their evaluation of the plans will take into account variances among companies in their core business lines, critical operations, domestic and foreign operations, capital structure, risk , complexity, financial activities, and size, among other things. The Agencies have indicated that they expect the review process to evolve as Covered Companies gain more experience in preparing their resolution plans.

If a Covered Company fails to timely submit a resolution plan or such plan fails to remedy the deficiencies identified by the Agencies, then the Agencies may subject the Covered Company or any of its subsidiaries to more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations. Such requirements or restrictions will apply until the Agencies determine that the Covered Company has submitted a revised resolution plan that adequately remedies the deficiencies. If the Covered Company does not submit a revised resolution plan that adequately remedies the deficiencies within two years of the imposition of the requirements or restrictions, then the Agencies in consultation with the FSOC, may order the divestiture of assets or operations as they deem necessary to facilitate an orderly resolution of the Covered Company under the Bankruptcy Code.

VI. Confidentiality

One of the major concerns expressed in many of the comments on the Proposed Rule was the extent to which information submitted in connection with a resolution plan would receive confidential treatment, given that the Final Rule requires Covered Companies to submit very detailed, internal proprietary information that would not normally be made available to the public. Commenters expressed concern that the Proposed Rule did not provide adequate assurance that resolution plans would be kept confidential, particularly given the public disclosure requirements of the Freedom of Information Act (FOIA). The Final Rule attempts to address this concern by explicitly permitting a Covered Company that submits a resolution plan to request confidential treatment in accordance with exemption 4 of FOIA (i.e., the exemption for trade secrets and commercial or financial information), and the corresponding regulatory exemptions of the Agencies. However, while the preamble to the Final Rule suggests that some information will be subject to exemption 8 of FOIA as “confidential supervisory information” (i.e., the “examination exemption”), the absence of explicit language in the Final Rule makes it unclear the extent to which confidential treatment will be granted under exemption 8 of FOIA.

The Final Rule states that each resolution plan must be divided into a public section and a confidential section. The public section of the resolution plan must include the executive summary. The Final Rule lists 11 types of information that must be included in the executive summary to the extent material to an understanding of the covered company, including:

- The names of material entities;
- A description of core business lines;
- Consolidated or segment financial statements regarding assets, liabilities, capital, and major funding sources;
- A description of derivative activities and hedging activities;
- A list of memberships in material payment, clearing, and settlement systems;
- A description of foreign operations;
- The identities of material supervisory authorities;
- The identities of the principal officers;
- A description of the corporate governance structure and processes related to resolution planning;
- A description of material management information systems; and
- A description, at a high level, of a Covered Company's resolution strategy.

A Covered Company must submit a properly substantiated request for confidential treatment of any information in the confidential section of its resolution plan that it believes is subject to protection from disclosure under exemption 4 of FOIA. The Agencies will determine at their discretion whether to grant FOIA exemption requests. Thus, confidentiality will likely remain a highly controversial issue as Covered Companies begin to submit their initial and annual resolution plans.

VII. Interplay Between the Final Rule and the Interim Final Rule

As a complement to the Final Rule, on September 13, 2011, the FDIC approved an Interim Final Rule that requires each US insured depository institution with US$50 billion or more in total assets to submit a plan for the resolution by the FDIC, as receiver, of such institution in the event of the institution's failure (the "IDI Interim Final Rule"). The IDI Interim Final Rule followed a Notice of Proposed Rulemaking that was published in the Federal Register on May 17, 2010, requiring Special Reporting, Analysis, and Contingent Resolution Plans at Certain Large Depository Institutions. That proposed rule would have required each insured depository institution with greater than US$10 billion in total assets that is owned or controlled by a holding company with more than US$100 billion in total assets to submit to the FDIC a resolution plan demonstrating the insured depository institution's ability to be separated from its parent structure and resolved in an orderly fashion. In response to comments related to the passage of the Dodd-Frank Act, the FDIC delayed the issuance of the IDI Interim Final Rule to coordinate with the rulemaking implementing Section 165(d). Furthermore, to align the IDI Interim Final Rule more closely with the Section 165(d) rule, the FDIC raised the minimum asset size for a covered insured depository institution (CIDI) from US$10 billion to US$50 billion and eliminated the requirement that the CIDI be owned or controlled by a holding company with US$100 billion in assets or more.

The FDIC drafted the IDI Interim Final Rule to closely correspond with the informational requirements of the Final Rule. The IDI Interim Final Rule specifically provides that an insured depository institution may incorporate data and other information from its holding company's resolution plan. Currently, with the exception of three thrifts covered by the IDI Interim Final Rule, the holding companies of each insured depository institution covered by the IDI Interim Final Rule are required to file resolution plans under the Final Rule which implements Section 165(d) of the Dodd-Frank Act.

The IDI Interim Final Rule states that it was meant to complement the Final Rule and avoid duplication of costs and efforts on insured depository institutions and their holding companies. However, the IDI Interim Final Rule and the Final Rule serve different purposes. The IDI Interim Final Rule requires a CIDI to submit a resolution that should enable the FDIC, as receiver, to resolve the institution in a manner that ensures that depositors receive access to their insured deposits within one business day of the institution's failure (two business days if the failure occurs on a day other than Friday), maximize the net present value from the sale or disposition of its assets, and minimize the amount of any loss realized by the creditors in the resolution. The Final Rule, on the other hand, is focused on minimizing systemic risk in the resolution of the Covered Company in order to protect the financial stability of the United States while maximizing recovery for the creditors.

VIII. Conclusion

The Final Rule imposes significant planning and information-gathering requirements on Covered Companies and raises a number of important legal and practical considerations for Covered Companies. Although the Final Rule addresses many of the concerns raised in public comments, it leaves many key issues unanswered. For example, it lacks a clear, objective definition for what constitutes a "credible" resolution plan. It also does not address how, if at all, the Agencies will coordinate with foreign jurisdictions to achieve international consistency for Covered Companies with cross-border operations. For foreign-based Covered Companies, it remains unclear at a practical level just how such companies are to apply the Final Rule's requirements to their relevant US operations. While the Final Rule attempts to address the important issue of the confidentiality of resolution plans, it is likely to remain a controversial issue and subject of great concern for Covered Companies.

The Agencies have recognized the significant burden associated with developing an initial resolution plan, as well as establishing the processes, procedures, and systems necessary to update the plan annually or as otherwise appropriate. The Agencies have postponed guidance on credit exposure reporting requirements and will likely issue such guidance in connection with the Board's separate rulemaking regarding credit concentrations. While the staggered submission deadlines and opportunities to qualify to submit tailored plans provide some relief to smaller Covered Companies, the largest Covered Companies face a tremendous challenge to prepare initial resolution plans by July 2012. Given the broad scope of the Final Rule, Covered Companies need to start promptly gathering information and preparing initial resolution plans. Such companies will also need to devote substantial resources to updating their resolution plans annually because the Agencies expect that the initial plans will serve as a foundation for the development of more robust annual resolution plans over the coming years. It will be important for Covered Companies to open a dialogue with the Board and the FDIC during the development of their resolution plans. Maintaining an open line of communication with the Agencies will help ensure that the resolution planning process will result in a plan that meets the requirements of the Final Rule.

Arnold & Porter LLP is available to assist you in determining how the Final Rule and IDI Interim Final Rule may affect your business. For further information, please contact your Arnold & Porter attorney or:

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ADVISORY

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Federal Reserve Issues Regulations Governing Savings and Loan Holding Companies

On September 13, 2011, the Board of Governors of the Federal Reserve System (Board) issued an interim final rule, Regulation LL, governing the activities of savings and loan holding companies (SLHCs). As of July 21, 2011, the regulation and supervision of SLHCs and their nondepository subsidiaries were transferred to the Board under the authority of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Generally, Regulation LL captures prior SLHC regulations of the Office of Thrift Supervision (OTS) and conforms these regulations to current Board regulations governing bank holding companies (BHCs). In that regard, Regulation LL implements substantive changes to those prior OTS regulations, with many (but not all) of these changes implementing provisions of the Dodd-Frank Act. For example, certain SLHCs must now declare that they are well-managed and well-capitalized in order to conduct activities deemed to be financial in nature, in accordance with the Dodd-Frank Act.

Regulation LL does not affect the Home Owners Loan Act's (HOLA) exemption from activities restrictions for certain SLHCs that were grandfathered (Grandfathered SLHCs) by the Gramm-Leach-Bliley Act of 1999 (GLB Act). Thus, Regulation LL provisions affecting SLHC activities only apply to those SLHCs subject to activities restrictions under the GLB Act (Nonexempt SLHCs).

The Board is accepting comments regarding Regulation LL until October 27, 2011. Specifically, the Board is requesting comment on whether it has captured all regulations related to the supervision of SLHCs through this rulemaking and whether the Board has collected any OTS regulatory provisions in Regulation LL that do not apply to SLHCs or their nondepository subsidiaries.

A general description of the major regulatory modifications created by Regulation LL is set forth below.

Background

Section 312 of the Dodd-Frank Act transferred supervisory and rulemaking authority for SLHCs and their nondepository subsidiaries from the OTS to the Board as of July 21,

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2011.[1] Upon this transfer, the Board was statutorily required to identify those OTS regulations that the agency would continue to enforce.[2] The Board published a listing of those regulations on July 21, 2011. Through Regulation LL, the Board is transitioning these OTS regulations to regulations of the Board. Regulation LL contains all regulations applicable to SLHCs that are in stock form,[3] and it will follow a structure similar to the Board's Regulation Y,[4] which governs the regulation and supervision of bank holding companies (BHCs).

Conformity with Regulation Y

The Board conformed those OTS Regulations governing SLHCs that are substantively similar to provisions of the Bank Holding Company Act of 1956, as amended (BHCA) or Regulation Y to the language and format used in Regulation Y. These changes affected several areas of SLHC regulation, including the following:

Applications

The Board has replaced the OTS's procedures for the processing and filing of applications with the Board's procedures, while not altering the substantive standards of transactions that trigger the filing of an application. The Board is continuing to use OTS application forms, but the Board is eliminating OTS requirements for prefiling meetings, the submission of draft business plans, and formal procedures that the OTS employed to determine when an application became complete. The Board is also publishing notices of proposed acquisitions of SLHCs in the *Federal Register* for public comment by interested persons.

1 12 U.S.C. § 5412.

2 12 U.S.C. § 5414(c).

3 The Board is implementing a separate regulation, Regulation MM, to collect regulations that separately apply to mutual holding companies which are SLHCs. Regulation MM only applies to a corporation organized as a holding company under the Home Owners Loan Act, 12 U.S.C. § 1467a(o), through reorganization from a savings association operating in mutual form. *See* 76 Fed. Reg. 56,508, 56,511 n. 28 (Sept. 13, 2011). Regulation MM will not apply to a mutual holding company that is not organized under 12 U.S.C. § 1467a(o) such as mutual insurance companies that established or acquired federal savings banks other than through a mutual conversion transaction using a mutual holding company structure pursuant to OTS regulations.

4 12 C.F.R. pt. 225.

Control Determinations

For savings association and SLHC control determinations, the promulgating release states that the Board intends to apply the same types of rules and processes to SLHCs that the agency currently applies to BHCs. Specifically, the Board intends to interpret the definition of "control" under HOLA in the same manner as it interprets control in the BHCA. The definition of control in HOLA is almost identical to the definition of control in the BHCA. For example, both of these statutes determine control through a three-prong test, measuring whether a company controls: a) 25 percent or more of another company's voting shares, b) the election of a majority of another company's board, or c) influence over another company's management or policies.[5] Also, the Board's control determination review procedures, as well as filing requirements under the Change in Bank Control Act[6] will apply to SLHCs in an identical manner to how these policies apply to BHCs.

Through this assimilation, any prior OTS regulations regarding control determinations and rebuttal of control matters that are inconsistent with Board policy on these issues as they are applied to BHCs will not be included in Regulation LL. This determination by the Board to treat SLHCs the same as BHCs in the control area will affect several past OTS practices regarding control determinations.

- First, the Board will make control determinations by reviewing the influence of *all* investors in a savings association or SLHC and not just the two largest shareholders, which was the past practice of the OTS.
- Second, unlike the OTS, the Board will not provide a separate application process for a party to rebut control if a regulatory control factor is triggered under the BHCA.
- Third, under the Change in Bank Control Act, the Board will not allow investors to avoid required filings through the use of passivity commitments and rebuttal

5 Unlike the BHCA, HOLA conclusively deems a person to be in control of a savings association if that person owns or controls more than 25 percent of the voting shares of the savings association. 12 U.S.C. § 1467a(a)(2).

6 12 U.S.C. § 1817(j).

agreements. The OTS previously permitted these practices in lieu of filing a Change in Bank Control Act notice.

The Board's proposal to conform these control regulations does not apply to institutions with ownership structures that were previously approved by the OTS. Regulation LL applies to new ownership investments, and the Board is only reviewing the ownership structures of past applicants to the OTS if a company proposes a new material transaction such as a major business plan modification, recapitalization, or expansion effort. Because such a review can be triggered by business plan changes, many SLHCs that otherwise may not contemplate having its ownership structure reviewed by the Board may find itself under scrutiny.

Transactions Subject to the Bank Merger Act

The Board also has created an exception in Regulation LL to HOLA's prior approval requirement for transactions that also require prior approval through the Bank Merger Act.[7] This exception mirrors similar provisions contained in Regulation Y.[8] In accordance with HOLA and the Bank Merger Act, the OTS previously required both an SLHC and an SLHC's subsidiary savings association to submit requests for prior approval when the institutions acquired another savings association by merger. In order to eliminate unnecessary duplication of filings, the Board has created an exception to the approval requirement under HOLA subject to certain conditions. The Board will generally defer to the determination of the agency reviewing the merger proposal under the Bank Merger Act, either the Office of the Comptroller of the Currency or the Federal Deposit Insurance Corporation. However, the Board retains jurisdiction over these transactions, and reserves the right to require an application if an SLHC's merger proposal presents issues that the Board determines to be unique to its jurisdiction.

Activities Closely Related to Banking

By conforming OTS regulations to Regulation Y, the Board is establishing new filing requirements for Nonexempt SLHCs that engage in activities that the Board has determined by rule or order to be "closely related to banking."[9] The OTS did not previously require filings for Nonexempt SLHCs to engage in these activities. However, Nonexempt SLHCs that begin new activities that are "closely related to banking" after July 21, 2011 must comply with the same filing requirements as BHCs governed by Regulation Y. These filing requirements include *prior approval* from the Board, unless the Nonexempt SLHC meets the following test and is deemed to be a well-run SLHC:

- A composite rating of "1" or "2" in the Nonexempt SLHC's most recent examination, or a rating of satisfactory or above if the most recent examination was prior to January 1, 2008;
- The Nonexempt SLHC is not in a troubled condition; and
- The Nonexempt SLHC is not proposing to commence the activity by an acquisition (in whole or in part) of a going concern.

If a Nonexempt SLHC has these above characteristics, then the company must alternatively provide notice to the appropriate Federal Reserve Bank within 10 business days *after* the commencement of the proposed activity.

Notice of Change in Director

Regulation LL transfers OTS regulations governing the filing of notices for changes of directors or senior executive officers in SLHCs in troubled condition. The Board conformed these provisions to similar requirements contained in Regulation Y for BHCs. As a result, the Board has added an appeal and informal hearing process in the event of the Board's disapproval of an SLHC's notice. OTS regulations did not previously grant these appeal and informal hearing rights to SLHCs.

Additional Substantive Changes to SLHC Regulations

Financial Holding Company Activities

In addition to conforming the previous OTS regulations to Board practice, the Board has used this issuance of Regulation LL to implement provisions of the Dodd-Frank Act that affect SLHCs. For example, the Regulation

7 12 U.S.C. § 1828.

8 *See* 12 C.F.R. 225.12.

9 *See* 12 U.S.C. §§ 1843(c)(8) & (k)(4)(F).

contains new provisions that conditionally limit the ability of Nonexempt SLHCs to perform activities that are permitted for financial holding companies (FHCs). These activities include various types of securities, merchant banking, and insurance activities. Prior to the Dodd-Frank Act, the OTS interpreted the HOLA[10] to permit SLHCs to conduct activities that were financial in nature and statutorily permitted for FHCs under the BHCA.[11] SLHCs were able to perform these financial activities without having to satisfy the same criteria required of FHCs to have well-managed and well-capitalized depository institution subsidiaries, to have at least a satisfactory rating under the most recent Community Reinvestment Act (CRA) examination, and to file a declaration and certification with the regulator.[12] However, the Dodd-Frank has implemented changes in the regulatory procedures of Nonexempt SLHCs that conduct the activities of an FHC.

Specifically, Section 606 of the Dodd-Frank Act amends HOLA to require Nonexempt SLHCs to meet all of the criteria that BHCs must meet to conduct the activities of an FHC. In addition, Section 606 adds to the regulatory criteria a requirement that a holding company, in addition to its depository institution subsidiary, must be well-capitalized and well-managed at the holding company and saving association levels before conducting activities that are permissible for FHCs. Regulation LL implements Section 606 of the Dodd-Frank Act by establishing a regulatory process for filings that a Nonexempt SLHC must make to the Board in order to be treated as an FHC. This filing process mirrors the process currently in place for BHCs seeking treatment as an FHC under Regulation Y.

Regulation LL requires that a Nonexempt SLHC seeking treatment as an FHC must be well-managed and well-capitalized, in addition to controlling a depository institution that has achieved at least a satisfactory rating under the most recent CRA examination. A Nonexempt SLHC is well-managed if at its most recent examination the company received at least a satisfactory composite rating, and at least a satisfactory rating for management, if such rating is given. This definition is substantively identical to the definition of well-managed in Regulation Y.[13] A Nonexempt SLHC is well-capitalized if each of the company's depository institutions is well-capitalized and the company is not subject to any written agreement, order, capital directive, or prompt corrective action directive issued by the Board to meet and maintain a specific capital level for any capital measure.

A well-managed and well-capitalized Nonexempt SLHC seeking treatment as an FHC to conduct new activities must file a written declaration with the appropriate Federal Reserve Bank. Also, for Nonexempt SLHCs already engaging in activities that are financial in nature upon the enactment of Regulation LL, the Board requires the submission of a description of the activities and a written declaration by December 31, 2011 in order for an SLHC to continue these activities in compliance with Section 606. A complete written declaration for either new or existing activities that are financial in nature must:

1. State that the SLHC elects to be treated as a FHC in order to engage in FHC activities;
2. Provide the name and head office address of the SLHC and each depository institution controlled by the SLHC;
3. Certify that the SLHC and each depository institution controlled by the SLHC is well-capitalized as of the date the SLHC submits its declaration; and
4. Certify that the SLHC and each savings association controlled by the SLHC is well-managed as of the date the SLHC submits its declaration.

10 12 U.S.C. § 1467a(c)(9)(A).

11 12 U.S.C. § 1843(k).

12 *See* 12 U.S.C. § 1843(l)(1).

13 For the Nonexempt SLHC, if any, that has not been examined, it will be considered well-managed if after a review of the managerial and other resources of the company and after consulting with the appropriate federal and state banking agencies, the Board determines the company to be well-managed.

If a Nonexempt SLHC is already engaging in activities that are financial in nature upon the enactment of Regulation LL and is unable to file a declaration, then that Nonexempt SLHC must submit an alternative declaration by December 31, 2011 including:

1. A list of activities that are financial in nature in which the SLHC engages;
2. A description of why the SLHC cannot file a declaration that can be declared effective; and
3. A description of how the SLHC will achieve compliance prior to June 30, 2012.

If that Nonexempt SLHC is unable to achieve compliance with these declaration requirements by June 30, 2012, then it will be subject to the notice, remediation agreement, and divestiture consequences of the BHCA.[14] The BHCA permits the Board to order a company to divest ownership or control of any depository institution if after Board notice, and the expiration of 180 days, the conditions described in the Board notice are not corrected. However, the interim final rule notes that the Board will exercise discretion in its enforcement of these provisions and take into account the fact that SLHCs were not subject to the declaration criteria prior to the Dodd- Frank Act.

SLHC Activities Explicitly Authorized by HOLA

The Board is permitting Nonexempt SLHCs to continue conducting certain activities that are explicitly authorized in the HOLA. This includes activities that are financial in nature, as well as certain activities that BHCs or FHCs are not permitted to conduct. For example, the HOLA specifically allows SLHCs to engage in insurance agency and escrow activities,[15] which are activities that are financial in nature under the BHCA.[16] Because of this statutory authority, the Board will permit Nonexempt SLHCs to conduct these activities without having to meet the criteria that BHCs must meet when seeking treatment as an FHC.

14 12 U.S.C. § 1843(m); *see also* 12 C.F.R. 225.83.
15 12 U.S.C. § 1467a(c)(2)(B).
16 *See* 12 U.S.C. § 1843(k).

Similarly, the HOLA permits SLHCs to engage in activities that multiple SLHCs were authorized to directly engage in on March 5, 1987.[17] Some of these activities, such as real estate development, are impermissible for BHCs or FHCs. The Board will permit Nonexempt SLHCs to continue these activities subject to notice requirements under Regulation LL. The notice requirements are limited to Nonexempt SLHCs that are subject to restrictions on its activities under Regulation LL. Thus, Grandfathered SLHCs may continue to engage in these activities without any notice restrictions under Regulation LL.

17 12 U.S.C. § 1467a(c)(2)(F)(ii).

Arnold & Porter LLP is available to respond to questions raised by Regulation LL or to provide any assistance in drafting comments to the Board. We also can assist in determining how Regulation LL may affect your business and ensuring that your business is compliant with the requirements of the interim final rule. For further information, please contact your Arnold & Porter attorney or:

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Agencies Propose Regulations Implementing Volcker Rule

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On October 11 and 12, 2011, the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and Securities and Exchange Commission (SEC) proposed a common set of rules to implement Section 619 of the Dodd Frank Wall Street Reform and Consumer Protection Act, also known as the "Volcker Rule." Section 619 is codified as Section 13 of the Bank Holding Company Act, 12 U.S.C. 1851. The CFTC is expected to propose a similar rule. Comments on the proposed rules are due by January 13, 2012.

The Volcker Rule prohibits banks and their affiliates (referred to as "banking entities") from (1) engaging in "proprietary trading" in most securities and derivatives and (2) owning an interest in or sponsoring a private investment fund that relies on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act for an exemption under that Act, or other similar types of funds designated by the regulators (referred to as "covered funds"). The Volcker Rule also restricts certain relationships between a banking entity and a covered fund. The Volcker Rule applies to all US banking entities (other than nondepository trust companies with no FDIC-insured affiliate banks) and their domestic and global affiliates, and to non-US banks that have a branch, agency, or commercial lending subsidiary in the US to the extent that the foreign banks' activities are conducted in the United States or with US investors or counterparties.

The Volcker Rule does not add any powers. Instead, it limits powers that banking entities might otherwise have under other laws. In determining whether an investment, position, or activity is permitted for a banking entity, it is necessary first to determine whether there is authority for the investment, position, or activity in the relevant banking laws and any limits or conditions placed by those other laws, and then to determine whether the Volcker Rule prohibits or restricts the investment, position, or activity that would otherwise be authorized for the banking entity. The activities subject to the Volcker Rule may also be limited or conditioned by other provisions of the Dodd-Frank Act and related rules, particularly the Title VII provisions on regulation of the swaps and derivatives markets and the provisions regarding compensation of bank and securities firm management.

The statute, and the implementing rules, go into effect on June 21, 2012. Pre-existing investments must be conformed to the new requirements by June 21, 2014, with the possibility of three one-year extensions by the Federal Reserve in some cases, and for five additional years for certain illiquid investments that were committed prior to May 2010.

Key early action items for banking entities include:

- Assessing the impact of the Volcker Rule on current and planned activities, investments, and positions;
- Developing compliance, control, recordkeeping, and reporting systems and infrastructure to address compliance with the rule (the infrastructure required by the rule is greater for larger banking entities);
- Involving the board of directors and senior management in the development of policies and procedures to address Volcker Rule requirements;
- Conforming new activities, investments, and positions as of June 21, 2012; and
- Preparing to conform pre-existing investments and positions by June 21, 2014, or such later date as may be permitted through an extension from the Federal Reserve.

The Volcker Rule contains statutory exemptions from both sets of prohibitions, including exemptions for:

- Trading in US government and municipal government obligations;
- Underwriting and market making-related activities;
- Risk-mitigating hedging activity;
- Trading on behalf of customers;
- Investments in Small Business Investment Companies (SBICs) and Community Reinvestment Act investments;
- Trading for the general account of insurance companies;
- Organizing and offering a covered fund (including limited investments in such funds);
- Foreign trading by non-US banking entities; and
- Foreign covered fund activities by non-US banking entities.

The proposed rule implements these exemptions and imposes tests and conditions to reliance upon them.

The proposed rule has five parts and three appendices:

- Subpart A contains general provisions and defines some basic terms;
- Subpart B addresses proprietary trading;
- Subpart C addresses "covered fund" investments and relationships;
- Subpart D requires banking entities to establish a compliance program regarding the Volcker Rule, including written policies and procedures, internal controls, a management framework, independent testing, training, and recordkeeping;
- Subpart E (which is included only in the Federal Reserve version of the proposed rule) contains provisions on conforming prior investments and positions, and the process for requesting extensions. This portion was adopted by the Federal Reserve in early 2011 as part of Regulation Y and is being moved to subpart E of the proposed rule;
- Appendix A details quantitative measurements of trading activities that certain banking entities must compute and report;
- Appendix B provides factors that distinguish permitted market making-related activities from prohibited proprietary trading; and
- Appendix C details standards for compliance programs required under subpart D.

Proprietary Trading

The proposed rules treat securities and derivatives positions in a "trading account" as presumptively prohibited unless documented by the banking entity to be permitted under an exception. Positions held for less than 60 days bring a rebuttable presumption that they involve proprietary trading. The term "trading account" is defined in the proposed rule to include positions that are: (a) taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position; (b) deemed to be a "covered position" under the federal banking agencies' Market Risk Capital Rules, other than certain foreign exchange and commodities positions; or (c) acquired or taken by securities or derivatives dealer units. The definition excludes positions that do not involve short-term trading intent, such as in repo and securities lending transactions, as well as positions taken for liquidity management.

Covered financial positions include all long, short, synthetic, and other positions in securities and derivatives, but do not include positions in loans, spot foreign exchange, or spot commodities. Swaps and forward contracts on FX and other commodities are, however, covered.

The proposed rule exempts underwriting, market making-related activities and risk-mitigating hedging, trading in government obligations, trading on behalf of customers, trading by a regulated insurance company, and trading by foreign banking entities outside the United States, but establishes requirements for each exemption. The proposed rule describes three categories of transactions that would qualify for the "customer trading" exemption in the Volcker Rule: transactions conducted by a banking entity as investment adviser, commodity trading advisor, trustee, or in another fiduciary capacity for the account of a customer; riskless principal transactions; and transactions conducted by an insurance company.

The proposed rule specifies the permitted trading outside of the United States by a foreign banking entity and when trading will be considered to have occurred solely outside of the United States.

The proposed rule requires banking entities with significant trading activities to undertake reporting and recordkeeping on their proprietary trading activities. Banking entities with larger and more significant covered trading are subject to detailed and extensive recordkeeping and reporting requirements. The recordkeeping and reporting is designed to help determine whether the activity and particular transactions and positions are permitted under the Volcker Rule, as well as to measure and control risk.

Investments in and Relationships with Covered Funds

Subpart C of the proposed rule implements the provisions of the Volcker Rule related to banking entity investments in and relationships with private investment funds. The proposal expands the list of covered funds beyond private funds that rely on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act to also cover commodity pools and foreign investment funds. The proposed rule exempts third-party bank- owned life insurance (BOLI) from the Volcker Rule investment prohibition and certain bank asset securitization structures, joint ventures, and corporate entity structures from the Volcker Rule prohibitions. The proposed rule also clarifies that securities and derivatives trading activity conducted within a covered fund that happens to be "controlled" by the banking entity, and thus technically a subsidiary and therefore a "banking entity" within the meaning of the BHC Act, is not subject to the Volcker Rule prohibition on proprietary trading.

The proposed rule implements and defines some of the requirements for investment in covered funds by a banking entity, including certain aspects of how the statutory 3%/3% limits on those investments must be calculated. The proposed rule excludes from being counted as an ownership interest a profits interest in a fund that is not capitalized by the banking entity and held for purposes of obtaining a carried interest or other performance allocation.

In addition to limiting the direct ownership by a banking entity and its subsidiaries of interests in a covered fund, in some cases the proposed rule also attributes to the banking entity ownership interests owned by other related persons and entities. For example, the proposed rule attributes to a banking entity the ownership of a covered fund by a company that the covered fund owns 5 percent or more of, and may also attribute ownership if the banking entity invests in parallel with the covered fund in underlying portfolio transactions. The proposed rule also attributes ownership interest in a covered fund by a banking entity director or employee to the banking entity, if the banking entity lends money to the person to acquire the interest, guarantees the purchase, or guarantees the director or employee against investment loss.

The proposed rule requires written disclosures to investors that any losses will be borne solely by investors and not by the banking entity and that the banking entity's losses in the fund will be limited to losses on the interests in the fund owned as principal by the banking entity. The proposed rule also requires the offering documents to clearly disclose that an investor should read the fund offering documents before investing in the fund; that the interests are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed by any banking entity; and disclose the services provided by the banking entity to the fund.

Compliance Program

Appendix C to the proposed rule sets out detailed standards for the compliance program (which must be periodically reviewed and revised) covering trading activities and covered fund activities and investments. The six required elements of the compliance program are written policies and procedures; internal controls (including identification, monitoring, measurement, risk limits, documentation and analysis of the activities conducted, and methods of detecting violations); and standards for responsibility and accountability, including involvement and responsibility of the board of directors, senior management, and managers at each relevant business unit, independent testing, training of personnel, and recordkeeping.

Conclusion

The agencies have requested comments on the proposal, and asked specifically for comments on a long list of questions posed by the agencies in the release. In the open meetings at which the agencies determined to propose the rules, members of the governing boards and staff members of the agencies expressed interest in further refining the rules in response to comments received on the proposed rules. There may be changes to the proposed rules before they are adopted. In view, however, of the long lead time required to build a compliance program that includes the elements in the proposed rule, and to prepare for compliance on June 21, 2012, it would be appropriate for banking entities to begin now to prepare to comply with the Volcker Rule.

Arnold & Porter LLP has long represented financial companies in resolving their regulatory and supervisory issues. We have been assisting such companies during the legislative and rulemaking process in understanding the implications of the Dodd-Frank Act and its implementing rules. We are available to respond to questions raised by the Volcker Rule, or to help guide your business in responding to it. For further information, please contact your Arnold & Porter attorney or:

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CFPB's New Supervisory Manual Focuses on Risk to Consumers

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On October 13, 2011, the Consumer Financial Protection Bureau (CFPB) released the CFPB Supervision and Examination Manual (Manual). The Manual provides the CFPB's examiners with guidelines for determining whether entities providing consumer financial products and services are complying with the consumer protection laws that are subject to the CFPB's jurisdiction. Consistent with the purpose of the agency, and not surprisingly, the Manual indicates that when the CFPB evaluates the policies and practices of an institution, it will focus on the risk to consumers and will direct its resources toward those areas with higher degrees of risk.

The Manual incorporates examination procedures developed by the Federal Financial Institutions Examination Council for many of the laws now enforced by the CFPB. The CFPB is responsible for enforcing the "federal consumer financial laws," which include nearly every existing federal consumer financial statute, as well as new mandates prescribed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act).[1] These include, among other things, Title X of the Act, which prohibits unfair, deceptive, or abusive acts and practices in connection with consumer financial products and services. The entities within the scope of the CFPB's supervision and enforcement authority include both insured depository institutions that have total assets over US$10 billion ("large depository institutions") and their affiliates, and nondepository consumer financial services companies ("nonbanks"), such as mortgage lenders, payday lenders, and private education lenders.

The examination structure and approach presented in the Manual is generally similar to those employed by the other federal banking agencies (indeed, it was drafted based largely on guidance issued by the other agencies). While its drafters have estimated that approximately 75 percent of the Manual was based on existing guidance, there are aspects that are new and significant. For example, the Manual includes detailed examination procedures for mortgage servicing, which is an indication that the agency plans to devote a great deal of attention to that area. In fact, Raj Date, the *de facto* head of the CFPB in

1 One notable exception is the Community Reinvestment Act, regulation and enforcement of which remain with a depository institution's primary federal bank regulatory agency.

the absence of an appointed director, stated over a month ago that the CFPB was working with other federal agencies to develop basic standards for mortgage servicing and examination thereof.[2]

Under the CFPB's new procedures, mortgage servicers will be subject to nine examination "modules:"

(1) servicing and loan-ownership transfers;

(2) payment processing and account maintenance;

(3) customer inquiries and complaints;

(4) maintenance of escrow accounts and insurance products;

(5) credit reporting;

(6) information sharing and privacy;

(7) collections;

(8) loss mitigation; and

(9) foreclosures.

In preparation for examinations, mortgage servicers would be advised to analyze their practices within each of these modules and determine how their compliance policies may need to be revised or enhanced.

The CFPB has indicated that in the coming months it will release additional specific guidelines like the mortgage servicing modules to prescribe specific examination procedures organized by product and line of business. If the mortgage servicing procedures are any guide, the forthcoming guidance will likely be more detailed than that currently used by the other federal banking agencies. Each set of new procedures will provide insight into the CFPB's priorities, as well as a framework around which institutions can revise or enhance compliance policies.

In addition to focusing on the risk to consumers, the Manual states that CFPB examinations will be data-driven and that examiners should use the same procedures to examine both the large depository institutions and the nonbanks that the CFPB supervises. The Manual will initially be used by the CFPB to examine large depository institutions. It will also be used to supervise providers of consumer financial products and services that are not depository institutions, but only after a permanent CFPB director is confirmed.

The Manual states that the CFPB expects each entity it regulates to have an effective compliance management system adapted to its business strategy and operations. It states that an effective compliance management system commonly has the following four components: (1) board management and oversight; (2) a compliance program comprised of policies, procedures, training, and monitoring and corrective action; (3) a system for responding to consumer complaints; and (4) a compliance audit program.

The Manual states that every examination will include a review of the entity's compliance management system, as well as a review for any potential unfair, deceptive, or abusive practice (UDAAP), and regulatory compliance matters presenting risks to consumers. The Manual also provides that every examination covering lending activities must include a review for discrimination and fair lending compliance.

The Manual's provisions relating to UDAAP do not provide any insight as to how the term "abusive" will be interpreted and applied in practice. While it provides examples of potentially unfair or deceptive acts or practices, the Manual does not provide any examples of abusive acts or practices. As part of the UDAAP provisions, the Manual states that examiners should evaluate whether an institution's servicing and collections practices raise potential UDAAP concerns. As noted above, mortgage servicing will receive greater regulatory scrutiny than it typically has received in the past, given the detailed procedures on mortgage servicing in the Manual. The Manual also instructs examiners to interview consumers, as necessary, if the examiner uncovers a potential UDAAP issue. This is a departure from the normal examination process of the other federal banking agencies, which generally do not interview customers.

2 *See Lessons Learned from the Financial Crisis: The Need for the CFPB*, Raj Date, Special Advisor to the Secretary of the Treasury for the Consumer Financial Protection Bureau, National Constitution Center, Philadelphia, Pennsylvania (Sept. 15, 2011).

In addition to regular examinations, the CFPB plans to conduct targeted reviews, focusing on particular issues at an institution, as well as horizontal reviews, which focus on a particular issue across multiple institutions. The timing of the examinations will be based upon an assessment of risks to consumers for both large depository institutions and nondepository consumer financial services companies. However, the CFPB will also coordinate the examinations of large depository institutions with those conducted by their prudential and state regulators. We understand that the CFPB will begin examining some large depository institutions before the end of this year.

The CFPB is asking for feedback from the industry, consumer advocates, and the public on its first iteration of the Manual, which it describes as an evolving document. Providing such feedback could be an important way for affected institutions to ensure that the CFPB applies a reasonable and appropriate approach to its examinations. Further, as the CFPB updates the Manual and shifts its regulatory focus to new products and business lines, regulated entities should review and enhance corporate compliance policies to directly address the agency's new priorities and areas of concern.

Arnold & Porter LLP is available to assist you with compliance with the federal consumer financial laws and with preparation for examinations by the CFPB. For further information, please contact your Arnold & Porter attorney or:

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Federal Reserve Proposes Enhanced Prudential Standards for Large Financial Institutions

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On December 20, 2011, the Board of Governors of the Federal Reserve System (Board) issued a proposed rule and request for public comment[1] (Notice) to implement provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA).[2] Sections 165 and 166 require the Board to impose enhanced prudential standards on certain large bank holding companies (BHCs) and on nonbank financial companies designated for Board oversight by the Financial Stability Oversight Council (FSOC).[3] These statutory provisions and the regulations proposed by the Board will create significant new obligations and, in some instances, restrictions on the largest participants in the US financial system. The Board has asked for feedback on all aspects of the proposed regulations, including in response to 95 specific questions posed in the Notice. Comments are due March 31, 2012.

Purpose

The recent financial crisis revealed significant limitations in the prudential regulation of large and systemically significant financial companies. At the peak of the crisis, it became clear that many institutions' capital levels were insufficient to support their risk profiles, and that even institutions with adequate capital were, in times of extreme stress, vulnerable to crippling liquidity challenges that rendered capital cushions nearly meaningless. Further, it became evident that neither regulators nor the industry itself fully appreciated the extent to which the largest industry participants, as frequent counterparties, were exposed to one another, such that the failure of one institution could have a "domino effect" on others. It was equally apparent that regulators and the industry alike did not comprehend the extent to which institutions had leveraged themselves and taken on significant amounts

1 "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies," Board of Governors of the Federal Reserve System, RIN 7100-AD-86, December 20, 2011 (*available at* http://www.federalreserve.gov/newsevents/press/bcreg/20111220a.htm).

2 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 Section 113 of the DFA authorizes the FSOC to designate a US nonbank financial company for supervision by the Board if the FSOC determines, pursuant to factors set forth in the DFA, that the US nonbank financial company could pose a threat to the financial stability of the United States. To date, no such designation has been made.

of risk through derivative transactions and other "exotic" instruments, which both caused and amplified the losses experienced during the financial downturn. These factors combined to force an unprecedented level of government intervention to prevent the failure of several of the largest US financial institutions, confirming that those institutions were, in fact, "too big to fail."

Sections 165 and 166 of the DFA seek to address a number of these concerns and to reduce the moral hazards associated with a presumption of government support in times of stress. The provisions' goal is to ensure that large and systemically important institutions can survive future instances of severe market dislocation, or that, if not, the impact of their failure on other market participants will be minimized. Particular emphasis is placed on tightening the requirements governing the financial condition, risk management, and contingency planning of the largest and most interconnected institutions in the United States, so as to prepare proactively for the next market crisis. Although BHCs have always been subject to prudential regulation and agency guidance in these areas, these requirements will be new to nonbank entities, and in any event the DFA specifically requires the Board to impose requirements that go beyond what is currently expected of BHCs.

Significantly, the proposed regulations are not intended solely to strengthen the resiliency of large companies. In some cases, the goal is also to prompt certain large institutions to rein in their activities to address the unintended and undesirable consequences of "too big to fail." To that end, the Board expects that the proposed regulations, which increase in stringency according to the systemic risk posed by an entity, will provide an incentive for financial companies to reduce their systemic footprint—and thereby their systemic risk. The Board views this process as a means of "encourag[ing] covered companies to consider the external costs that their failure or distress would impose on the broader financial system, thus helping to offset any implicit subsidy they may have enjoyed as a result of market perceptions of implicit government support."

Scope

The regulations proposed in the Notice address seven primary areas: risk-based capital and leverage, liquidity, single-counterparty credit limits, overall risk-management and risk committees, stress tests, debt-to-equity limits, and early remediation requirements. Each of these areas is discussed below. In most instances, the proposed rules will apply to two categories of institutions (each a "Covered Company"): (i) BHCs with US$50 billion[4] or more in consolidated assets and (ii) nonbank financial companies designated by the FSOC for Board supervision. With respect to the latter category, the Board acknowledges in the Notice that its exiting BHC-focused regulations and guidance will not in every instance translate well to non-BHC entities, and comments are specifically invited regarding what characteristics of nonbank Covered Companies should be considered in determining how to apply each of the seven areas listed above to such entities.

In addition to Covered Companies, BHCs and state member banks with US$10 billion or more in consolidated assets will be subject to the Notice's stress-test requirement, and publicly traded BHCs with US$10 billion or more in consolidated assets will also be subject to the risk-committee requirements proposed in the Notice. Savings and loan holding companies (SLHCs) and foreign banking organizations[5] (FBOs) are, to differing degrees, covered by portions of Sections 165 and 166 and by the rules proposed in the Notice, but, as discussed below, the Board has largely excluded them from the initial scope of the Notice in favor of forthcoming proposed rulemakings that will address SLHCs and FBOs directly.

Timing of Implementation

The Board has sought in the proposed rulemaking to establish initial and ongoing compliance timeframes that

4 Whether a BHC satisfies the US$50 billion requirement will be based on the average of the BHC's total consolidated assets as reported to the Board for the four previous quarters on Federal Reserve Form FR Y-9C (Consolidated Financial Statements for Bank Holding Companies). The US$10 billion threshold applicable to the stress-test requirements discussed herein is calculated in a similar fashion.

5 FBOs include any foreign nonbank financial company supervised by the Board or any foreign-based bank holding company.

allow institutions sufficient time to implement the necessary internal processes. In recognition of the significant time and resources that many institutions will need to dedicate to achieving compliance with the proposed regulations, the Board has proposed an implementation period of approximately one year from the effective date of the final regulations, or from the date an entity becomes subject to the final rules. The Board has also proposed an ongoing reporting/ compliance schedule that seeks to coordinate both new and existing requirements. "For example," the Notice states, "the requirement that Covered Companies conduct stress tests is specifically timed to coordinate with the reporting requirements associated with the capital plan, and the capital plan and stress test requirements are specifically timed to minimize overlap with resolution plan update requirements." The Board has specifically requested feedback on the proposed implementation and compliance schedule.

Savings and Loan Holding Companies and Foreign Banking Organizations

As noted above, both SLHCs and FBOs are subject to certain of the DFA provisions implemented by the proposed regulations. Other provisions will be applied at the Board's discretion. To that end, the proposed regulations themselves, as a technical matter, cover both types of entities. However, the Notice delays the effective date of a majority of the rules proposed in the Notice with respect to SLHCs and FBOs until further rulemakings can be issued.

SLHCs: The DFA requires that all financial companies with US$10 billion or more in total consolidated assets whose primary federal regulator is the Board, which includes SLHCs, conduct an annual stress test. Moreover, although not specifically required by the DFA, the Notice states that the Board will apply the DFA's enhanced prudential standards and early remediation requirements to SLHCs with "substantial banking activities," meaning any SLHC that has US$50 billion or more of total consolidated assets and either (i) has savings association subsidiaries that comprise a quarter or more of the SLHC's total consolidated assets or (ii) controls one or more savings associations with US$50 billion or more in total consolidated assets. The Board will also retain the ability to apply the enhanced standards to any other SLHC as determined on a case-by-case basis on safety and soundness grounds. However, because the proposed rule presupposes that an entity is already subject to consolidated capital requirements, which are still in development for SLHCs, application of the Notice's proposed regulations will be delayed until at least such time as the Board finalizes its capital requirements for such entities.

FBOs: Sections 165 and 166 apply to FBOs that have US banking operations[6] and global consolidated total assets of US$50 billion or more. In crafting regulations to address FBOs, Section 165(b)(2) of the DFA instructs the Board to "give due regard to the principle of national treatment and equality of competitive opportunity" and to "take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States." In recognition of the limitations of existing international agreements on bank regulation and the complex structures and operations of many FBOs, the Board states that crafting suitable rules to apply Sections 165 and 166 to FBOs will be "difficult" and therefore largely exempts FBOs from coverage under the proposed rules in favor of specially tailored rules that are in development. We anticipate that such forthcoming rules for FBOs will attempt to create a regulatory structure as identical as possible to the one proposed in the current Notice, so as to apply similar standards to foreign- and domestic-based organizations alike. In the meantime, foreign-owned domestic BHCs with total consolidated assets of US$50 billion or more will be subject to the proposed rules as would any other similarly situated BHC.

Specific Requirements

1. Risk-Based Capital Requirements and Leverage Limits

To address deficiencies identified in capital levels in stressed environments, and more generally to ensure a

6 US banking operations for these purposes include a US branch, a US agency, or a US subsidiary BHC or bank.

forward-thinking approach to capital management efforts at large institutions, the proposed rule would extend the application of the Board's recently adopted Capital Plan Rule to all Covered Companies, including nonbank financial companies designated by the FSOC.[7] That rule, currently applicable only to BHCs, will require all Covered Companies to meet several risk-based and leverage capital requirements. The compliance date for the proposed capital planning and minimum capital requirements will generally be the later of the effective date of the proposed rule or 180 days after Board designation as a Covered Company.

All Covered Companies will be required to submit annual capital plans to the Board demonstrating in detail the company's ability to maintain capital above the Board's minimum risk-based capital ratios (total capital ratio of eight percent and tier 1 capital ratio of four percent) and tier 1 leverage ratio (four percent) under both baseline and stressed conditions over a minimum nine-quarter, forward-looking planning horizon. In addition, Covered Companies will be required to demonstrate an ability to maintain a minimum tier 1 common risk-based capital ratio of five percent over the same planning horizon and under the same conditions. A Covered Company unable to satisfy these requirements generally will be prohibited from making any capital distributions until it provides a satisfactory capital plan to the Board. Covered companies may seek reconsideration or hearing of Board objection by written request.

In certain circumstances the proposed rule will require Covered Companies to obtain prior approval from the Board before making a capital distribution. The Board could require prior approval even where it has previously provided nonobjection to the company's capital plan if, among other things, the company's capital levels fall below Board requirements or the distribution would result in a material adverse change to the organization's capital, liquidity, or earnings structure.

Additionally, the proposed rule will subject nonbank Covered Companies to the same minimum risk-based capital and leverage requirements as BHCs and require them to report risk-based capital and leverage ratios to the Board. Nonbank Covered Companies will be required to hold capital sufficient to meet (i) a tier 1 risk-based capital ratio of four percent and a total risk-based capital ratio of 8 percent, as calculated according to the Board's risk-based capital rules,[8] and (ii) a tier 1 leverage ratio of 4 percent as calculated under the Board's leverage rule.[9] A Covered Company that fails to meet these requirements will be required to notify the Board immediately.

Finally, under the proposed rule's "reservation of authority," the Board could in its discretion require any Covered Company to hold additional capital or subject any Covered Company to other requirements or restrictions if it decided the proposed rule did not adequately mitigate the risks posed by the company to US financial stability.

The proposed rule also contemplates, but does not yet propose, a risk-based capital surcharge, ranging from 100 to 350 basis points based on an entity's systemic footprint, to be levied on a subset of Covered Companies known as Global Systemically Important Banks (G-SIBs). The proposed rule contemplates phasing in the capital surcharge from 2016 to 2019 and requests feedback on how best to craft and implement the surcharge.

2. Liquidity Requirements

Currently, the Board oversees liquidity risk management at BHCs primarily through supervisory guidance rather than regulatory requirements. This approach, while serving well under normal market conditions, proved insufficient in stressed scenarios where traditional sources of liquidity became unavailable amid a broader market paralysis. The proposed rule addresses this shortcoming by requiring all Covered Companies to take a number of prudential steps to manage liquidity risk, with the goal of forcing institutions to develop a better understanding of their liquidity needs under a variety of economic conditions, to identify and shore up areas that present unacceptable liquidity exposure, to

7 12 C.F.R. § 225.8. *See* 76 Fed. Reg. 74631 (December 1, 2011).

8 *See* 12 C.F.R. part 225, Appendix A and G.

9 *See* 12 C.F.R. part 225, Appedix D, section II.

monitor liquidity on an ongoing basis, and to prepare in advance for potential liquidity needs. The requirements increase in stringency based on the systemic footprint of the Covered Company. The specific steps required of Covered Companies include:

- Developing comprehensive and dynamic cash flow projections arising from contractual maturities, new business, funding renewals, customer options, and other potential events that may impact liquidity;
- Conducting monthly and *ad hoc* stress testing of the company's activities, exposures, and risks, including off-balance sheet exposures, based on the various process and system requirements imposed by the proposed rule;
- Maintaining a liquidity buffer of highly liquid, unencumbered assets that is sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios;
- Establishing and updating at least annually a detailed Contingency Funding Plan describing the policies, procedures, and action plans for managing liquidity stress events;
- Establishing and maintaining limits on potential sources of liquidity risk, including limits on (i) concentrations of funding in particular instruments, counterparties, counterparty types, or other liquidity risk identifiers; (ii) the amount of specified liabilities that mature within various time horizons; and (iii) off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events;
- Monitoring liquidity risk related to collateral positions, liquidity risks across the enterprise, and intraday liquidity positions; and
- Comprehensively documenting all material aspects of the company's liquidity risk-management processes and compliance with the proposed rule and providing such documentation to the Board upon request.

The proposed rule will place much of the responsibility for compliance with these and additional liquidity requirements with the company's board of directors, risk committee, and senior management. The board of directors will be required to establish the Covered Company's overall liquidity risk tolerance (defined as the acceptable level of liquidity risk the Covered Company may assume in connection with its operating strategies) at least annually and to review compliance with that level at least semi-annually. The board of directors will also be required to approve the company's Contingency Funding Plan at least annually.

Ongoing liquidity risk-management obligations will be substantial. A company's risk committee will be required to review and approve the liquidity costs, benefits, and risk of each significant new business line and product prior to implementation, as well as the liquidity stress testing, liquidity buffer, and limits on liquidity risk outlined above. The risk committee will also be required to review the comprehensive cash flow projections, liquidity risk-management information used to assess liquidity risk, and an independent validation of the liquidity stress tests. The company's senior management will be responsible under the proposed rule for implementing the liquidity risk strategies, policies, and procedures and for reporting regularly to the risk committee on the company's liquidity risk profile. Finally, the proposed rule requires an independent review of the company's liquidity risk-management activities to be performed at least annually.

The proposed rule also contemplates, but does not propose, specific quantitative liquidity requirements consistent with the international standards of Basel III. These requirements are to be implemented by Basel Committee member countries in 2015 and 2018.

It is clear that these new rules will require Covered Companies to dedicate significant resources to liquidity planning, monitoring, and maintenance. The enhanced liquidity rules will almost certainly require greater liquidity reserves than currently exist at Covered Companies. As the kinds of highly liquid collateral necessary to offset risky activities typically yield relatively small returns, this result may lead to a migration of certain higher-risk activities to smaller or non-US firms that are not subject to these enhanced rules.

The Board has asked for comments on all aspects of its proposal for enhanced liquidity standards, including whether other possible approaches, such as limits on short-term debt, should be considered as alternative or additional methods for safeguarding liquidity positions at Covered Companies.

3. Single-Counterparty Exposure Limits

Much of the government's justification for its large-scale intervention in financial markets was the avoidance of a potential domino effect that could have followed the failure of the largest financial institutions. To limit the mutual interconnectedness of large institutions, Section 165(e) of the DFA requires the Board to impose concentration limits on Covered Companies. The Board must limit a Covered Company's credit exposure to any unaffiliated company to 25 percent of the Covered Company's capital stock or surplus, or a lower percentage that the Board deems necessary. The regulation must become effective no earlier than July 2013 and no later than July 2015. The Board indicated in the Notice that periodic credit exposure reporting requirements, also required by the DFA, will be developed in coordination with these single-counterparty exposure limits.

Credit Exposure Limits

The proposed rule would limit the aggregate net credit exposure[10] of a Covered Company to any unaffiliated counterparty to 25 percent of the capital stock and surplus of the Covered Company. The aggregate net credit exposure of a Covered Company to any counterparty is calculated on a consolidated basis with respect to both parties, although the Board has invited comments on whether such consolidation is appropriate. Furthermore, the proposed rule would limit the aggregate net credit exposure of a "major covered company" (defined as a BHC with US$500 billion or more in total consolidated assets or a FSOC-designated nonbank company) to any unaffiliated "major counterparty" (defined as a "major covered company" or an FBO that is or is treated as a BHC and has total consolidated assets of US$500 billion or more) to 10 percent of the capital stock and surplus of the "major covered company." The proposed exposure limits will be in addition to the loan-to-one-borrower and investment limits imposed on depository institutions, and the Board has asked what conflicts may arise out the interaction of these various requirements.

Credit Exposure Calculation

Net credit exposure is defined as gross credit exposure adjusted for certain netting agreements or eligible collateral, guarantees, or derivatives. Under the proposed rule, a Covered Company would have gross credit exposure to a counterparty if it engages in any of the following types of credit transactions, with the amount determined according to specific provisions—including in some cases specific multiplier tables—in the proposed rule:

- Loans and leases
- Debt and equity securities
- Repurchase and reverse repurchase agreements
- Securities borrowing or lending transactions
- Committed credit lines
- Guarantees and letters of credit
- Derivative transactions between the Covered Company and the counterparty
- Credit or equity derivative transactions where the Covered Company is the protection provider

The proposed rule includes detailed procedures for calculating the value of the above transactions. The Board has asked for comments on possible impediments to its proposal for calculating gross credit exposure and whether additional or alternative valuation methodologies should be considered.

For purposes of calculating gross credit exposure to a counterparty, the proposed rule restates the "attribution rule" in Section 165(e) of the DFA, which provides that if the proceeds of a credit transaction between a Covered Company and any person are used for the benefit of, or

10 The Board has asked whether, in certain circumstances, limits on gross credit exposure may also be appropriate.

transferred to, a company, the Covered Company must treat the credit transaction as one with that company. The Board recognizes that the attribution rule, if interpreted too broadly, "would lead to inappropriate results and would create a daunting tracking exercise for Covered Companies." It therefore sought to "minimize the scope of application of this attribution rule," and the proposed rule seeks feedback on its efforts to do so.

To arrive at the amount of net credit exposure, gross credit exposure may be adjusted using the following considerations:

- Bilateral netting agreements, with respect to repurchase and reverse repurchase transactions and securities lending and borrowing transactions;
- Market value of any eligible collateral for a credit transaction, as such value is adjusted as set forth in the proposed rule;
- The unused portion of a credit extension, under certain enumerated circumstances;
- Any "eligible guarantee" from an "eligible protection provider," as such terms are defined in the proposed rule, that covers the credit transaction;
- The notional amount of any "eligible credit or equity derivative" from an "eligible protection provider" that references the counterparty, as such terms are defined in the proposed rule; and
- The face amount of a short sale of the counterparty's debt or equity security (i.e., sale of a security that the Covered Company does not own).

When a credit transaction between a covered company and a counterparty is covered by an eligible guarantee or an eligible credit or equity derivative, the above adjustments to the gross credit exposure would be mandatory, and the covered company would substitute credit exposure to the guarantor or the protection provider for credit exposure to the counterparty for purposes of the proposed rule.

The proposed rule would exempt certain categories of credit transactions from the limits on credit exposure, including intraday credit exposure to a counterparty and claims involving the United States and its agencies and certain government sponsored entities. Notably, transactions with US state and local governments and with foreign sovereigns are *not* exempt, and such parties and are treated as counterparties for purposes of the proposed rule—a decision regarding which the Board has invited feedback.

Compliance

A Covered Company must comply with the limits on credit exposure on a daily basis, as of the end of each business day, and must submit a monthly report to the Board demonstrating such compliance. Accordingly, a Covered Company must value many types of credit exposure and related collateral on a continuous basis. There are limited exemptions from this daily compliance requirement where the amount of a Covered Company's capital stock and surplus decreases (which results in a decrease in the credit exposure limit), or where there is a business combination involving either a Covered Company or its counterparties, although compliance must be re-established promptly—typically within 90 days.

We anticipate that the effort needed to achieve compliance with the exposure limits as drafted will be substantial, particularly for very large institutions. As an initial matter, each Covered Company will need to make a qualitative and quantitative assessment throughout the organization of all forms of credit exposure (both direct and "attributed"), all offsets to credit exposure, and all counterparties. Once that process is complete, a Covered Company must determine which counterparties are affiliated with one another, and therefore must be consolidated, for calculation of single-counterparty exposure—a massive undertaking in the case of large multinational enterprises. Finally, these same factors must be monitored throughout the organization on an ongoing, real-time basis in order to satisfy the daily compliance requirement under the proposed rule. In view of the size of some organizations and the sheer volume of transactions that will require tracking and aggregating, implementation of this mandate, if left in its current form, will be daunting.

4. Risk Officer and Risk Committee

A significant component of the government's effort to head off future crises is to require better risk management at large financial institutions. While all banking institutions are already required to have risk-management practices in place, the DFA goes a step further by requiring the establishment of a formal risk committee at large financial institutions. Such requirements, in most instances, would also be new to nonbank financial companies that may become subject to the DFA requirements.

As mandated by Section 165, the Board is proposing that publicly traded nonbank Covered Companies and publicly traded BHCs with US$10 billion or more in total consolidated assets establish a risk committee of the board of directors to document and oversee enterprise-wide risk-management policies and practices. The proposed rule will require certain procedures for risk committees, including a formal, written charter that is approved by the company's board of directors, regular meetings, full documentation and maintenance of records of proceedings, and direct reporting to the company's board of directors. The risk committee's substantive duties would include reviewing and approving an institution-appropriate risk-management framework that includes the company's stated risk limitations for each business line, processes for identifying and reporting risks and deficiencies, and specification of management's authority to carry out risk-management duties. The proposed rule would also require Covered Companies to appoint a chief risk officer who will implement and maintain the risk-management framework and practices approved by the risk committee.

The proposed standards would be more stringent for risk committees of Covered Companies than for other entities subject to the risk committee requirement. The Board expects the expertise of the risk-committee membership to be commensurate with the complexity and risk profile of the organizations. Thus, the requirements of the proposed rule would increase in stringency with the systemic footprint of the company. Additionally, all banking organizations supervised by the Board must continue to follow existing Board guidance on risk management.

The Board has requested feedback on whether it should establish independence and competence requirements for service as a member of the risk committee or as the chief risk officer, or whether the proposed rules are sufficient. The Board has also asked for comments on the appropriate role of members of the risk committee in overseeing enterprise-wide risk management, the scope of that role, and how to ensure that the committees are sufficiently supported to carry out their duties. As the parameters of potential director liability will flow from these requirements, institutions that are potentially subject to the proposed rule will want to consider these questions carefully and respond as appropriate.

5. Stress Tests

The proposed rules implement Section 165's requirement that the Board conduct annual stress tests of Covered Companies under baseline, adverse, and severely adverse scenarios, and publicly disclose information on the company-specific results of those tests. The supervisory tests would evaluate whether each Covered Company has the necessary capital to absorb losses under the "normal" and adverse economic and financial conditions of the designated scenarios. This evaluation would include a review, among other things, of the Covered Company's estimated losses, pre-provision net revenue, allowance for loan losses, and the impact of those factors on the company's capital position. The Board would update the scenarios each year to reflect changes in the outlook for economic and financial conditions.

The Board intends to conduct the supervisory stress tests using data supplied by each Covered Company. The tests would use information regarding the company's on- and off-balance sheet exposures to evaluate the sensitivity of the company's revenues and expenses to several economic and financial scenarios. The Board will issue a separate proposal outlining the specific data requirements. The Board will also publish a separate overview of its methodology for the supervisory stress tests.

Additionally, the proposed rules implement Section 165's requirement that any financial company regulated by a primary federal financial regulatory agency that has more than US$10 billion in total consolidated assets conduct its own annual stress test, and that Covered Companies conduct additional semi-annual stress tests. For the semi-annual company-run test, a Covered Company would be required to create and employ its own scenarios reflecting a minimum of three sets of economic and financial conditions—baseline, adverse, and severely adverse conditions—and any additional conditions that the Board requires. The company must then report to the Board the results of the stress tests, publish a summary of the results,[11] and take the results of the stress tests and the Board's analyses thereof into account in making appropriate changes to the company's capital structure, concentrations, and risk positions. The Board may also require other actions consistent with safety and soundness of the company.

While Sections 165 and 166 generally do not apply to SLHCs, the company-run stress test requirement does apply to SLHCs with US$10 billion or more in total consolidated assets (as well as to state member banks with total assets of US$10 billion or more). However, as with other provisions of the proposed rulemaking, the effective date of this requirement for SLHCs will be delayed until the Board has established risk-based capital requirements for SLHCs.

6. Debt-to-Equity Limit

Section 165(j) of the DFA requires the Board to limit a Covered Company's debt-to-equity ratio (calculated as the ratio of a company's total liabilities to its total equity capital less goodwill) to 15 to 1, upon a determination by the FSOC that the company poses a grave threat to the financial stability of the United States and that the limit is necessary to mitigate the risk posed by the company to the financial stability of the United States. It also requires the Board to establish procedures and timelines for complying with the limit. The proposed rule would require a Covered Company to comply with the limit within 180 days of receiving written notice from the FSOC of its determination under Section 165(j) of the DFA. It would allow the Board to extend the time for compliance for up to two additional periods of 90 days each. The limit would cease to apply upon notice from the FSOC that the company no longer poses a grave threat to the financial stability of the United States and that the imposition of the limit is no longer necessary.

7. Early Remediation

While Congress and the Board obviously hope that the enhanced prudential standards created by the DFA and the proposed rules will prevent further crises, a framework is nonetheless established in the proposed rule, consistent with Section 166 of the DFA, for the Board to take specific steps to address weaknesses and, if necessary, failures of Covered Companies. The process established in the proposed rules is intended to go beyond the Prompt Corrective Action mechanism used by the federal banking agencies, which mandates progressively stronger remedial action as the condition of an insured depository institution deteriorates and which was criticized as insufficient to protect the deposit insurance fund in recent years. In addition to Covered Companies, the Board also would impose early remediation requirements on SLHCs with substantial banking activities once the Board has established risk-based capital requirements for them.

Under the proposed rule, the Board would impose certain remediation requirements on Covered Companies based on various triggering events, including the Board's existing definitions of minimum risk-based capital and leverage ratios, the results of the Board's supervisory stress tests under the proposed rule, market indicators, and weaknesses in complying with enhanced risk-management and liquidity standards under the proposed rule. The Board would like to be advised of any possible alternative or additional triggering events that may be employed in the proposed rulemaking. The Board is also particularly interested in comments regarding the market indicators it has proposed as triggering events for remedial actions.

11 The Board has asked for feedback on the benefits and drawbacks of company-specific disclosures and whether any alternatives should be considered.

The proposed rule establishes four levels of remediation requirements that are designed to identify emerging issues before they develop into larger problems. At the first level—heightened supervisory review—the Board would conduct a targeted review of the Covered Company to determine if it is experiencing financial distress or material risk-management weaknesses such that it should be moved to the next level of remediation. At the second level—initial remediation—a Covered Company would be subject to restrictions on growth and capital distributions. At the third level—recovery—a firm would face growth and capital-distribution prohibitions, executive compensation limitations, and capital raising requirements. Finally, at the fourth level—recommended resolution—the Board would determine whether to recommend that the firm be resolved under the orderly liquidation authority created by the DFA. Required actions would vary based on the severity of the situation.

The proposed early remediation regime would be in addition to the Board's other supervisory processes with respect to Covered Companies and would in no way diminish the Board's authority to initiate administrative actions, under Section 8 of the Federal Deposit Insurance Act and elsewhere, to address supervisory concerns.

Conclusion

The proposed regulations are a significant step towards implementing the enhanced prudential standards mandated by the DFA. While the rules attempt to create a more resilient and potentially less-interdependent industry, the implementation of the rules will not be without cost. In recognition of the far-reaching impact of this rulemaking, the Board has posed nearly 100 specific questions in the Notice that address multiple aspects of each element of the proposal. Industry participants that may be subject to these proposed rules should give careful consideration to their feasibility and whether better, less onerous alternatives may be available that would achieve the results required under the DFA. Large SLHCs and FBOs, for which similar rulemakings are forthcoming, will certainly wish to review the current proposal in the context of their unique organizational structures to assist the Board in crafting appropriate implementing regulations.

We hope you have found this Advisory useful. If you would like more information or assistance in addressing the issues raised in this Advisory, please feel free to contact:

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ARNOLD & PORTER LLP

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Consumer Financial Protection Bureau and Federal Trade Commission Announce Memorandum of Understanding

On January 23, 2012, the Consumer Financial Protection Bureau (CFPB) and the Federal Trade Commission (FTC) announced that they had signed a memorandum of understanding (MOU). In doing so, the two agencies fulfilled requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that they negotiate an agreement to coordinate enforcement actions against entities subject to both agencies' jurisdiction and harmonize certain rulemakings. The MOU also provides for coordination in other areas such as sharing supervisory information and consumer complaints, preserving the confidentiality of shared information, and consumer education. We provide a summary of the MOU below.

Law Enforcement

Under section 1024 of the Dodd-Frank Act, the CFPB has enforcement authority over nonbank entities that offer or provide consumer financial products or services. Because the FTC retains enforcement authority over such entities under the Dodd-Frank Act, both agencies could bring enforcement actions against the same entity over the same issue in the absence of coordination. Accordingly, the Dodd-Frank Act requires the CFPB and the FTC to negotiate an agreement to coordinate enforcement actions against nonbank entities subject to the enforcement authority of both agencies regarding the offering or provision of financial products or services.

Under the MOU, each agency will give notice to the other before commencing an investigation, filing an action or commencing a proceeding, settling an action or proceeding, or intervening in an action against a supervised entity where the other agency also has the authority to bring an enforcement action against the supervised entity. They will coordinate to avoid duplicative or conflicting enforcement actions.

Each agency will take the following steps before commencing an investigation of a supervised entity regarding the offering or provision of consumer financial services:

Brussels
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Denver
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London
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Los Angeles
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- Each agency will inquire or otherwise seek to determine whether the other agency: (i) has investigated or is investigating the supervised entity; (ii) has filed a court action or administrative proceeding against the entity; or (iii) has obtained an order or judgment against the entity. The agency receiving such an inquiry must respond within 10 business days.
- If one of the agencies decides to investigate a supervised entity, it generally must notify the other agency of the identity of the supervised entity and the topic or topics of the investigation five business days before commencing the investigation. If one agency seeks to investigate an entity because the entity may have violated an order or judgment that the other agency has obtained against the entity, it must articulate a rationale for commencing a new investigation.

To help identify pre-existing enforcement actions, each agency will provide the other with a list of currently binding orders and judgments against supervised entities within 60 days of the execution of the MOU. The agencies will provide each other with updated lists quarterly. Furthermore, the two agencies will develop a secure computerized system that each can independently search to determine whether the other agency has or had an investigation, action or proceeding, or order or judgment concerning a supervised entity.

The two agencies agree to provide each other with at least ten business days' notice before filing an action or commencing an administrative proceeding. If the agency initiating the action or proceeding seeks a finding of contempt, a temporary restraining order, expedited preliminary injunction, a temporary cease and desist order, or other similar relief and thus cannot provide ten business days' notice, it must provide at least three business days' notice.

Each agency agrees to give the other agency at least ten business days' notice before filing a consent decree, consent order, or settlement agreement in court to settle an action, or accepting for public comment a proposed consent order or issuing a final consent order to settle an administrative proceeding.

Each agency agrees to forward any notice of a state's intent to file an action against a supervised entity for violating the Mortgage Assistance Relief Services Rule or Mortgage Act and Practices – Advertising Rule of the CFPB as soon as practicable after receiving the notice from the state.

Each agency agrees to do its best to provide notice of its intention to intervene in a court action filed by the other agency and the reason for such intervention at least 20 days before moving to intervene.

If one of the agencies initiates a court action or administrative proceeding against a supervised entity, the other agency will not initiate such an action or proceeding against the same entity regarding the same alleged violations either at the same time or during the pendency of the first agency's action or proceeding. But the agencies may pursue parallel actions or proceedings after consultation in what they consider to be unusual circumstances. They may also pursue joint or coordinated court actions or administrative proceedings, and one agency may intervene in a court action filed by the other. Such coordination should help reduce the risk of duplicative enforcement actions against a supervised entity; at the same time, it could be an incentive for pursuing a case that one agency might otherwise forego.

Rulemaking and Guidelines

Section 1061(b)(5)(D) of the Dodd-Frank Act requires the two agencies to negotiate an agreement to coordinate the CFPB's rulemaking to prohibit "unfair, deceptive, or abusive acts or practices" under section 1031 of the Dodd-Frank Act and the FTC's rulemaking to prohibit "unfair or deceptive acts or practices" under section 18 of the Federal Trade Commission Act as applied to nonbank entities that are subject to the jurisdiction of both the CFPB and the FTC. Under the MOU, each agency will provide the other agency with at least 60 days' notice before publishing any proposed or final rules under these statutory provisions. They will discuss the proposed rules and comments received on the proposed rules. Each agency will provide the other with at least 30 days' notice before issuing any formal comprehensive guidance documents, whether proposed or final, under these statutory provisions. They will consult on such guidance documents. Such coordination should help the two agencies formulate consistent standards for determining what constitutes an unfair, deceptive, or abusive act or practice.

The CFPB will consult with the FTC in exercising its rulemaking authority in general. With respect to certain consumer financial laws for which the FTC had rulemaking authority before that authority was transferred to the CFPB, the CFPB will give the FTC at least 30 days' notice before publishing an Advance Notice of Proposed Rulemaking. The FTC's input should be valuable in imparting the CFPB with relevant practical experience in interpreting and enforcing such statutes in various contexts. The agencies also will meet periodically to discuss interpretive guidance under consumer financial laws that both agencies enforce.

Supervision and Examination

The two agencies agree to meet at least quarterly to discuss the CFPB's plans to examine supervised entities that are also subject to FTC jurisdiction, as well as results of examinations and proposed activities to address the results. The CFPB will update the FTC on any significant changes to the examination plans between meetings. In addition, the CFPB will tell the FTC the anticipated start date of an examination within two business days after receiving the FTC's request.

Within ten business days of receiving a written request from the FTC, the CFPB will provide the FTC with an examination report on a supervised entity that is also subject to FTC jurisdiction; it will also provide updates on any revisions to the report. Moreover, the CFPB will provide the FTC with other information collected through its supervision of an entity that is also subject to FTC jurisdiction unless it articulates good cause not to do so.

Consumer Complaints

The CFPB agrees to share consumer complaints with the FTC through the Consumer Sentinel Network, which is the secure and searchable Internet-based consumer complaint database that the FTC administers and makes available to federal, state, local, and foreign law enforcement agencies, including the CFPB. As a result, consumer complaints collected by the CFPB will also be available to all law enforcement agencies that have access to the FTC's Consumer Sentinel Network. A larger number of consumer complaints could increase the interest of law enforcement in the entities or issues involved in the complaints. One might expect this to have more impact than, for example, the sharing by state officials of consumer complaints they receive with the Office of the Comptroller of the Currency for purposes of investigations and enforcement actions against national banks.

The two agencies will develop guidance to help consumers determine the proper agency to complain to, as well as procedures to transfer consumers with complaints to the agency best situated to assist. They will consult on methods to help ensure that any processes they establish to respond to individual consumer complaints do not prejudice future enforcement or legal action. The agencies agree to revisit the procedures for sharing and handling consumer complaints by July 21, 2013.

Information Sharing and Confidentiality

The two agencies agree to take all actions reasonably necessary to preserve all privileges and claims of confidentiality related to all nonpublic information they share with each other. Each agency agrees not to disclose nonpublic information received from the other to third parties without written permission. In the event of a third-party request, the agency that has received the requested information from the other agency will take the following steps:

- The recipient agency will notify the other agency of the third-party request.
- If the request is made pursuant to the Freedom of Information Act or the Privacy Act, the recipient agency will refer the request to the providing agency for a direct

response if practicable; otherwise, it will consult with the providing agency in responding.

- If the request is not made pursuant to the Freedom of Information Act or the Privacy Act, the recipient agency will consult with the providing agency before responding, and to the extent applicable, give the providing agency a reasonable opportunity to assert legal exemptions or privileges that it wants the recipient agency to assert on its behalf.
- The recipient agency will consent to an application by the providing agency to intervene in any action to preserve the confidentiality of the shared information or any related privilege.

Other Areas of Coordination

The two agencies agree to meet at least twice a year to coordinate their regulation and supervision of entities over which they both have jurisdiction with respect to the offering and provision of consumer financial products or services. They also agree to meet at least quarterly to coordinate initiatives to educate consumers on consumer financial products and services, including initiatives for military service members and their families and older Americans. They will also coordinate research projects on consumer financial products or services offered or provided by entities subject to their jurisdiction.

Implications

Under previous coordination agreements between the FTC and other federal agencies, the agencies have tended to allocate their respective responsibilities along subject-matter lines. For example, in a memorandum of understanding between the FTC and the Food and Drug Administration (FDA), the two agencies agreed that the FTC would assume primary responsibility for regulating food, cosmetic, medical device, and dietary supplement advertising, while the FDA would take primary responsibility for regulating the labeling of such products. Under the Memorandum of Agreement Between the Federal Trade Commission and the Antitrust Division of the United States Department of Justice Concerning Clearance Procedures for Investigations, the agencies allocate the review of proposed mergers or other competition matters to one or the other agency based on industry lines.

The MOU between the FTC and the CFPB, in contrast, generally does not require either agency to defer to the other with respect to any entities or subject matters within its jurisdiction. Handling the matters over which they share jurisdiction could prove a test of personal relationships as well as mutual professional respect—in that regard, it may help that many CFPB officials were previously members of the FTC staff. Banks and other regulated financial institutions will want to pay close attention to how the agencies implement the MOU, including which agency appears to dominate on certain decisions and which may be more aggressive in the investigatory and enforcement contexts.

Arnold & Porter LLP is available to assist you with compliance with the federal consumer financial laws and with preparation for examinations by the CFPB. For further information, please contact your Arnold & Porter attorney or:

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FSOC Issues Final Rule for Making "Systemically Important" Designations

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In crafting the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA), Congress took particular aim at nonbank institutions that were engaged in "financial" activities but fell outside the established regulatory framework. These institutions, several of whose rescue (or failure) played out dramatically in the national news, were blamed for contributing to the cause and severity of the 2008 financial crisis. In Congress's view, such institutions had become overleveraged, undercapitalized, and too interconnected with other financial institutions, jeopardizing both themselves and the broader economy. Congress therefore determined that nonbank financial companies whose financial distress or failure could pose significant risk to the US economy—so-called "systemically important financial institutions," or "SIFIs"—should be identified and subjected to prudential standards and to supervision by the Board of Governors of the Federal Reserve System (Board).[1] The result was Title I of the DFA and the creation of the Financial Stability Oversight Council (FSOC).

Critical to the FSOC's mission is the identification of the nonbank financial companies that should be subjected to enhanced regulation and supervision. Section 113 of the DFA provides the grounds for making this determination and requires that two rulemakings be finalized—one each by the FSOC and the Board. Section 113 requires that the Board issue regulations defining whether a company is "predominantly engaged in financial activities" for purposes of determining whether a company is eligible to be deemed a SIFI. The FSOC will then use that definition in exercising its Section 113 authority to designate SIFIs. The Board recently issued an amended notice of proposed rulemaking with regard to this requirement on April 10, 2012 extending the comment period through May 25, 2012.

Concurrently with the Board's rulemaking process, the FSOC, as required by Section 113, has been preparing its own regulatory framework to identify SIFIs. The FSOC issued its final regulation on April 3, 2012. The rule will become effective on May 11, 2012.

1 The exact parameters of enhanced supervision are subject to a separate proposed rulemaking by the Board and will likely include risk-based capital requirements and leverage limits, liquidity requirements, single-counterparty exposure limits, stress tests, debt-to-equity limits, corporate governance requirements, and early remediation by the Board.

The final regulation consists of two parts: the rule and its accompanying interpretive guidance. The rule itself is straightforward and addresses significant definitional and procedural points, such as the statutory factors to be considered in making a SIFI determination, the right to a hearing, the votes that are required for designation, and the appeals process, among other things. However, the rule focuses on the events that occur once the FSOC has notified a company that it is under consideration for designation as a SIFI. There is, of course, a considerable amount of work and analysis that occurs "behind the scenes" at the FSOC before a nonbank financial company becomes an active participant in the process. In an effort to be as transparent as possible with the SIFI-designation process, the FSOC has also provided interpretive guidance as part of the regulation that explains the steps taken prior to the involvement of the potential SIFI in the proceedings. The process is summarized below.

SIFI Considerations

Under section 113 of the DFA, the FSOC may designate a nonbank financial company for Board supervision if it determines that: (a) material financial distress at the company could pose a threat to the financial stability of the United States; or (b) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company could pose a threat to the financial stability of the United States.

In making its determination, the FSOC is required to consider ten statutory factors and any other risk-related factors that it deems appropriate. The FSOC has developed an analytical framework that groups the ten statutory factors and other risk-related factors into six categories. The FSOC will examine quantitative and qualitative data relevant to each of the categories, including data that reflect stressed market conditions. The six categories are described below.

Interconnectedness. Interconnectedness captures the degree to which a nonbank financial company is directly or indirectly connected with other financial companies. Interconnectedness depends on the number of counterparties a company has, the importance of the company to its counterparties, and the extent to which the counterparties are interconnected with other financial firms, the financial system, and the broader economy. Examples of data the FSOC will examine in assessing interconnectedness include:

- The aggregate amount of a nonbank financial company's derivative transactions and the number of counterparties;
- The aggregate notional amount of credit default swaps outstanding that relate to the obligations of a nonbank financial company or its parent company;
- The extent to which the counterparties of a nonbank financial company are exposed to the company, measured as a percentage of the counterparties' capital; and
- The extent to which a nonbank financial company's assets are financed by a small number of firms, and the importance of the financing firms to the market.

Substitutability. Substitutability captures the extent to which other firms could provide similar financial services in a timely manner at a similar price and quantity if a nonbank financial company withdraws from a particular market. In assessing substitutability, the FSOC will consider, among other things:

- The market share of a nonbank financial company and its competitors;
- The ability of the competitors to expand to meet market needs in the absence of the company even if they are faced with the same stressed conditions;
- The costs that the company's customers would incur to switch providers; and
- The disruption that customers will experience in switching providers and the economic implications of the disruption.

Size. Size captures the amount of financial services or financial intermediation that a nonbank financial company provides. It is generally measured by the assets, liabilities, and capital of the firm. The FSOC will also consider off-balance sheet assets and liabilities, assets under management, and the number of customers and counterparties, as appropriate. For an insurance company, the FSOC will also consider the aggregate amount of direct written premiums, which serves as a proxy for the amount of insurance underwritten by the insurance company and risk in force, which is the aggregate risk exposure that the company incurs for insuring against a certain financial risk.

Leverage. Leverage captures a company's risk level in relation to its equity capital. Leverage is typically measured by the ratio of debt to capital, but it can also be measured by economic risk relative to capital. With respect to the latter measurement, the FSOC will consider the gross notional amount of derivative contracts and off-balance sheet obligations relative to total equity or to net assets under management. For an insurance company, the FSOC will also consider the ratio of risk to statutory capital, which shows how much risk exposure an insurance company has as compared to its ability to absorb loss. The FSOC will also examine changes in leverage ratios over time to identify any rapid increase in a company's risk profile.

Liquidity risk and maturity mismatch. Liquidity risk generally refers to the risk that a company may not have sufficient funding to satisfy its short-term needs, either through its cash flows, maturing assets, assets salable at prices equivalent to book value, or its ability to access funding markets. A maturity mismatch generally refers to the difference between the maturities of a company's assets and liabilities. In assessing liquidity risk and maturity mismatch, the FSOC will consider:

Ratios of a company's liquid assets to total assets, short-term debt, and the net cash flows that the company could encounter in a short-term stress scenario;

- The ratio of callable debt to total debt, which indicates a company's ability to reduce cash outflow when interest rates go down;
- Funding sources, which indicate whether a company relies heavily on particular markets such as the asset-backed securities markets or the short-term debt markets; and
- Asset-liability duration and gap analysis.

Existing regulatory scrutiny. The FSOC will consider the extent to which a nonbank financial company is already subject to regulation. For a company based outside the US, the FSOC will consider the extent to which the company is subject to consolidated prudential regulation in its home country.

Evaluation Process

The FSOC's interpretive guidance provides a detailed description of the three-stage process it intends to use to identify nonbank financial companies for determinations under nonemergency situations (the "Determination Process").[2] Each stage of the Determination Process involves an analysis based on an increasing amount of information to determine whether a nonbank financial company meets the standard for enhanced supervision.

Due to the preliminary nature of the FSOC's evaluation of a nonbank financial company prior to a final determination of designation (Final Determination), and the potential for market participants to misinterpret such an announcement, the FSOC does not intend to publicly disclose the name of any company under evaluation prior to a Final Determination after Stage 3.

Stage 1: Narrowing the Universe

Stage 1 of the FSOC's three-stage Determination Process is designed to narrow the universe of nonbank financial companies under consideration for enhanced supervision. The progression of a company from Stage 1 to Stage 2 does not reflect a determination by the FSOC that the nonbank financial company meets the criteria for designation, but rather only that it should be subject to further evaluation.

In Stage 1, the FSOC will apply uniform quantitative thresholds that are broadly applicable across the financial sector using four of its framework categories: size,

2 If the FSOC determines that it is necessary or appropriate to waive or modify the procedures laid out below to prevent or mitigate threats posed to the financial stability of the United States, it may do so upon written notice to the nonbank financial company. The company will then undergo an accelerated Determination Process which will include an opportunity to contest the waiver or modification and an evidentiary hearing challenging the determination itself.

interconnectedness, leverage, and liquidity risk and maturity mismatch. This determination will be made using only information available through existing public and regulatory sources. The FSOC will use the following six thresholds[3] for its Stage 1 analysis:

- US$50 billion in total consolidated assets;
- US$30 billion in gross notional credit default swaps outstanding for which a nonbank financial company is the reference entity;
- US$3.5 billion of derivatives liabilities;
- US$20 billion in total debt outstanding (including loans, bonds, repurchase agreements, commercial paper, securities lending arrangements, surplus notes (for insurance companies), and other forms of indebtedness), a metric which the FSOC will use as a proxy for interconnectedness;
- 15 to 1 leverage ratio of total consolidated assets (excluding separate accounts[4]) to total equity; and
- 10% short-term debt ratio of total debt outstanding with a maturity of less than 12 months to total consolidated assets (excluding separate accounts).

A nonbank financial company will be subject to further review if it meets both the total consolidated assets threshold and any one of the other thresholds. At its discretion, the FSOC also reserves the right to subject any nonbank financial company to further review, regardless of whether it meets the above criteria, if the FSOC believes the company may pose a threat to US financial stability.

Stage 2: Comprehensive, Company-Specific Analysis

In Stage 2, the FSOC will conduct a comprehensive analysis of each nonbank financial company identified in Stage 1 for further review using the six-category analytic framework. In general, this analysis will be based on quantitative and qualitative information available to the FSOC through existing public and regulatory sources as well as company-specific information obtained by FSOC through consultations with the company's primary financial regulatory agency or home country supervisor, as appropriate. According to the FSOC, each company will also be permitted to submit additional information on a voluntary basis. Although the rule does not provide for formal notice from the FSOC that a company has become subject to Stage 2 review, most companies will know based on the quantitative measures of Stage 1 that they are subject to further review and may proactively submit additional information on that basis.

Stage 3: In-Depth Evaluation and Proposed Determination

Based on the analysis conducted in Stage 2, the FSOC will send a notice of consideration of a proposed determination to each nonbank financial company identified that they will be subject to an in-depth evaluation during Stage 3. The FSOC's Stage 3 analysis will include additional quantitative and qualitative information collected directly from the nonbank financial company, generally by the Office of Financial Research. The company will also be given an opportunity to submit information concerning whether, in the company's view, material financial distress at the company, or the nature, scope, size, scale concentration, interconnectedness, or mix of activities of the company, could pose a threat to the financial stability of the United States.

During Stage 3 the FSOC will likely consider a number of qualitative factors that could mitigate or aggravate the potential of a particular nonbank financial company to pose a threat to US financial stability, such as the company's resolvability, the opaqueness of its operations, its complexity, and the extent and nature of its existing regulatory scrutiny. At this point, the FSOC may consult with the company's primary financial regulatory agency or home country supervisor and consider the views of such entities.

After performing the Stage 3 analysis, the FSOC will vote on whether a nonbank financial company should be

3 For foreign nonbank financial companies, only the U.S. assets, liabilities, and operations of the company and its subsidiaries will be considered when applying these thresholds.

4 For purposes of this determination, a "separate account" is an account whose assets are not available to satisfy claims by general creditors of the company.

subject to the Board's enhanced supervision and prudential standards (called a "Proposed Determination"). A Proposed Determination requires the vote of not fewer than two-thirds of the voting members of the Council then serving, including the affirmative vote of the Secretary of the Treasury as Chairperson of the Council.

Post-Determination Process

Following a Proposed Determination, the FSOC will issue a written notice of the determination to the nonbank financial company providing an explanation of the basis for the decision. The company may then request a written or oral evidentiary hearing before the FSOC or its representatives to contest the Proposed Determination.

After the evidentiary hearing, or, if no hearing is requested, shortly after the notice of Proposed Determination, the FSOC will vote on a Final Determination that the nonbank financial company should be subject to the Board's enhanced supervision and prudential standards. A Final Determination, like a Proposed Determination, requires the vote of not fewer than two-thirds of the voting members of the Council then serving, including the affirmative vote of the Secretary of the Treasury as Chairperson of the Council. The FSOC will then notify the company of the Final Determination, including the basis for its decision, and publicly announce the determination.

Not less than annually, the FSOC will reevaluate each final determination for enhanced supervision made under the rule and rescind the determination if the company no longer meets the standard for designation. The FSOC will reapply the Stage 1 thresholds to nonbank financial companies not designated initially using the most recently available data on a quarterly basis, or less frequently for companies for which quarterly data are unavailable.

Confidentiality of Information

A clear industry concern that emerged as part of the comment process was whether the information collected by the FSOC in the course of conducting its SIFI analysis would be adequately protected from disclosure. To address that concern, the final rule seeks to clarify that information collected during the FSOC's analysis of nonbank financial companies, whatever the source, is subject to the Freedom of Information Act (FOIA), including its exceptions. As such, nonpublic information collected pursuant to the Section 113 process should be protected from disclosure to the extent that an exception to disclosure under the FOIA is available.

Two important caveats to this protection bear noting. First, although the final rule states that the submission of privileged materials to the FSOC does not waive any applicable privilege, it is unclear how strong a protection that regulation—absent statutory support—will prove to be. Although section 18(x) of the Federal Deposit Insurance Act provides for such protection for materials provided to enumerated federal bank regulatory agencies, the FSOC is not among those enumerated entities. The Consumer Financial Protection Bureau, which is also absent from that list, has proposed a similar rule that would protect the privilege of materials provided to it by the industry, but it has faced considerable pushback on the effectiveness of such a rulemaking. To that end, Congress is poised to pass legislation providing for statutory protection for such materials.

Secondly, it is important to note that members of the FSOC may share among themselves information that is derived from their respective agencies and elsewhere. Although the protection from public disclosure of such materials is intended to travel with the materials, the FSOC members may share the information with their own agencies for enforcement or other purposes. Therefore, protection from public disclosure does not guarantee that a SIFI determination will be the only application of materials gathered during the Section 113 process.

Conclusion

The FSOC has provided guidance in the final rulemaking that should allow nonbank financial companies to assess whether they may be subject to a possible SIFI designation. Until the Board finalizes its rulemaking with regard to the meaning of "predominantly engaged in financial activities," there will not be absolute clarity, but organizations can nonetheless begin reviewing their balance sheets to determine what the results of a Stage 1 analysis would be. Companies whose activities would raise the potential for a SIFI designation would be well advised to implement regular monitoring of the Stage 1 thresholds to track the likelihood of receiving a Section 113 information request from the FSOC. Companies that clearly meet the Stage 1 thresholds may wish to begin consideration of the impact of a SIFI designation and the possible arguments that could be employed to rebut such a designation.

We hope you have found this Advisory useful. If you would like more information or assistance in addressing the issues raised in this Advisory, please feel free to contact:

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ADVISORY

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Proposed Federal Banking Agency Regulations Implementing Basel III Standards Would Substantially Revise Capital Requirements

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On June 7, 2012, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) released three notices of proposed rulemaking[1] and one joint final rule (the Market Risk Final Rule)[2] that would revise and replace the agencies' current capital rules. The proposed rules and the joint final rule would update the agencies' general risk-based and leverage capital requirements to incorporate agreements reached by the Basel Committee on Banking Supervision (BCBS) in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" and certain other revisions to the Basel capital framework in response to the global financial crisis. They would also implement Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which calls for new leverage and risk-based capital requirements.[3]

The agencies' revised general regulatory capital framework (DFA/Basel III Capital Rule) and proposed "Standardized Approach Rule" for calculating risk-weighted assets would apply to all banking organizations that are currently subject to minimum capital requirements (including national banks, state member banks, state nonmember banks, state and federal savings associations, and top-tier bank holding companies domiciled in the United States not subject to the Board's Small Bank Holding Company Policy Statement (12 C.F.R. part 225, Appendix C)), as well as top-tier savings and loan holding companies domiciled in the United States (together, banking organizations).

1 Joint Notice of Proposed Rulemaking, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action* (June 7, 2012); Joint Notice of Proposed Rulemaking, *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements* (June 7, 2012); Joint Notice of Proposed Rulemaking, R*egulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule* (June 7, 2012) (All rules are available: http://www.federalreserve.gov/newsevents/press/bcreg/20120607a.htm).

2 Joint Final Rule, *Risk-Based Capital Guidelines: Market Risk* (June 7, 2012).

3 Codified at 12 U.S.C. § 5371.

The additional "Advanced Approaches Rule" would apply, in general, to banking organizations with consolidated total assets of US$250 billion or more or consolidated total on-balance sheet foreign exposure of US$10 billion or more (advanced approaches banking organizations).

The Market Risk Final Rule will apply, in general, to banking organizations with trading assets and trading liabilities of (1) 10% or more of total assets, or (2) US$1 billion or more.

The proposed rules would be phased in over the next ten years, from January 1, 2013 to January 1, 2022. The agencies have proposed an effective date of January 1, 2015 for the risk-weighted asset calculations with an option for early adoption. Comments on the three proposed rules are due by September 7, 2012. The Market Risk Final Rule will go into effect on January 1, 2013.

Broadly, the proposed rules would:

- Implement a new common equity tier 1 minimum capital requirement, a higher minimum tier 1 capital requirement, and a tier 1 leverage ratio;
- For only the advanced approaches banking organizations, implement a supplementary leverage ratio that incorporates a broader set of exposures in the denominator as well as a countercyclical capital buffer requirement;
- Apply limits on a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not maintain a capital conservation buffer (plus a countercyclical capital buffer in the case of advanced approaches banking organizations) composed of common equity tier 1 capital as required;
- Establish more conservative standards for including an instrument in regulatory capital;
- Revise and harmonize the agencies' rules for calculating risk-weighted assets to enhance risk sensitivity;
- Establish alternatives to credit ratings for calculating risk-weighted assets consistent with section 939A of Dodd-Frank; and
- Update the market risk capital rule to better capture the positions and risks for which the application of the rule is appropriate, reduce procyclicality, enhance disclosures, and apply the rule to savings associations and savings and loan holding companies (SLHCs) that meet the applicable thresholds.

Below we provide a more detailed summary of the proposed rules, and attached as an Appendix is a table outlining the differences between the current and proposed treatments of risk-weighted assets, credit conversion factors, and credit risk mitigation.

Minimum Capital Requirements

The proposed rules would require banking organizations to maintain the following minimum regulatory capital ratios on a consolidated basis:

- A common equity tier 1 capital ratio of 4.5%, which is the ratio of common equity tier 1 capital to total risk-weighted assets;
- A tier 1 capital ratio of 6%, which is the ratio of tier 1 capital to total risk-weighted assets;
- A total capital ratio of 8%, which is the ratio of total capital to total risk-weighted assets; and
- A leverage ratio of 4%, which is the ratio of tier 1 capital to average consolidated assets (i.e., on-balance sheet assets as reported in the banking organization's regulatory report), net of amounts deducted from tier 1 capital.

In addition, advanced approaches banking organizations would need to meet a supplementary leverage ratio of 3, which is the ratio of tier 1 capital to total leverage exposure. Total leverage exposure would include not only average consolidated assets but also certain off-balance sheet assets, such as potential future exposures associated with derivative contracts to which the banking organization is a counterparty.

The common equity tier 1 capital ratio would be a new requirement. Tier 1 capital would be composed of common equity tier 1 capital and additional tier 1 capital, and the minimum tier 1 capital ratio would increase from 6% to 8%. The minimum leverage ratio would be 4% for all banking organizations, including those with a supervisory composite rating of 1 and currently subject to a 3% leverage ratio requirement.

The Federal Reserve indicates its intent to propose a quantitative risk-based capital surcharge consistent with the amount and implementation timeframe that the BCBS is to adopt for globally systemically important banks. The surcharge would apply to some or all of the bank holding companies and nonbank financial companies subject to enhanced prudential supervision by the Federal Reserve.

Capital Conservation Buffer

The proposed rules would require a banking organization to maintain a capital conservation buffer in an amount greater than 2.5% of total risk-weighted assets or else be subject to limitations on capital distributions and discretionary bonus payments to executive officers.

The capital conservation buffer would have to be composed of common equity tier 1 capital. The buffer would be measured as the lowest of: (a) the amount by which the banking organization's common equity tier 1 capital ratio exceeds 4.5%, (b) the amount by which its tier 1 capital ratio exceeds 6%, and (c) the amount by which its total capital ratio exceeds 8%. As a result of this requirement, a banking organization must have a common equity tier 1 capital ratio greater than 7%, a tier 1 capital ratio greater than 8.5%, and a total capital ratio greater than 10.5%.

The limitations that would apply in the event the buffer standards were not met include the following:

- If a banking organization had a capital conservation buffer of 0.625% or less at the end of the previous calendar quarter, it may not make any capital distributions or discretionary bonus payments to executive officers during the current quarter.
- If it had a capital conservation buffer greater than 0.625% but no greater than 1.25%, the capital distributions or discretionary bonus payments to executive offices during the current quarter are limited to 20% of its eligible retained income, which is defined as the organization's net income for the preceding four calendar quarters (net of any such distributions and payments) as reported in the quarterly regulatory reports.
- If the buffer is greater than 1.25% but no greater than 1.875%, the limit is 40% of eligible retained income.
- If the buffer is greater than 1.875% but no greater than 2.5%, the limit is 60%.

Countercyclical Capital Buffer

The proposed rules also would require an advanced approaches banking organization to maintain a countercyclical capital buffer. The countercyclical capital buffer would have to be composed solely of common equity tier 1 capital. If a banking organization has private sector credit exposures (*i.e.*, credit exposure to a private sector entity that is included in credit risk-weighted assets) in more than one national jurisdiction, the amount of the buffer is determined by calculating the weighted average of the countercyclical capital buffer amounts established by each of the national jurisdictions. The weight assigned to a jurisdiction's countercyclical capital buffer amount is calculated as the ratio of the total risk-weighted assets for the organization's private sector credit exposures located in the jurisdiction to the total risk-weighted assets for all of the organization's private sector credit exposures.

In the United States, the initial countercyclical capital buffer amount is set at zero. The agencies may increase it to 2.5% of total risk-weighted assets, however, depending on credit market condition.

The countercyclical capital buffer would be an extension of the capital conservation buffer of an advanced approaches banking organization. Accordingly, an advanced approaches banking organization would need to maintain a capital conservation buffer in an amount greater than 2.5% of total risk-weighted assets, plus the required countercyclical capital buffer. Otherwise, it will be subject to restrictions on capital distributions and discretionary bonus payments to executive officers.

Prompt Corrective Action

The proposed rules would also change the definitions of capital categories for insured depository institutions for purposes of the Prompt Corrective Action statute (12 U.S.C. § 1831o) as follows:

- To be well capitalized, an insured depository institution must have a common equity tier 1 capital ratio of at least 6.5%, a tier 1 capital ratio of at least 8%, a total capital ratio of at least 10%, and a leverage ratio of at least 5%.
- To be adequately capitalized, an insured depository institution must have a common equity tier 1 capital ratio of at least 4.5%, a tier 1 capital ratio of at least 6%, a total capital ratio of at least 8%, and a leverage ratio of at least 4%.
- An insured depository institution is undercapitalized if it has a common equity tier 1 capital ratio less than 4.5%, a tier 1 capital ratio less than 6%, a total capital ratio less than 8%, or a leverage ratio less than 4%.
- An insured depository institution is significantly undercapitalized if it has a common equity tier 1 capital ratio less than 3%, a tier 1 capital ratio less than 4%, a total capital ratio less than 6%, or a leverage ratio less than 3%.
- An insured depository institution is critically undercapitalized if it has a tangible equity (now defined as tier 1 capital plus non-tier 1 perpetual preferred stock) to total assets of 2% or less.
- An advanced approaches banking organization would also need to have a supplementary leverage ratio of at least 3% to be adequately capitalized.

Eligibility Criteria for Inclusion in Regulatory Capital

The proposed rules would introduce a new capital component, namely, common equity tier 1 capital, and set out eligibility criteria for this capital component. Tier 1 capital would be composed of common equity tier 1 capital and additional tier 1 capital. The proposed rules would also revise the eligibility criteria for inclusion in additional tier 1 capital and tier 2 capital.

Eligibility Criteria

A banking organization's common equity tier 1 capital would be the sum of its outstanding common equity tier 1 capital instruments (which generally would be common stock) and related surplus, retained earnings, accumulated other comprehensive income, and minority interests (subject to certain limits, as discussed below), minus regulatory adjustments and deductions.

With respect to mutual banking organizations (which would include certain savings and loan holding companies that are insurance companies in mutual form), the instruments that would be considered common equity tier 1 capital would be those that are fully equivalent to common stock instruments in terms of their subordination and availability to absorb losses, and that do not possess features that could cause the condition of the company to weaken as a going concern during periods of market stress. According to the agencies, most of the capital of mutual banking organizations consists of retained earnings (including retained earnings surplus accounts), which is common equity tier 1 capital. Under the proposed rules, certain capital instruments issued by mutual banking organizations, such as non-withdrawable accounts, pledged deposits, or mutual capital certificates, could also be considered common equity tier 1 capital. However, certain instruments that currently are includable in the regulatory capital of mutual banking organizations, such as those that constitute liabilities under GAAP or are cumulative, would not be considered tier 1 capital.

Under the proposed rules, unrealized gains and losses on all available-for-sale securities would flow through to common equity tier 1 capital (specifically, accumulated other comprehensive income). However, the agencies appear open to excluding from regulatory capital the unrealized gains and losses on debt securities with very low levels of credit risk (*e.g.*, U.S. government securities), and invite comment on such an approach.

The proposed rules also set out eligibility criteria for inclusion of certain capital instruments in additional tier 1 capital and tier 2 capital. The agencies indicate that non-cumulative perpetual preferred stock generally would qualify as additional tier 1 capital. Trust preferred securities and cumulative perpetual preferred securities generally would not qualify as tier 1 capital, but many of them could qualify as tier 2 capital. Instruments allowing the accumulation of interest payable would not be considered sufficiently loss-absorbent to be included in tier 1 capital. And no instrument could be included in tier 1 capital unless it qualifies as equity under GAAP.

Limits on Minority Interests

The proposed rules would limit the amount of minority ownership interest in consolidated subsidiaries that could be included in the regulatory capital of the parent company. Such interest would be included in the common equity tier 1, additional tier 1, or total capital of the parent company only if the underlying capital instrument meets the eligibility criteria for that capital component. In addition, only capital instruments issued by a depository institution or foreign bank subsidiary of a parent holding company would be includable in the common equity tier 1 capital of the parent company.

Furthermore, if a consolidated subsidiary has regulatory capital in excess of the sum of its minimum capital requirement plus the required capital conservation buffer, the minority interest that contributes to the excess would not be includable in the parent company's regulatory capital. For example, if a bank subsidiary of a bank holding company has a common equity tier 1 capital ratio of 8%, which is one percentage point higher than the sum of its minimum common equity tier 1 capital requirement of 4.5% plus the 2.5% capital conservation buffer, and minority shareholders own 30% of the common equity of the bank subsidiary, then the bank subsidiary has excess common equity tier 1 capital in the amount of 1% of risk-weighted assets, 30% of which is contributed by the minority shareholders of the bank. This 30% of the excess would not be includable in the regulatory capital of the parent bank holding company.

The rationale stated in the preamble to the proposed rules is that the bank subsidiary would not be required to maintain the excess capital, so that excess capital might not be available to absorb losses in other parts of the consolidated parent organization. For a consolidated subsidiary that is not subject to the same regulatory capital requirement as the parent holding company, it would need to be treated as if it were subject to such requirements.

The agencies propose specific interpretive guidance on whether preferred stock issued by consolidated subsidiaries that are real estate investment trusts (REITs) could be included as minority interest in the regulatory capital of the parent banking organization. Under the guidance, preferred stock issued by a REIT that does not have the ability to declare a consent dividend (*i.e.*, a dividend that is not actually paid to the shareholders but that the shareholders have consented to treat as if paid in cash) would not qualify as tier 1 minority interest, but such preferred stock may meet the eligibility criteria for tier 2 capital.

Regulatory Capital Deductions and Adjustments

The proposed rules would require banking organizations to make certain deductions from and adjustments to regulatory capital, most of which would apply only to common equity tier 1 capital.

Deductions from Common Equity Tier 1 Capital

The proposed rules would require a banking organization to make the following deductions from its common equity tier 1 capital:

- Good will and other intangible assets other than mortgage servicing assets, net of deferred tax liabilities.
- Deferred tax assets that arise from operating losses and tax credit carryforwards net of any related valuation allowances and deferred tax liabilities.
- After-tax gain-on-sale associated with a securitization exposure.

- Defined benefit pension fund assets (other than those of an insured depository institution) net of any associated deferred tax liabilities, except that, with supervisory approval, a banking organization would not be required to deduct defined benefit pension fund assets to which the banking organization has unrestricted and unfettered access.
- Outstanding equity investments in financial subsidiaries (as defined in the regulations of the banking agencies) of banks or investments by a federal savings association in a subsidiary that engages in activities not permissible for a national bank.

Adjustments to Common Equity Tier 1 Capital

The proposed rules would require the following adjustments to common equity tier 1 capital:

- Unrealized gains and losses on cash flow hedges that relate to the hedging of items that are not recognized at fair value on the balance sheet would be excluded. The agencies recognize that this exclusion could be problematic given that unrealized gains and losses on available-for-sale securities are included in common equity tier 1 capital, and solicit comment on the proposed exclusion.
- Any change in the fair value of a liability that results from changes in a banking organization's own creditworthiness would be excluded.

Deductions Related to Investments in Capital Instruments

The proposed rules would require the following deductions related to investments in capital instruments:

- A banking organization would be required to deduct the amount of its investments in its own capital instruments, whether held directly or indirectly.
- A banking organization would be required to deduct reciprocal cross-holdings in the capital instruments of financial institutions. A reciprocal cross-holding results from an arrangement between two financial institutions to hold each other's capital instruments with the intent to artificially inflate each other's capital positions.
- If the aggregate amount of a banking organization's non-significant investment in the capital of unconsolidated financial institutions exceeds 10% of the banking organization's common equity tier 1 capital, the banking organization would have to deduct the excess. Non-significant investments in the capital of unconsolidated financial institutions would be investments where a banking organization owns 10% or less of the issued and outstanding common shares of an unconsolidated financial institution.

Significant investments in the capital of unconsolidated financial institutions that are not in the form of common stock would be deducted. A significant investment would be an investment where the banking organization owns more than 10% of the issued and outstanding common shares of the unconsolidated financial institution.

The deductions related to investments in capital instruments would be made using the corresponding deduction approach. Under this approach, if the capital instrument for which deductions are made would qualify for a certain capital component of the banking organization if issued by the organization itself, then the deductions would be made from that capital component of the banking organization. Therefore, for any given banking organization, not all these deductions would necessarily have to be made from common equity tier 1 capital.

Deductions of Certain Assets Exceeding Thresholds

If the amount of any of the following assets individually exceeds 10% of the common equity tier 1 capital of the banking organization (before deductions related to such assets), the banking organization would have to deduct the excess from its common equity tier 1 capital:

- Deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks (net of any related valuation allowances and deferred tax liabilities).

- Mortgage servicing assets net of associated deferred tax liabilities.
- Significant investments in the capital of unconsolidated financial institutions in the form of common stock.

In addition, if the aggregate amount of the above three items, after the deductions made for individual items that exceeded the 10% threshold, exceeds 15% of the banking organization's tier 1 common equity capital, the excess would have to be deducted from its common equity tier 1 capital.

Furthermore, the amount of mortgage servicing assets deducted from common equity tier 1 capital must be no less than 10% of their fair market value. The amount of the above three items not deducted from common equity tier 1 capital would receive a 250% risk weight.

With respect to deductions of amounts of significant investments in the capital of unconsolidated financial institutions, the agencies note that their proposal to implement the Volcker Rule would require deducting from tier 1 capital the aggregate value of certain investments of a banking organization in hedge funds and private equity funds that the banking organization organizes and offers. The agencies indicate that they would amend the regulatory capital rule as appropriate once the regulatory capital requirements of the Volcker Rule are finalized.

Risk-Weighted Assets

The Standardized Approach Rule, applicable to all banking organizations, would alter the method under which the organizations must calculate risk-weighted assets. Once aggregated, a banking organization's calculation of risk-weighted assets forms the denominator of its risk-based capital ratios. The agencies have proposed an effective date of January 1, 2015 for the risk-weighted asset calculations with an option for early adoption.

Broadly, the proposed Standardized Approach Rule is the agencies' effort to make the calculation of risk-weighted assets more risk-sensitive, to better account for risk-mitigation techniques, and to create substitutes for credit ratings (as required by section 939A of Dodd-Frank). The Standardized Approach Rule also includes additional exposure categories as compared with current rules.

The proposed rule's methodology uses a series of standardized risk weights for on-balance sheet exposures, over-the-counter (OTC) derivatives contracts, and off-balance sheet commitments (which are calculated using credit conversion factors), trade and transaction-related contingencies, guarantees, repo-style transactions, financial standby letters of credit, and forward agreements. The calculations for the risk weights of several other exposures, including unsettled transactions, cleared transactions, default fund contributions, securitization exposures, and equity exposures other than equity derivative contracts, are more complex. The treatment of each of these items under current law and under the proposed Standardized Approach Rule is summarized in the attached Appendix.

Although a number of asset classes would be risk-weighted differently under the proposed Standardized Approach Rule than under current law, those types of assets for which the treatment would change most significantly under the proposed rule are equity exposures to investment funds (including mutual funds), foreign exposures, and residential real estate assets. Specifically:

- Equity exposures to investment funds: banking organizations would need to choose one of three methods (which vary in their administrative burden with the more extensive calculations likely returning a lower risk-weight) for calculating the risk-weight of equity exposures to investment funds;
- Foreign exposures (whether to a foreign government, foreign bank, or foreign public sector entity) would be risk-weighted according to the OECD's Credit Risk Classification for the country, with a variance from 0% to 150%;
- Residential real estate assets would be divided into two categories (based on the underwriting standards and the seniority of the loan) and assigned risk

weights between 35% and 200% based on the Loan-to-Value Ratio of the loan.

Disclosures

The proposed Standardized Approach Rule and Advanced Approaches Rule also establish disclosure requirements for certain banking organizations. In general, a banking organization with total consolidated assets of US$50 billion or more that follows the Standardized Approach Rule would be required to make extensive disclosures of the banking organization's capital ratio calculations and risk-weighted assets (on an asset-by-asset basis) on a quarterly basis. Banking organizations would be encouraged to provide these disclosures on their public websites, and in any event, the disclosures would have to be available to the public for three years (or twelve quarters). To reduce some of the burden on banking organizations required to disclose, the proposed rules note that portions of the disclosure requirement may be met by relying on similar disclosures made in accordance with existing SEC mandates.[4] Banking organizations subject to the Advanced Approaches Rule would be required to make similar disclosures. The Advanced Approaches Rule also contains heightened disclosure requirements with respect to securitizations.[5]

Advanced Approaches Rule

As mentioned above, banking organizations with consolidated total assets of US$250 billion or more or consolidated total on-balance sheet foreign exposures of US$10 billion or more will also be subject to the Advanced Approaches Rule. A banking organization subject to the Advanced Approaches Rule would be required to calculate its risk-based capital ratios under both the general Standardized Approach and the Advanced Approach (incorporating the Market Risk Final Rule if applicable) and use the lower of each of the relevant capital ratios to determine whether it meets the minimum risk-based capital requirements.

Market Risk Final Rule

As mentioned above, the Market Risk Final Rule will continue to apply, in general, to banking organizations with trading assets and trading liabilities of (1) 10% or more of total assets, or (2) US$1 billion or more. Although 208 FDIC-insured institutions had trading assets or trading liabilities according to December 31, 2011 Call Report data, only 25 banking organizations had trading assets and liabilities that were greater than 10% of total assets or US$1 billion. For the banking organizations to which the Market Risk Final Rule will apply, the new rule will alter the way these entities currently calculate the market risk adjustment to their risk-weighted assets. Among other things, the rule introduces an intent component to the definition of covered position (which will now include trading assets and liabilities that are held for the purpose of short-term resale, to lock in arbitrage profits, to benefit from actual or expected short-term price movements, or to hedge covered positions). Covered positions will now include not only commodities and foreign exchange positions, but also certain debt positions, equity positions, and securitization positions. The rule also contains a number of risk-management provisions for covered banking organizations.

For the first time, the proposed rules would extend the Market Risk Capital Rule to savings associations and savings and loan holding companies, if they meet the threshold. According to the preamble to the rule, however, as of March 31, 2012, no OCC-regulated savings association met the threshold for the Market Risk Final Rule to apply.

Savings and Loan Holding Companies

Consistent with the requirements of Section 171 of the Dodd-Frank Act (known as the Collins Amendment), under the proposed rules, savings and loan holding companies would, for the first time, be subject to the same consolidated capital requirements as bank holding companies. The Federal Reserve declines to exempt savings and loan

4 Information that would be exempt from public disclosure under the "commercial or financial information" exemption of the Freedom of Information Act (FOIA) would also be protected from disclosure, although the banking organization must provide a general statement about the information withheld and include the reason for withholding it.

5 Under the Advanced Approaches Rule "commercial or financial information" that is "proprietary or confidential in nature" is also protected from public disclosure (although the proposed Rule does not specifically reference FOIA).

holding companies whose depository institution subsidiaries' activity constitutes only a small part of the consolidated organization's assets and revenues.

With respect to "grandfathered" savings and loan holding companies that are predominantly engaged in commercial activities, there may be questions as to how regulatory capital requirements that are designed to reflect the risk of financial activities could be applied to a commercial firm. Such questions are not addressed in the proposed rules. In some cases, the Federal Reserve could require a grandfathered savings and loan holding company to establish an intermediate holding company to conduct its financial activities, and limit the application of the consolidated capital requirements to the intermediate holding company, but the Federal Reserve did not specifically indicate in the proposed rules that it would exercise this option. At the consolidated holding company level, a commercial firm generally would have a much higher level of equity relative to total assets, and it may not find it difficult to meet the consolidated capital ratios, but clearly there are costs associated with complying with the consolidated capital requirements, such as calculating and reporting the ratios.

Savings and Loan Holding Companies that are Insurance Companies

A number of insurance companies in the United States are savings and loan holding companies. Historically, such parent insurance companies have been subject only to the regulatory capital standards of the state insurance regulators, and their subsidiary savings associations have been subject to the consolidated capital requirements of the banking agencies. The different capital standards effectively respond to the different risks posed by the insurance activities of the parent company and the banking activities of the subsidiary savings association(s). Under the proposed rules, however, the Federal Reserve would require an insurance company that is a savings and loan holding company to comply with the consolidated capital requirements required of a *bank holding company*. In effect, the Federal Reserve is rejecting sole reliance on the capital standards required by insurance regulators. As a result, these companies would have to comply with consolidated capital requirements that, at least arguably, would not reflect their organizational and capital structure. They also would have to work with two sets of regulatory capital requirements, which could be conflicting in some areas.

Savings and loan holding companies that are insurance companies which prepare financial statements according to Statutory Accounting Principles would also have to prepare GAAP-based financial statements because consolidated capital requirements are based on regulatory reports that generally must be prepared according to GAAP.

The proposed rules would address some regulatory capital issues unique to the activities of insurance companies that are savings and loan holding companies:

- Policy loans: A policy loan, which is a loan to a policyholder that is secured by the cash surrender value or collateral assignment of the related insurance policy, would be assigned a 20% risk weight.
- Separate accounts: Assets held in non-guaranteed separate accounts where all the losses are passed on to the contract holders are assigned a zero risk weight. Assets held in a separate account that does not qualify as a non-guaranteed separate account would be assigned to risk-weight categories based on the risk weight of the underlying assets.
- Deferred acquisition costs and value of business acquired: Deferred acquisition costs represent certain costs incurred in acquiring a new contract or renewal insurance contract that are capitalized pursuant to GAAP. Value of business acquired reflects revenue streams from insurance policies purchased by an insurance company. These assets would be assigned a 100% risk weight.
- Surplus notes: A surplus note is a financial instrument issued by an insurance company that is included in surplus for statutory accounting purposes

as required or permitted by state law. Surplus notes would not be includable in tier 1 capital, but they may be eligible for inclusion in tier 2 capital.

- Additional deductions for insurance underwriting subsidiaries: A savings and loan holding company or bank holding company that has insurance underwriting subsidiaries would be required to deduct the minimum regulatory capital requirement of such subsidiaries, as imposed by the insurance regulators, from total capital. The deduction would be 50% from tier 1 capital and 50% from tier 2 capital.

We will be providing additional analysis on various aspects of the revised regulatory capital framework as the practical implications of the new rules emerge. As indicated, the new capital requirements imposed by Basel III, the Dodd-Frank Act, and the implementing regulations of the banking agencies are complex and raise a number of very significant questions. To discuss these issues and obtain further information, please contact your Arnold & Porter attorney or:

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Appendix

All section number citations are to the joint agency portion of the proposed DFA/Basel III Capital Rule.

Risk-Weighted Asset*	Current Treatment	Proposed Treatment
Cash	0%	SAME. [§ .32(l).]
Direct and unconditional claims on U.S. Government, agencies, and FRB	0%	SAME. [§ .32(a)(1).]
Conditional claims on the U.S. government (requiring satisfaction of certain conditions, ex. servicing requirements)	20%	SAME. [§ .32(a)(1).]
Claims on U.S. GSEs	20% 100% on GSE preferred stock (20% for national banks)	20% on exposures other than equity exposures. [§ .32(c).]
Claims on supranational entities and multilateral development banks (ex. IMF)	20%	0%. [§ .32(b).]
Claims on foreign governments and their central banks	0% for direct and unconditional claims on OECD governments; 20% for conditional claims on OECD governments; 100% for non-OECD governments that entail some degree of transfer risk.	Exposures to foreign governments will be risk-weighted according to the OECD's country risk classification (CRC), and will vary from 0% to 150%. A foreign government with no CRC will receive a 100% risk-weight. A banking organization may apply a lower risk weight to an exposure in a foreign currency to the extent it has an equivalent amount of liabilities in that currency. [§ .32(a)(2)-(5).]
Cash items in the process of collection	20%	SAME. [§ .32(l).]
Claims on U.S. depository institutions and NCUA- insured credit unions	20% 100% risk weight for an instrument included in the depository institution's regulatory capital.	20% . [§ .32(d).] 100% risk weight for an instrument included in the depository institution's regulatory capital, although instruments included in capital may be deducted or treated as an equity exposure. [§ .32(d)(1).]
Claims on foreign banks	20% for claims on banks in OECD countries and short-term claims on banks in non-OECD countries; 100% for long-term claims on banks in non-OECD countries.	Exposures to foreign banks will be risk-weighted according to the OECD's CRC classification, and will vary from 0% to 150%. A foreign bank in a country with no CRC will receive a 100% risk-weight. [§ .32(d)(2).]
Claims on U.S. public sector entities	20% for general obligations. 50% for revenue obligations.	SAME. [§ .32(e)(1).]
Claims on foreign public sector entities	20% for general obligations of states and political subdivisions of OECD countries; 50% for revenue obligations of states and political subdivisions of OECD countries; 100% for all obligations of non-OECD countries.	Exposures to foreign public sector entities will be risk-weighted according to the OECD's CRC classification, and will vary from 0% to 150%. A foreign public sector entity in a country with no CRC will receive a 100% risk-weight. [§ .32(e)(2).]
Industrial development bonds	100%	SAME. [§ .32(l).]

Risk-Weighted Asset*	Current Treatment	Proposed Treatment
Claims on qualifying securities firms	20%	100%, although instruments included in capital may be deducted or treated as an equity exposure.
1-4 family loans	50% if first lien, prudently underwritten, owner occupied or rented, current or <90 days past due.	Category 1 loans (first-lien mortgage products that meet certain prudential underwriting characteristics detailed on pgs. 29-30 of the proposed rule): 35%, 50%, 75%, or 100% depending on LTV. Category 2 loans (junior-liens and mortgages that do not meet Category 1 criteria): 100%, 150%, or 200% depending on LTV. Restructured loans must be reevaluated as Category 1 or Category 2. [§ .32(g).]
1-4 family loans modified under HAMP	50% or 100%.	35% to 200% depending on whether the banking organization determines that the HAMP modification make the loan a Category 1 or Category 2 loan. [§ .32(g)(4).]
Loans secured by 1-4 family properties presold under firm contracts	50% if the loan meets all criteria of section 618(a)(1) and (2) of RTCRRI and additional criteria on pg. 35 of the proposed rule; 100% if the contract is cancelled; 100% for loans not meeting the criteria.	SAME. [§ .32(h).]
Loans on multifamily properties	50% if the loan meets all criteria of section 618(b)(1) of RTCRRI and additional criteria on pg. 35-36; 100% otherwise.	SAME. [§ .32(i).]
Corporate exposures	100%	100%, although if the instrument is included in the capital of the financial company, deduction treatment may apply. [§ .32(f).]
High volatility commercial real estate loans	100%	150%. [§ .32(j).]
Past due exposures	Generally the risk weight does not change when a loan is past due (although 1-4 family >90 days past due is assigned a 100% risk weight).	150% for the portion that is not guaranteed or secured (does not apply to sovereign exposures or 1-4 family residential mortgage exposures). [§ .32(k); § .37 for the collateralized portion.]

Risk-Weighted Asset*	Current Treatment	Proposed Treatment
MBS, ABS, and structured securities	Ratings-based approach; Gross-up approach	Banking organizations may elect to follow a Gross-up approach, similar to existing rules. Simplified Supervisory Formula Approach – the risk weight for a position is determined by a formula and is based on the risk weight applicable to the underlying exposures, the relative position of the securitization position in the structure (subordination), and measures of delinquency and loss on the securitized assets; Deduction for the after-tax gain-on sale of a securitization; 1,250% for a Credit-Enhancing Interest-Only Strip (CEIO); 100% for interest only MBS that are not credit enhancing; 1,250% otherwise, or if banking organization cannot demonstrate that it has made a comprehensive analysis of credit risk to the satisfaction of its regulator. [§§ .41-.45.]
Unsettled transactions	Not addressed.	Depending on the type of transaction and the number of days between the settlement date and the counterparty's delivery or payment, the risk weight varies from 100% (5 to 15 days) to 1,250% (46 or more days). [§ .38.]
Equity exposures	100% or incremental deduction approach for nonfinancial equity investments.	Under the Simple Risk Weight Approach: 0% risk weight for equity exposures to a sovereign, certain supranational entities, or an multilateral development bank whose debt exposures are eligible for 0% risk weight; 20%: Equity exposures to a PSE, a FHLB, or Farmer Mac; 100%: Equity exposures to community development investments and small business investment companies and nonsignificant equity investments; 250%: Significant investments in the capital of unconsolidated financial institutions that are not deducted from capital pursuant to section 22. 300%: Most publicly traded equity exposures; 400%: Equity exposures that are not publicly traded; 600%: Equity exposures to certain investment funds. [§§ .51-.53.]

Risk-Weighted Asset*	Current Treatment	Proposed Treatment
Equity exposures to investment funds	Generally, the risk weight assigned is the same as the highest risk weight investment the fund is permitted to hold.	The proposed rule includes three different methods for determining the equity exposure to investment funds depending on the banking organization's ability to calculate the risk-weighted asset amount for each of the exposures held by the fund. A banking organization may choose which approach to apply for each equity exposure to an investment fund. [§§ .51-.53.]
Consumer loans	100%	100% because not a specific category under the proposal. [§ .32(l).]
Assets not assigned to a risk-weight category, including fixed assets, premises, and OREO	100%	100%. [§ .32(l).]

Credit Conversion Factors (CCFs) under the Current and Proposed Rules The proposed rules would retain the same general calculation for off-balance sheet items while covering a wider range of items and increasing the CCF of some items. The proposed rules make several changes to the treatment of OTC derivatives contracts while also retaining the same calculation.		
Off-balance sheet items	CCFs of: 0% for the unused portion of a commitment with an original maturity of one year or less, or which unconditionally cancellable at any time; 10% for unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less; 20% for self-liquidating, trade-related contingent items; 50% for the unused portion of a commitment with an original maturity of more than one year that are not unconditionally cancellable; 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit); and 100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.	CCFs of: 0% for the unused portion of a commitment that is unconditionally cancellable by the banking organization; 20% for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable; 20% for self-liquidating trade-related contingent items; 50% for the unused portion of a commitment over one year that are not unconditionally cancellable; 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit); and 100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements. Banking organizations must hold risk-base capital against all repo-style transactions, regardless of whether they generate on-balance sheet exposures. [§ .33.]
Derivative contracts	Conversion to an on-balance sheet amount based on current exposure plus potential future exposure and a set of conversion factors. Cap of 50%.	The proposed rule updates the definition of an OTC derivative contract, revises the conversion factor matrix for calculating potential future exposure (PFE), revises the criteria for recognizing the netting benefits of qualifying master netting agreements and of financial collateral, and removes the 50% risk weight limit for OTC derivative contracts. [§ .34.]

Credit Risk Mitigation under the Current and Proposed Rules

The Proposed Rules adopt a similar standardized approach to credit risk mitigation as Basel II, while accepting a wider range of eligible guarantors and financial collateral.

Guarantees	Generally recognizes guarantees provided by central governments, GSEs, PSEs in OECD countries, multilateral lending institutions, regional development banking organizations, U.S. depository institutions, foreign banks, and qualifying securities firms in OECD countries.	The proposed rule recognizes guarantees from sovereigns and their affiliated entities, depository institutions, BHCs, SLHCs, foreign banks, and entities other than SPEs that have investment grade debt whose creditworthiness is not positively correlated with the credit risk of the exposures for which it provides guarantees and is not a monoline insurer or reinsurer. [§ .36.]
Collateralized transactions	Recognize only cash on deposit, securities issued or guaranteed by OECD countries, securities issued or guaranteed by the U.S. government or a U.S. government agency, and securities issued by certain multilateral development banks. Substitute risk weight of collateral for risk weight of exposure, sometimes with a 20% risk weight floor.	The proposed rule recognizes an expanded range of financial collateral including cash on deposit at the banking organization (or 3rd party custodian); gold; investment grade securities (excluding resecuritizations); publicly traded equity securities; publicly traded convertible bonds; money market mutual fund shares; and other mutual fund shares if a price is quoted daily. The proposed rule allows banking institutions to use the "Simple Approach," similar to the current rule for any exposure where the collateral is subject to a collateral agreement for at least the life of the exposure; the collateral is revalued at least every six months; and the collateral (other than gold) and the exposure are denominated in the same currency. For repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions, a banking organization could alternatively use the "Collateral Haircut Approach" which allows for supervisory haircuts or, in some cases, the banking organization's own estimates. A banking organization would be required to use the same approach for similar exposures or transactions. [§ .37.]

* Any asset not specifically listed is assigned a 100% risk weight under the proposed rule (other than exposures that would be deducted from tier 1 or tier 2 capital).

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ADVISORY June

SEC Adopts Dodd-Frank Rules on Independence of Compensation Committees and their Advisers

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On June 20, 2012, the Securities and Exchange Commission (SEC) approved rules directing securities exchanges to require companies whose equity securities are listed on such exchanges to comply with standards relating to the independence of compensation committee members and the retention of compensation advisers. The rules give considerable discretion to the exchanges in their implementation of the standards. The SEC also amended its proxy disclosure rules regarding the use of compensation consultants and related conflicts of interest.

The SEC rules implement the Dodd-Frank Wall Street Reform and Consumer Protection Act's (Dodd-Frank Act) requirements regarding compensation committees and compensation advisers. The exchanges must provide the SEC with proposed rule changes within 90 days after publication of the final rules in the Federal Register, and must finalize these rules within one year of the date of publication. The new SEC disclosure rules will be in effect for stockholder meetings at which directors will be elected occurring on or after January 1, 2013.

Compensation Committee Independence Standards

Under the new rules, exchanges must establish listing standards that require each member of a listed company's compensation committee to be "independent," as defined by the exchanges. The rules do not require the exchanges to establish a uniform definition of independence, but rather provide that the exchanges must consider "relevant factors" in defining independence, including:

- a director's source of compensation (including consultant, advisory or other fees paid by the company to the director), and
- whether a director is affiliated with the company or its subsidiaries or affiliates.

The rules do not define "affiliate," nor do they require that the listing standards prohibit committee membership based on any specific relationship.

Current listing standards generally require companies to have a compensation committee or to have the company's independent directors make decisions regarding certain executive compensation issues. The new SEC independence rules apply not only to specifically designated compensation committees, but also to committees performing functions typically assigned to a compensation committee and to directors who, in the absence of a board committee, oversee executive compensation matters on behalf of the board.

Exempt from this requirement are controlled companies, smaller reporting companies, limited partnerships, companies in bankruptcy proceedings, open-end management investment companies registered under the Investment Company Act of 1940, and foreign private issuers that disclose in their annual reports the reasons they do not have an independent compensation committee. Additionally, the exchanges may exempt particular relationships from the independence requirements, taking into account the size of a company and other relevant factors.

Compensation Adviser Standards

The new rules also require the exchanges to establish listing standards relating to compensation advisers, including compensation consultants, independent legal counsel and other advisers (compensation advisers). The listing standards must provide that:

- Compensation committees, in their sole discretion, have authority to retain or obtain advice from compensation advisers;
- Compensation committees are directly responsible for appointing, compensating and overseeing the work of compensation advisers; and
- Companies grant funding for the payment of reasonable fees to compensation advisers.

The SEC emphasized that compensation advisers do not have to be independent, but that compensation committees must consider an adviser's independence prior to its selection. Thus, the listing standards proposed by the exchanges must require that compensation committees consider:

- whether the compensation adviser or its employer provides other services to the company;
- the amount of fees received from the company (as a percentage of the total revenue of the adviser's employer);
- policies and procedures of the adviser's employer that are designed to prevent conflicts;
- any personal or business relationship of the compensation adviser with a compensation committee member;
- the compensation adviser's ownership of stock in the company; and
- any personal or business relationships between the company's executive officers and the compensation adviser or person employing the adviser.

Although these factors must be considered in their totality by compensation committees, companies do not have to discuss the selection process in their proxy statements. Additionally, the SEC specified that the company's in-house counsel need not be subject to this process.

Like the rules on compensation committee independence, these listing standards (with a few exceptions noted below) also apply to any committee of the board that performs functions typically assigned to a compensation committee and to directors who, in the absence of a board committee, oversee executive compensation matters on behalf of the board. Exceptions are the rules relating to the compensation committee's authority to retain compensation advisers and payment to such advisers, which will not apply to directors who oversee executive compensation matters outside the structure of a formal board committee.

Enhanced Proxy Disclosure Regarding Compensation Consultant Conflicts of Interest

As required by the Dodd-Frank Act, the SEC's new rules expand the current disclosure requirements relating to compensation consultants. The amendments to Item 407 of Regulation S-K require companies to disclose whether the compensation consultant's work has raised any conflict of interest. Companies must describe the nature of any conflicts of interest and disclose how the conflicts are being addressed. The SEC did not define "conflict of interest"; instead, the rule requires that the same factors used to evaluate compensation consultant independence should be considered in determining whether conflicts of interest exist.

This disclosure is required of all companies subject to the requirements of the Exchange Act, not just those listed on an exchange.

Conclusion

The overall impact of the SEC's new rules will depend on the specific listing standards adopted by the exchanges. Companies should assess the independence of their compensation committee members based upon these new listing standards when they are announced. Additionally, companies may need to revise their (1) compensation committee charters to integrate any changes from the current rules and (2) D&O questionnaires to make sure they obtain the information needed to make independence determinations under the new standards. Companies should also look ahead to their 2013 annual meetings and consider whether additional proxy statement disclosure will be necessary in light of the changes to the rules on compensation consultant conflicts of interests. To help prepare for this process, companies may wish to ask their compensation consultants about their policies for preventing conflicts of interest.

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

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CFPB Proposes New Mortgage Disclosure Rules

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On July 9, 2012, the Bureau of Consumer Financial Protection (CFPB) issued a proposed rule on mortgage disclosures (Proposed Rule) implementing requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Proposed Rule would create an integrated disclosure for mortgage loan transactions by combining the disclosures currently required under the Truth in Lending Act (TILA) (as implemented by the CFPB's Regulation Z), with the disclosures currently required under the Real Estate Settlement Procedures Act (RESPA) (as implemented by the CFPB's Regulation X). It would also reconcile statutory differences between TILA and RESPA as necessary and incorporate new disclosures required by Congress under the Dodd-Frank Act. The Proposed Rule introduces two new integrated mortgage disclosure forms: a Loan Estimate and a Closing Disclosure (collectively, the Forms).

I. Overview of the Proposed Rule

A. Purpose

The Forms were designed to facilitate compliance with the disclosure requirements of TILA and RESPA and to aid the borrower in understanding a mortgage transaction by using readily understandable, plain language to simplify the technical nature of the disclosures. One of the primary purposes of the integrated Loan Estimate is to inform consumers of the cost of credit early in the process when they have bargaining power to negotiate for better terms and time to compare different mortgages more effectively. The Forms were also designed to highlight important information that consumers need on the first page and provide clear warnings about features that consumers might want to avoid, such as prepayment penalties and negative amortization. Additionally, the Proposed Rule would limit the circumstances in which the costs of the loan may increase at closing.

B. Scope

The Proposed Rule applies to most closed-end consumer mortgages. It does not apply to home-equity lines of credit, reverse mortgages, or mortgages secured by a mobile home or a dwelling that is not attached to real property. Thus, reverse mortgages would remain subject to the current Regulation X and Z disclosure requirements until the CFPB addresses those unique transactions in one or more future rulemakings.[1] The

1 However, the Proposed Rule incorporates into the appendices of Regulation X the guidance issued in the RESPA FAQs released by the Department of Housing and Urban Development on April 2, 2010 to clarify use of the RESPA settlement disclosure in reverse mortgage transactions.

Proposed Rule also does not apply to loans made by a person who is not a "creditor" as defined by Regulation Z (*e.g.,* a person who makes five or fewer mortgages in a year). The integrated disclosure requirements would apply, however, to construction-only loans, vacant-land loans, and 25-acre loans, all of which are currently exempt from RESPA coverage.

C. Comment Period

Comments are generally due on the Proposed Rule by November 6, 2012. However, comments are due on the following two parts of the rule on September 7, 2012: (1) the changes to the calculation of the finance charge and Annual Percentage Rate (APR), and (2) the delay of the effective date for certain disclosures required by the Dodd-Frank Act.

D. Other Rulemakings Related to Mortgage Credit

In addition to the Proposed Rule, the CFPB is engaged in six other rulemakings related to mortgage credit in order to implement requirements of the Dodd-Frank Act. The CFPB issued a proposed rule on high-cost mortgage protections on the same day as the Proposed Rule. The CFPB is also in the process of developing rulemakings relating to mortgage servicing, loan originator compensation, appraisals, escrows, and the ability-to-repay requirement of the Dodd-Frank Act. The CFPB has indicated that the rulemakings are intended to function collectively as a whole. Thus, the CFPB may have to modify aspects of the proposed rules not only in response to public comment, but also to maintain consistency among the rulemakings.

E. Affected Title XIV Disclosures

The CFPB stated that it believes that both consumers and the industry will benefit by incorporating many of the disclosure requirements in Title XIV of the Dodd-Frank Act into the Proposed Rule (Affected Title XIV Disclosures). The Dodd-Frank Act provides that any section of Title XIV for which regulations have not been issued by January 21, 2013 will take effect on that date. The CFPB stated that it plans to issue a final rule to delay the requirements of the Affected Title XIV Disclosures by temporarily exempting entities from the requirement to comply on January 21, 2013 until it has issued a final rule implementing the integrated TILA-RESPA disclosure.[2]

F. Recordkeeping Requirements

The Proposed Rule would require a creditor to retain evidence of compliance with the new integrated disclosure requirements for three years. A creditor would be required to retain the Closing Disclosure for five years from the date of the transactions. Significantly, the Proposed Rule requires creditors to keep electronic records of the Loan Estimate and Closing Disclosure forms. This requirement varies from the current requirements under Regulations X and Z, which permit, but do not require, electronic records.

G. Significant Definitions

Application. TILA and RESPA do not currently define the term "application." Regulation X, however, defines "application" as "the submission of a borrower's financial information in anticipation of a credit decision relating to a federally related mortgage loan, which shall include the borrower's name, the borrower's monthly income, the borrower's social security number to obtain a credit report, the property address, an estimate of the value of the property, the mortgage loan amount sought, and any other information deemed necessary by the loan originator."[3] The Proposed Rule would define "application" for purposes of Regulation Z by retaining all of the elements currently set forth in Regulation X, except for the seventh catch-all element. The removal of that catch-all element was designed to prevent a creditor from delaying

2 The following statutory provisions constitute the Affected Title XIV Disclosures:

- Warning regarding negative amortization features;
- Disclosure of state law anti-deficiency protections;
- Disclosure regarding creditor's partial payment policy;
- Disclosure regarding mandatory escrow accounts;
- Disclosure regarding waiver of escrow at consummation;
- Disclosure of monthly payment, including escrow, at initial and fully-indexed rate for variable-rate transactions;
- Repayment analysis disclosure to include amount of escrow payments for taxes and insurance;
- Disclosure of settlement charges and fees and the approximate amount of the wholesale rate of funds;
- Disclosure of mortgage originator fees;
- Disclosure of total interest as a percentage of principal; and
- Optional disclosure of appraisal management company fee.

3 *See* 12 C.F.R. § 1024.2(b).

the provision of disclosures to the consumer by claiming that additional information, such as the consumer's combined liabilities, is needed. Thus, while a creditor is free to collect additional information, once it has received the six pieces of information set forth in Regulation X, it would be deemed to have an application for Regulation Z purposes.

Finance Charge. The Proposed Rule would revise the definition of a "finance charge" by largely eliminating the current exclusions from it so that the finance charge and APR more accurately reflect the cost of credit. However, the Proposed Rule would continue to exclude from the finance charge "late fees and similar default or delinquency charges, seller's points, amounts required to be paid into escrow accounts if the amounts would not otherwise be included in the finance charge, and premiums for property and liability insurance if certain conditions are met."[4]

Prepayment Penalty. The Proposed Rule expands the definition of "prepayment penalty" to include a penalty with respect to a prepayment of "all or part of" the principal balance, rather than solely a prepayment "in full."[5] The expanded definition would likely result in more instances where a penalty would constitute a prepayment penalty, thus requiring more frequent disclosure by financial institutions. The CFPB has indicated that it will attempt to adopt a consistent definition of prepayment penalty across the various pending rulemakings, including those concerning ability-to-repay requirements, high-cost mortgages, and mortgage servicing.

Annual Percentage Rate. The Proposed Rule redefines the way the "Annual Percentage Rate" (APR) is calculated, encompassing almost all of the up-front costs of the loan to make it easier for consumers to compare loans.

II. New Disclosure Forms

A. Loan Estimate

1. General Requirements

The Loan Estimate form would replace the Good Faith Estimate (GFE) designed by the Department of Housing and Urban Development (HUD) under RESPA and the "early" Truth in Lending disclosure designed by the Board of Governors of the Federal Reserve System (Board) under TILA.[6] Under the Proposed Rule, the Loan Estimate form must be given to the consumer no later than three business days after the creditor receives the consumer's application for a mortgage loan and no later than the seventh business day before consummation of the transaction. A lender can rely on a mortgage broker to deliver the Loan Estimate form; however, the lender would also remain responsible for the accuracy of the form.

The Proposed Rule would require creditors to distinguish between preliminary written estimates of mortgage loan costs, which are not subject to the good faith requirements under TILA and RESPA, and the Loan Estimate disclosures, which are. Furthermore, under the proposed disclosure, no person may impose a fee on a consumer in connection with the consumer's application before the consumer has received the Loan Estimate form and indicated to the creditor an intent to proceed with the transaction described by the disclosures. The only exception to this fee restriction is that a creditor may impose a bona fide and reasonable fee for obtaining a consumer's credit report.

The disclosure of estimated charges in the Loan Estimate is required to be made in good faith. The Proposed Rule would impose a general rule that the estimated charges are not in good faith if the charges paid by or imposed on the consumer exceed the amounts originally disclosed. The good faith determination contains a few exceptions. First, when the lender permits the consumer to shop for a settlement service provider, the sum of all third-party services and recording fees imposed on the consumer may not exceed 10% of the amount of such charges disclosed in the Loan Estimate. Second, an estimate of the following charges is in good faith and may exceed the amount disclosed if it is consistent with the best information reasonably available to the creditor at the time it is disclosed: prepaid interest; property insurance premiums; amounts placed into an escrow, impound, reserve, or similar account; and charges paid to a third-party service provider selected by the consumer. Finally, a charge imposed

4 Preamble to the Proposed Rule at 104.

5 Preamble to the Proposed Rule at 141.

6 *See* Preamble to the Proposed Rule at 161 (proposing to integrate the TILA and RESPA good faith estimate requirements in a new 12 C.F.R. § 1026.19(e)).

on the consumer may exceed the originally estimated charge if the revision is due to (1) changed circumstances affecting settlement charges, (2) changed circumstances affecting eligibility, (3) revisions requested by the consumer, (4) interest rate dependent charges, (5) expiration,[7] or (6) delayed settlement date on a construction loan.

The Proposed Rule requires that a revised disclosure be delivered within three business days of the creditor establishing that a valid reason for the revision exists. Creditors would be prohibited, however, from providing a consumer with the Loan Estimate and Closing Disclosure at the same time.

2. Loan Estimate Contents

The Proposed Rule requires the disclosure of numerous items that are not currently required to be disclosed under RESPA or TILA. For example, the Loan Estimate requires the disclosure of the contract sale price and estimated property value, as applicable. The Loan Estimate requires the disclosure of the purpose of the loan as (1) purchase, (2) refinance, (3) construction, or (4) home equity. The creditor is also required to provide a description of the loan product on the first page of the Loan Estimate. If the loan product contains one or more features, the creditor may disclosure only one loan feature according to the following hierarchy: (1) negative amortization, (2) interest only, (3) step payment, (4) balloon payment, (5) seasonal payment, (6) adjustable rate, (7) step rate, and (8) fixed rate.

The following is a brief summary of the other disclosures required as part of the Loan Estimate:

<u>Form Purpose</u>. The Proposed Rule requires a creditor to provide the following statement at the top of all Loan Estimates, "Save this Loan Estimate to compare with your Closing Disclosure."[8]

<u>Loan Information</u>. The Proposed Rule requires a creditor to provide basic information on the Loan Estimate including the date the Loan Estimate is issued, the applicants, the property that is the subject of the transaction, the contract sale price and estimated property value (as applicable), loan term, purpose, product, type, loan identification number, and rate lock date.

<u>Loan Terms Table</u>. The Loan Estimate contains a Loan Terms Table in which the creditor is required to disclose the loan amount, interest rate, monthly principal and interest, as well as whether those amounts may increase after closing, the maximum amounts, and frequency of changes. The creditor is also required to disclose in the Loan Terms Table whether there is a prepayment penalty and/or balloon payment and the maximum prepayment penalty, the period in which a prepayment penalty may be imposed, and the amounts of any balloon payments and the dates of such payments.

<u>Projected Payment Table</u>. The Proposed Rule requires a creditor to provide on the first page of the Loan Estimate a Projected Payment Table that contains the projected principal and interest, mortgage insurance, estimated escrowed taxes and insurance, estimated total monthly payment, and estimated taxes, insurance and assessments.

<u>Cash to Close</u>. As part of the Loan Estimate, creditors must provide the estimated total closing costs and the estimated amount of cash needed at closing.

<u>Loan Costs</u>. On the second page of the Loan Estimate, creditors are required to disclose the total loan costs, which are comprised of "Origination Charges," "Services You Cannot Shop For," and "Services You Can Shop For."[9] Creditors must disclose total origination charges as part of the Loan Estimate, but are also permitted to provide an itemization of up to 13 component items comprising the origination charges.[10] Unlike the current RESPA GFE and TILA disclosures, all items must be listed in alphabetical order to make it easier for consumers to compare two disclosure documents, except for the points itemization, which is required to be listed first under the "Origination Charges" heading. While addenda may be

7 The term "expiration" refers to when the consumer expresses an intent to proceed with the transaction more than 10 business days after the original disclosures.

8 Proposed Rule § 1026.37(a)(2).

9 If the consumer is permitted to shop for a settlement service, the creditor must provide the consumer with a written list identifying available settlement service providers and stating that the consumer may choose a different provider.

10 The number of items disclosed under "Services You Cannot Shop For" may not exceed 13, while the number of items disclosed under "Services You Can Shop For" may not exceed 14.

used for the itemization of the disclosures under "Services You Can Shop For," they may not be used to itemize the "Origination Charges" and "Services You Cannot Shop For." If the number of lines is insufficient for purposes of itemizing those charges, the remaining charges must be disclosed as an aggregate amount at the bottom of the itemization.

Other Costs. Creditors are required to disclose "Other Costs" on the Loan Estimate. Such costs include costs that are necessary to complete the real estate closing, but which are not charged by the creditor, such as taxes and other government fees, insurance premiums, initial payments to establish an escrow account to pay for future recurring charges, and other costs that are for voluntary products. Premiums for optional insurance, warranty, guarantee, or even-coverage products must include the parenthetical "(optional)" at the end of the item.

Calculating Cash to Close. The Loan Estimate must include disclosure of the calculation of an estimate of the cash needed to close the transaction. This calculation is comprised of the total closing costs, closing costs financed, down payment funds from the borrower, a deposit (for a purchase transaction), funds disbursed to the borrower, seller credits, and adjustments and other credits.

Adjustable Payment Table. The Loan Estimate must include an Adjustable Payment (AP) Table if the periodic principal and interest payment may change after closing based on adjustments other than adjustments to the interest rate. Examples of the types of adjustments disclosed in the AP Table include whether the loan has interest only payments, optional payments, step payments, or seasonal payments.

The AP Table must disclose examples of the required periodic principal and interest payment, including the maximum possible required principal and interest payment, for loans with terms that allow the principal and interest payment to adjust not based on adjustments to the interest rate, such as loans with interest-only, optional-payment, or step-up payment periods.

Adjustable Interest Rate Table. If the interest rate of a mortgage may change after closing, creditors are required to disclose in a separate table—called the Adjustable Interest Rate Table—information regarding the terms of an adjustable interest rate, including the index and margin applicable to the interest rate changes, the lifetime cap and floor on the interest rate, and limits on interest rate adjustments.

Contact Information. The Proposed Rule requires that the Loan Estimate contain certain contact information for the loan officer, including the name and Nationwide Mortgage Licensing System and Registry (NMLSR) identification number, if any, a disclosure that is currently not required by TILA, RESPA, and their implementing regulations.

Comparisons. On the third page of the Loan Estimate, creditors are required to include a Comparisons Table that contains the total payments (of principal, interest, mortgage insurance, and loan costs) that the consumer will have made through five years, the APR, and the total interest percentage (TIP). The CFPB selected the total payments over 5 years disclosure over a total payments disclosure because it believes that it more accurately reflects the typical life of a mortgage loan (prior to sale or refinancing of the property), which it understands to be five to seven years, thus enhancing a consumer's understanding of the transaction. The CFPB indicated in the preamble to the Proposed Rule that it is grouping APR with the five year and TIP disclosures to make it easier to understand that the APR is a special metric created specifically for comparison purposes that may help the consumer think about their costs over the life of the loan. TIP is the total amount of interest that a consumer will pay over the life of the loan, expressed as a percentage of the principal of the loan.[11]

Other Considerations. On the third and final page of the Loan Estimate, creditors are required to disclose certain information relating to (1) the consumer's right to receive appraisals; (2) the ability of another person to assume the loan upon transfer; (3) homeowner's insurance requirements; (4) the creditor's late payment policy; (5) loan refinancing; (6) loan servicing; and (7) in refinance transactions, the consumer's liability for deficiency after foreclosure. Most of these

11 The CFPB proposes to require creditors to disclose the following descriptive statement next to the TIP disclosure: "The total amount of interest that you will pay over the loan term as a percentage of your loan amount." Proposed Rule § 1026.37(l)(3).

disclosures are already received by consumers at or after application or prior to closing.

Signature Statement. The creditor may include optional signature lines, but if it does, it must disclose that, by signing the Loan Estimate, the consumer is only confirming receipt of the form and is not required to accept the loan. If the creditor does not include a line for the consumer's signature, the creditor must include the following statement under the label "Loan Acceptance": "You do not have to accept this loan because you have received this form or signed a loan application."[12]

Exclusions. The Loan Estimate does not include certain statutory disclosures that the CFPB has determined based upon consumer testing are potentially distracting or confusing to consumers. Such excluded disclosures are the amount financed, the finance charge, a statement that the creditor is taking a security interest in the consumer's property, a statement that the consumer should refer to the appropriate contract document for information about their loan, a statement regarding certain tax implications, and the creditor's cost of funds. Although the finance charge is not disclosed on the Loan Estimate, creditors must document the finance charge used to calculate the APR disclosed on that form to comply with record retention requirements. The amount financed and the finance charge are required to be disclosed in the Closing Disclosure.

B. Closing Disclosure

1. General Requirements

The Closing Disclosure form would replace the current form used to close a loan, the HUD-1, which was designed by HUD under RESPA, as well as the revised Truth in Lending Disclosure designed by the Board under TILA.[13] The lender must give the consumer the Closing Disclosure form at least three business days before the consumer closes on the loan.[14]

12 Proposed Rule § 1026.37(n)(2).

13 *See* Preamble to the Proposed Rule at 161 (proposing to integrate the TILA and RESPA settlement statement requirements in a new 12 C.F.R. § 1026.19(f)).

14 The proposed disclosure rule would retain a provision of TILA and Regulation Z that allows a consumer to waive the three-business-day waiting period in the event of a bona fide personal financial emergency. In addition, if the consumer and the seller agree to make changes to the transaction that affect items disclosed, the creditor must deliver a revised disclosure reflecting such changes at or before the closing.

Subject to certain exceptions, the consumer must be provided a new form if there are changes between when the Closing Disclosure form is given and the closing. The Proposed Rule contains two alternatives for who is required to provide the customer with the new Closing Disclosure form. Under the first alternative, the lender would be responsible for delivering the form. Under the second alternative, the lender may rely on the settlement agent to provide the form; however, the lender would also remain responsible for the accuracy of the form.

The Proposed Rule restricts the instances in which a consumer can be required to pay more for settlement services than was stated on the Loan Estimate form. Subject to certain exceptions, charges for the following services may not increase: (1) the lender's or mortgage broker's charges for its own services; (2) charges for services provided by an affiliate of the lender or mortgage broker; and (3) charges for services for which the lender or mortgage broker does not permit the consumer to shop. Additionally, subject to certain exceptions, charges for other services may not increase by more than 10%. The Proposed Rule states that no fee may be imposed by a creditor or servicer for the preparation of the Closing Disclosure.

2. Closing Disclosure Contents

The following is a brief summary of the disclosures required as part of the Closing Disclosure:

Form Purpose. The Proposed Rule requires creditors to include a statement regarding the purpose of the Closing Disclosure, which is not currently required by TILA, RESPA, and their implementing regulations. Specifically, the form must state, "This form is a statement of the final loan terms and closing costs. Compare this document with your Loan Estimate."[15]

Closing, Transaction, and Loan Information. The Closing Disclosure must include basic information regarding the closing, including the date the Closing Disclosure is issued, the date funds are disbursed, the sale price of the property that is the subject of the transaction, and the file number assigned to the transaction. It must also include the names and addresses of the parties to the transaction. The loan information disclosures

15 Proposed Rule § 1026.38(a)(2).

required in the Closing Disclosure mirror those required in the Loan Estimate, except that a creditor must also provide a mortgage insurance case number.

Loan Terms Table. The creditor must disclose loan terms in the Closing Disclosure. Such terms generally mirror those required to be disclosed in the Loan Estimate.

Projected Payments Table. The creditor must disclose projected payments in the Closing Disclosure. Such terms generally mirror those required in the Loan Estimate.

Cash to Close. The creditor must disclose the actual total closing costs imposed upon the consumer and the amount of cash required from the consumer at closing.

Closing Cost Details. The creditor is required to disclose closing cost information that closely matches the format and organization of the loan cost information in the Loan Estimate to facilitate side-by-side comparisons of the Loan Estimate and the Closing Disclosure.

Other Costs. The creditor is required to disclose other costs that generally mirror those required to be disclosed on the Loan Estimate.

Calculating Cash to Close. The CFPB is proposing to require that the Closing Disclosure contain a Calculating Cash to Close Table that highlights the cash to close amount and its critical components and compares those amounts to the corresponding disclosures on the Loan Estimate. The table includes the estimated and final amounts, as well as a column titled, “Did this change?,” to highlight changes from the amounts listed in the Loan Estimate.

Closing Costs Paid Before Closing. While the Calculating Cash to Close table in the Closing Disclosure generally mirrors the corresponding table in the Loan Estimate, it requires disclosure of whether any closing costs were paid before closing as a reminder to the consumer of the costs that were previously paid.

Summaries of Borrower’s and Seller’s Transactions. The creditor or closing agent is required to provide the summaries of the consumer’s and seller’s transactions that are currently provided in the RESPA settlement statement. The summary of the borrower’s transactions must include an itemization of the amount due from the borrower, as well as an itemization of the amounts already paid by or on behalf of the borrower at closing. The summary must also calculate the total amount due from the borrower at closing. The summary of the seller’s transaction must include itemizations of the amount due to and from the seller at closing and a calculation of the total amount due to the seller at closing.

Loan Disclosures. The creditor is required to provide consumers with a variety of disclosures in the Closing Disclosure including disclosures related to assumption, demand features, late payment, negative amortization, partial payment policy, security interest, and escrow account information.

Adjustable Payment and Adjustable Interest Rate Tables. The creditor is required to disclose information in these tables that generally mirror the information required to be disclosed on the Loan Estimate.

Loan Calculations. The creditor is required to provide a Loan Calculations Table on the last page of the Closing Disclosure that contains disclosures relating to the total of payments, finance charges, amount financed, APR, total interest percentage, and the approximate cost of funds.

Other Disclosures. The creditor is required to disclose information regarding appraisals, contract details, liability after foreclosure, refinancing, and tax deductions under this heading on the last page of the Closing Disclosure.

Questions Notice. The creditor is required to provide a statement that the consumer should contact the creditor with any questions about the disclosures. This requirement is not currently imposed by TILA, RESPA, or their implementing regulations.

Contact Information Table. The Closing Disclosure must include a table that includes contact information for the creditor, mortgage broker, the consumer’s real estate broker, the seller’s real estate broker, and the closing agent, as applicable. For each party, the table would set forth the name, address, NMLSR identification/license number, as well as the name, e-mail address, and NMLSR identification/license number for the primary contact.

Signature Statement. The optional signature requirements in the Closing Disclosure mirror those in the Loan Estimate.

Arnold & Porter LLP is available to respond to questions raised by the Proposed Rule. We also can assist in determining how these rule changes may affect your business and in ensuring that your business is compliant when the Proposed Rule is finalized. For further information, please contact your Arnold & Porter attorney or:

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Federal Reserve Proposes Enhanced Prudential Standards and Early Remediation Requirements for U.S. Operations of Foreign Banks

On December 14, 2012, the Board of Governors of the Federal Reserve System (Board) approved for issuance a proposed rule and request for public comment[1] (Notice) to implement provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act or Act)[2] related to foreign banking organizations. Sections 165 and 166 generally require the Board to impose enhanced prudential standards on bank holding companies, including foreign banking organizations with a banking presence in the United States, with total consolidated assets of US$50 billion or more and on nonbank financial companies designated for Board oversight by the Financial Stability Oversight Council (Council).[3] This advisory will deal solely with the proposed regulations' impact on affected foreign banking organizations.

The regulations are broadly consistent with the standards that have been proposed for U.S. bank holding companies, and U.S. nonbank financial companies.[4] The Board has asked for feedback on all aspects of the proposed regulations, including in response to 103 specific questions posed in the Notice. Comments are due March 31, 2013. The proposed effective date is July 1, 2015.

Background

The proposed regulations are applicable to foreign banking organizations that are treated as U.S. bank holding companies for purposes of the Bank Holding Company Act of 1956, pursuant to section 8(a) of the International Banking Act of 1978: (1)

1 "Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies," Board of Governors of the Federal Reserve System, RIN 7100 AD 86, December 14, 2012 (*available at* http://www.federalreserve.gov/newsevents/press/bcreg/20121214a.htm).

2 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 Section 113 of the Dodd-Frank Act authorizes the Council to designate a U.S. nonbank financial company for supervision by the Board if the FSOC determines, pursuant to factors set forth in the Act, that the U.S. nonbank financial company could pose a threat to the financial stability of the United States. To date, no such designation has been made.

4 77 Fed. Reg. 594, January 5, 2012.

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any foreign bank that maintains a branch or agency in a State, (2) any foreign bank or foreign company controlling a foreign bank that controls a commercial lending company organized under State law, and (3) any company of which any foreign bank or company referred to in (1) and (2) is a subsidiary.[5] If the foreign banking organization has such a presence in the United States, and has total global consolidated assets of US$50 billion or more, at least US$10 billion of which is represented by a U.S. subsidiary, the enhanced prudential standards are even more stringent. The proposal also would bolster the capital and liquidity positions of the U.S. operations of foreign banking organizations.

Scope

The proposed regulations address seven major areas: establishment of intermediate holding companies, risk-based capital and leverage, liquidity, overall risk management and risk committees, single-counterparty credit limits, stress tests, debt-to-equity limits, and early remediation requirements. Each of these areas is discussed below. The proposed rules generally would apply to foreign banking organizations with total global consolidated assets of US$50 billion or more, and more stringent standards are proposed for such foreign banking organizations that also have combined U.S. assets of US$50 billion or more.[6]

Specific Requirements

1. U.S. Intermediate Holding Company Requirement

In order to enhance U.S. regulation and supervision of its combined U.S. operations, a foreign banking organization with both US$50 billion or more in global consolidated assets and U.S. consolidated assets of at least US$10 billion that are booked in U.S. subsidiaries would be required to form a U.S. intermediate holding company (IHC) to hold those assets. This IHC requirement would allow the Board to implement a consistent supervisory program across U.S. subsidiaries of foreign banking organizations. The proposed regulations do ***not*** require that branches become separately incorporated banking subsidiaries and placed under the IHC.

In calculating the US$10 billion threshold, the foreign banking organization should exclude the assets of its U.S. branches and agencies. In addition, U.S. subsidiaries held under section 2(h)(2) of the Bank Holding Company Act are not required to be held under the IHC and are not counted towards the US$10 billion threshold for forming an IHC. Section 2(h)(2) of the Bank Holding Company Act allows qualifying foreign banking organizations to retain their interest in foreign commercial firms that conduct business in the United States.[7]

In the event that the U.S. subsidiary operations of a foreign banking organization must be resolved or restructured, a U.S. IHC could help facilitate that resolution or restructuring by providing one top-tier U.S. legal entity to be resolved or restructured. The IHC requirement also would reduce the ability of foreign banking organizations to minimize or avoid enhanced prudential requirements by restructuring their U.S. operations in ways that would not reduce their U.S. risk profile.

2. Risk-Based Capital and Leverage Requirements

The proposal would require IHCs to meet the same capital standards applicable to U.S. bank holding companies. These requirements would help bolster the consolidated capital positions of the IHCs as well as promote a level playing field among all banking firms operating in the United States.

5 *See* Dodd-Frank §102(a)(1), 12 U.S.C. § 5311; 12 U.S.C. § 3106 (a) (International Banking Act).

6 Pub L No 111-203, 124 stat. 1376, 1426-1427; *see* 12 USC 5365, 5366.

7 The IHC requirement excludes a foreign banking organization's U.S. branch and agency assets and investments in 2(h)(2) companies when determining the combined U.S. assets of the foreign banking organization. In determining the applicability of other requirements in the proposed regulations that are triggered by combined U.S. assets of the foreign banking organization, the foreign banking organization would include its U.S. branch and agency requirements and any investments in 2(h)(2) companies.

A foreign banking organization with total global consolidated assets of US$50 billion or more would be required to certify that it meets capital adequacy standards established by its home country supervisor on a consolidated basis, and that those standards are consistent with the Basel Capital framework. The capital plan rule would require IHCs to submit annual capital plans to the Board in which they demonstrate an ability to maintain capital above the Board's minimum risk-based capital and leverage ratios under both baseline and stressed conditions. An IHC that is unable to satisfy the capital plan rule's requirements generally may not make any capital distributions until it provides a capital plan that is satisfactory to the Board.

3. Liquidity Requirements

During the financial crisis, many global financial companies experienced significant financial stress, due in part to inadequate liquidity risk management. The U.S. operations of foreign banking organizations also experienced liquidity stresses during the financial crisis and more recently in response to financial strains in Europe. The liquidity requirements in the Board's proposal would establish a regulatory framework for the management of liquidity risk for U.S. operations of foreign banking organizations with at least US$50 billion in total global consolidated assets and combined U.S. assets of US$50 billion or more.

The U.S. operations of these companies would be required to meet enhanced liquidity risk-management standards, conduct liquidity stress tests, and hold a 30-day buffer of highly liquid assets. The U.S. branch and agency network would be required to maintain the first 14 days of its 30-day buffer in the United States and would be permitted to meet the remainder of the requirement at the parent consolidated level. The IHC would be required to maintain the full 30-day buffer in the United States.

A foreign banking organization with total global consolidated assets of US$50 billion or more but combined U.S. assets of less than US$50 billion would be required to report the results of an internal liquidity stress test (either on a global consolidated basis or for its combined U.S. operations) to the Board on an annual basis.

4. Single-Counterparty Credit Limits

During the financial crisis, counterparties of a failing firm were placed under severe strain when the failing firm could not meet its financial obligations, in some cases resulting in the counterparties' inability to meet their own obligations. Section 165(e) of the Dodd-Frank Act addresses single-counterparty concentration risk among large financial companies. It directs the Board to establish single-counterparty credit exposure limits for bank holding companies and foreign banking organizations with total global consolidated assets of US$50 billion or more and U.S. and foreign nonbank financial companies supervised by the Board in order to limit the risks that the failure of any individual firm could pose to the company.[8]

The Board's proposal would impose a two-tier single-counterparty credit limit on foreign banking organizations. First, the proposal would impose a 25 percent net credit exposure limit between an IHC or the combined U.S. operations of a foreign banking organization and a single unaffiliated counterparty. It would prohibit an IHC from having aggregate net credit exposure to any single unaffiliated counterparty in excess of 25 percent of the IHC's capital stock and surplus. Similarly, it would prohibit the combined U.S. operations of a foreign banking organization from having aggregate net credit exposure to any single unaffiliated counterparty in excess of 25 percent of the consolidated capital stock and surplus of the foreign banking organization.

The proposal also would apply a more stringent limit to the combined U.S. operations of a foreign banking organization that has total global consolidated assets of

8 *See* 12 U.S.C. § 5365(e)(1).

US$500 billion or more and financial counterparties of similar size[9] with respect to exposures to certain large financial counterparties.

5. Risk Management and Risk Committee Requirements

The risk management weaknesses revealed during the financial crisis among many large U.S. bank holding companies also were present in the U.S. operations of large foreign banking organizations. Section 165(b)(1)(A) of the Dodd-Frank Act requires the Board to establish overall risk management requirements as part of the enhanced prudential standards.[10] Implementing section 165(h) of the Dodd-Frank Act, the Board's proposed regulation requires any publicly traded bank holding company with US$10 billion or more in total consolidated assets to establish a risk committee. A foreign banking organization with total global consolidated assets of US$10 billion or more would be required to certify that it maintains a U.S. risk committee.[11] In general, the company's enterprise-wide risk committee may serve as the U.S. risk committee.

Any foreign banking organization, regardless of whether its stock is publicly traded, with combined U.S. assets of US$50 billion or more would be subject to additional U.S. risk committee requirements and a requirement to appoint a U.S. chief risk officer in charge of implementing and maintaining a risk management framework for the company's combined U.S. operations.

6. Stress Test Requirements

The Board has previously highlighted the use of stress testing as a means to better understand the range of a banking organization's potential risk exposures.[12] The Board's proposed regulations would help to ensure that IHCs have sufficient capital in the United States to withstand a severely adverse stress scenario.

The proposal would apply stress testing requirements to the U.S. branches and agencies of a foreign banking organization by first evaluating whether the home country supervisor for the foreign banking organization conducts a stress test and, if so, whether the stress testing standards that are applicable to the consolidated foreign banking organization in its home country are broadly consistent with U.S. stress testing standards. If a foreign banking organization with combined U.S. assets of US$50 billion or more is subject to a home country stress testing regime that is broadly consistent with U.S. standards, the company could generally meet the stress test requirement of the proposed regulations by submitting a high-level summary of annual stress test results for the consolidated company.

However, if the U.S. branch and agency network of a foreign banking organization with combined U.S. assets of US$50 billion or more generally provides, on a net basis, funding to its parent, the foreign banking organization would be required to provide additional, more detailed, information regarding the results of its annual consolidated capital stress test. Foreign banking organizations with combined U.S. assets of less than US$50 billion that are subject to and comply with a consistent consolidated capital stress test regime in their home country would not be required to submit results of their home country stress tests on an annual basis.

7. Early Remediation Framework

The Board's proposal would implement early remediation requirements for foreign banking organizations with total global consolidated assets of US$50 billion or more. The combined U.S. operations of a foreign banking organization would be subject to early remediation triggers based on capital ratios, stress test results,

9 Major counterparty would be defined to include a bank holding company or foreign banking organization with total consolidated assets of US$500 billion or more, and their respective subsidiaries, and any nonbank financial company supervised by the Board.

10 12 U.S.C. § 5365(b)(1)(A).

11 12 U.S.C. § 5365(h).

12 *See e.g.*, Supervisory Guidance on Stress Testing for Banking Organizations With More Than $10 billion in Total Consolidated Assets, 77 FR 29458 (May 17, 2012); SR 10-6 Interagency Policy Statement on Funding and Liquidity Risk Management (March 17, 2010), *available at* http://www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm.

market indicators and liquidity, and risk management weaknesses. The framework would minimize the probability that such companies will become insolvent and mitigate the potential harm of such insolvencies to the financial stability of the United States.[13]

A foreign banking organization with total global consolidated assets of at least US$50 billion and combined U.S. assets of at least US$50 billion that exceeds an early remediation trigger would be subject to a set of non-discretionary remediation actions imposed on its U.S. operations. Foreign banking organizations with a smaller U.S. presence would not be automatically subject to remediation actions.

There are four levels of remediation:

- Heightened supervisory review (Level 1), in which supervisors conduct a targeted review of the foreign banking organization's U.S. operations to determine if it should be moved to the next level of remediation;
- Initial remediation (Level 2), in which a foreign banking organization's U.S. operations are subject to an initial set of remediation measures, including restrictions on growth and capital distributions;
- Recovery (Level 3), in which a foreign banking organization's U.S. operations are subject to a prohibition on growth and capital distributions, restrictions on executive compensation, requirements to raise additional capital, and additional requirements on a case-by-case basis; and
- Recommended resolution (Level 4), in which the Board would consider whether the U.S. operations of the foreign banking organization warrant termination or resolution based on the financial decline of the combined U.S. operations and other relevant factors.

8. Debt-to-Equity Limitation

Section 165(j) of the Dodd-Frank Act provides that the Board must require a foreign banking organization with US$50 billion or more in total global consolidated assets to maintain a debt-to-equity ratio of no more than 15-to-1, upon a determination by the Council that such company poses a grave threat to the financial stability of the United States, and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States. The proposal would implement the debt-to-equity ratio limitation with respect to a foreign banking organization by applying a 15-to-1 debt-equity limitation to its IHC (or, if the foreign banking organization does not have an IHC, on each U.S. subsidiary) and a 108 percent asset maintenance requirement on its U.S. branch and agency network, if applicable.

Timing of Implementation

The Board has proposed an extended phase-in period to allow foreign banking organizations time to implement the proposed requirements. For foreign banking organizations that meet the total global consolidated assets threshold of US$50 billion and, as applicable, the combined U.S. asset threshold of US$50 billion as of July 1, 2014, the enhanced prudential standards required under this proposal would apply beginning on July 1, 2015.

Unless accelerated or extended by the Board in writing, a foreign banking organization that becomes subject to the requirements of the proposal after July 1, 2014, would be required to form a U.S. IHC beginning one year after it reaches the total global consolidated asset threshold of US$50 billion and the US$10 billion minimum in combined U.S. assets excluding assets of the foreign banking organization's branches and agencies and the foreign banking organization's (2)(h)(2) investments. Such foreign banking organization would be required to comply with the enhanced prudential standards (other than stress test requirements and the capital plan rule) beginning on the same date as it is required to establish the IHC, unless accelerated or extended by the Board. The stress test requirements and the capital plan rule would be applied in October of the year after that in

13 *See* 12 U.S.C. 5366(b).

which the foreign banking organization is required to establish the IHC.

Arnold & Porter LLP has long represented large financial companies and their subsidiaries in resolving their regulatory and supervisory issues, including many foreign banking organizations. We have been assisting such companies during the regulatory process in understanding the implications of the Dodd-Frank Act and its many regulations. We are available to respond to questions raised by the Act, or to help guide your business in responding to it. For further information, please contact your Arnold & Porter attorney or:

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The Consumer Financial Protection Bureau (CFPB) had a busy holiday season, ending 2012 and beginning 2013 with a flurry of activity involving several key initiatives mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). This advisory summarizes the CFPB's recent significant activities.

First, underscoring its focus on the fair lending laws, on December 6, 2012, the CFPB published its first annual Fair Lending Report and announced that it had entered into a Memorandum of Understanding with the U.S. Department of Justice (DOJ) regarding fair-lending enforcement. Second, on December 13, the CFPB announced a proposed policy to allow companies to test new consumer disclosures on a case-by-case basis without the risk of supervisory criticism. Third, on December 19, the CFPB announced that it is seeking public comment on how the Credit Card Accountability Responsibility and Disclosure Act (CARD Act) has impacted consumers and the credit card market. Additionally, on December 21, 2012, the CFPB announced its first joint enforcement action with state attorneys general, and on the same day it issued proposed revisions to its remittance rule regarding disclosures that must be given in connection with international funds transfers. Finally, on January 9, 2013, the CFPB issued its long-anticipated qualified mortgage rule, under which lenders are presumed to have complied with the ability-to-repay rule of the Dodd-Frank Act if they issue a "qualified mortgage" as defined in the regulation.

I. Fair Lending Developments

A. Memorandum of Understanding with the Department of Justice

The Equal Credit Opportunity Act (ECOA) makes it illegal for creditors to discriminate against credit applicants based on race, color, religion, national origin, sex, and age, among other factors. While historically DOJ has had sole authority to initiate court actions to enforce ECOA, the Dodd-Frank Act granted the CFPB its own independent authority to do so. In order to coordinate their fair-lending enforcement activities and avoid duplication of efforts, DOJ and the CFPB entered into a Memorandum of Understanding (MOU) in December describing how the two agencies would share their fair-lending responsibilities. Specifically, the MOU provides the following framework for (i) sharing information and preserving its confidentiality, (ii) joint investigations and coordination, and (iii) referrals and notifications between the CFPB and DOJ:

- **Sharing information and preserving its confidentiality.** The CFPB and DOJ will share non-public information in matters that the CFPB refers to DOJ, in joint investigations under ECOA, and in coordinating fair-lending enforcement. The MOU provides that the CFPB and DOJ will treat all non-public shared information as confidential and establishes the permissible uses and strict confidentiality protections for this shared information.
- **Joint investigations and coordination.** The CFPB and DOJ will seek to collaborate on investigations and conduct joint investigations of entities where appropriate. Following joint investigations, they will consult to determine whether multiple or joint actions are necessary or appropriate. They will also meet regularly to discuss pending fair lending investigations and coordination opportunities.
- **Referrals and notifications.** The CFPB will refer matters to DOJ when it has reason to believe that a pattern or practice of lending discrimination exists. Because a referral to DOJ does not affect the CFPB's authority to take independent enforcement action, the MOU establishes procedures for the two agencies to coordinate efforts. The CFPB and DOJ also agree to notify each other at key stages of enforcement, such as the opening of an investigation or filing of a lawsuit.

A copy of the MOU is available at http://files.consumerfinance.gov/f/201212_cfpb_doj-fair-lending-mou.pdf.

The MOU states that the sharing of non-public information pursuant to the MOU does not constitute public disclosure and does not constitute a waiver of confidentiality, the work product doctrine, or other applicable privileges, including the examination, deliberative process, law enforcement, or common interest privilege. Recently enacted legislation guarantees that providing privileged information to the CFPB, whether directly or through a federal bank regulatory agency, will not waive any privilege with respect to third parties. It remains to be seen, however, whether courts will agree that the subsequent disclosure of non-public information by the CFPB to DOJ pursuant to the MOU will not waive any applicable privileges.

B. Fair Lending Report

The CFPB's first annual Fair Lending Report describes the CFPB's fair lending activities during its first year, including the following:

- Establishment of the Office of Fair Lending and Equal Opportunity, which will lead the CFPB's fair lending efforts;
- Commencement of the CFPB's fair lending supervision program, and completion of fair lending reviews at numerous financial institutions, ranging from assessments of the institutions' fair lending compliance management systems to reviews of products or activities that may pose fair lending risks to consumers;
- Commencement of the CFPB's fair lending enforcement program, and initiation of a number of fair lending investigations, including matters arising from the CFPB's supervisory authority and joint investigations with other federal agencies;
- Ongoing work on amendments to Regulation C, which implements the Home Mortgage Disclosure Act, and planning for amendments to Regulations B and Z, which implement ECOA and the Truth in Lending Act, respectively; and
- Completion of an empirical study and report to Congress addressing various fair lending issues related to private education loans, such as the use of cohort default rates.

A copy of the report is available at http://files.consumerfinance.gov/f/201212_cfpb_fair-lending-report.pdf.

II. Policy to Encourage Trial Disclosure Programs

On December 13, 2012, the CFPB requested public comment on its *Policy to Encourage Trial Disclosure Programs*.[1] The proposed program will be a part of *Project Catalyst*, a new initiative, launched by the CFPB in November, that is designed to "advance consumer-friendly innovation" in the financial services market. The trial disclosure program would implement Section 1032(e) of the Dodd-Frank Act, which grants the CFPB authority to permit covered companies to research and develop innovative disclosures and test them in the market while enjoying a safe harbor or waiver that would "deem" the company "in compliance with," or "exempt from," current disclosure laws.[2]

Companies may use the program to suggest improvements to the CFPB's existing model disclosure forms, propose changes to delivery mechanisms, or recommend the replacement or elimination of existing disclosure requirements and model forms. The CFPB has stated that it intends to use the information produced in these trials to "create more effective disclosure rules and practices."[3] The CFPB has also indicated that it believes the new program is consistent with its goal to provide consumers with clear and accurate information to make better financial decisions.

A. Eligibility and Approval Process

To be eligible to participate in the trial disclosure program, a company must meet certain requirements. For instance, a company must describe the trial disclosure and explain how the suggested change will improve existing disclosures. The company must place an emphasis on how the new disclosure will enhance consumer understanding or cost-effectiveness.

The company would also be required to submit data identifying the duration and scope of the trial disclosure program, including the location and demographics of the consumer population involved in the trial. In addition, the company must substantiate why those characteristics are reasonably necessary for sound testing, provide a reasonable justification for expecting the potential improvements, and provide a method for testing whether the improvements are attained. It would also be required to identify any third-party vendors that will participate in the trial disclosure program and commit to sharing the results of the trial with the CFPB.

In approving a proposed trial disclosure program, the CFPB will consider many factors. Perhaps the most significant factor is the program's ability to assist the CFPB in creating policies that will enhance consumers' "understanding of the costs, benefits, and risks associated with consumer financial products or services."[4] Upon approval of the trial disclosure program, the CFPB will delineate the terms and conditions of the trial program and publish notice of the approved trial disclosure program on its website.

B. Comments on the Proposal

The CFPB has requested feedback concerning all aspects of its new policy. Financial institutions may want to request clarification on the CFPB's ability to revoke an approved waiver and whether a violation may result in enforcement penalties or the retroactive revocation of the safe harbor. It may also benefit companies to seek more guidance on the nature of the data necessary to substantiate that a proposed disclosure's improvements will be realized.

III. Request for Comment on the CARD Act

On December 19, 2012, the CFPB announced that it was seeking public comment on how the CARD Act had affected consumers of credit card products and the business practices of credit card issuers. In conjunction with the announcement, the CFPB posted a Request for Information Regarding Credit Card Market (Request) on its website. Comments are due by February 19, 2013.

The CARD Act was enacted in May 2009 mainly to regulate the terms and conditions of consumer credit cards through amendments to the Truth in Lending Act (TILA). Before the enactment, TILA had required disclosures to consumers but generally had not restricted substantive terms of credit cards. As summarized in the Request, the CARD Act imposes

1 *Policy to Encourage Trial Disclosure Programs; Information Collection*, 77 Fed. Reg. 74625 (Dec. 17, 2012).

2 Dodd-Frank Act § 1032(e)(2).

3 77 Fed. Reg. 74626.

4 77 Fed. Reg. 74627.

limitations on interest rate increases, penalty fees, and overlimit fees; prescribes certain requirements for payment processing and monthly statements; requires the issuer to consider the consumer's ability to repay; and restricts on-campus marketing of credit cards.

After the enactment of the CARD Act, the Board of Governors of the Federal Reserve System (Federal Reserve) amended its Regulation Z to implement the TILA amendments made by the CARD Act. The CFPB assumed TILA rulemaking authority from the Federal Reserve on July 21, 2011 under the Dodd-Frank Act. It has reissued the amended Regulation Z as its regulation implementing TILA.

Section 502 of the CARD Act requires the Federal Reserve to conduct a review of the consumer credit card market every two years and solicit public comment as part of the review. This responsibility has been transferred to the CFPB under the Dodd-Frank Act. In the Request, the CFPB invites the public to answer questions listed under the following seven topics, which Section 502 of the CARD Act requires the CFPB to include in its review:

1. How the terms of credit card agreements and the pricing, marketing, and underwriting practices of credit card issuers have changed;
2. The effectiveness of disclosure of terms, fees, and other expenses of credit card plans;
3. The adequacy of protections against unfair or deceptive acts or practices relating to credit card plans;
4. Whether the implementation of the CARD Act has affected the cost and availability of credit, particularly with respect to non-prime borrowers;
5. Whether the CARD Act has impacted the safety and soundness of any credit card issuers;
6. Whether the CARD Act has affected the use of risk-based pricing; and
7. Whether the implementation of the CARD Act has had any effect on credit card product innovation.

The CFPB has also invited commenters to submit any other information they believe to be relevant to assessing the impact of the CARD Act on the consumer credit card market.

Section 502 requires the CFPB to either propose new or revised regulations or interpretations relating to consumer credit cards or state the reason why the CFPB determines that new or revised regulations are not necessary following the review. Therefore, persons interested in the factors enumerated above should consider the possibility of CFPB rulemakings in deciding whether and how to respond to the Request.

IV. Payday Loan Debt Solution Joint Action

On December 21, 2012, the CFPB concluded its first joint litigation with state attorneys general to enforce consumer financial laws. The United States District Court for the Southern District of Florida entered a stipulated final judgment and order (Order) between defendants Payday Loan Debt Solution, Inc. (PLDS), and PLDS' president, and plaintiffs including the CFPB, Hawaii, New Mexico, North Carolina, North Dakota, and Wisconsin. The Order found that PLDS marketed debt-relief services to consumers to settle their outstanding payday loan balances. According to the Order, PLDS promised consumers that it would seek to renegotiate or settle the outstanding payday loan debts and charged fees in advance of settling consumers' debts. The debt settlement advance fees were found to be violations of the Telemarketing and Consumer Fraud and Abuse Prevention Act, as well as the state plaintiffs' respective consumer protection statutes.

The Order imposes several injunctive, monetary, and supervisory penalties upon PLDS and its president. PLDS and its president are enjoined from charging any further fees in advance of providing debt-relief services and are permanently enjoined from providing any debt-relief services within the states of Hawaii and North Carolina. PLDS must also pay restitution of US$100,000 to the CFPB on behalf of consumers who were charged fees but received no debt-relief services. PLDS must pay a separate civil money penalty of US$5,000, which the CFPB acknowledges as being reduced because PLDS and its president immediately ceased their conduct and cooperated with the investigation related to the lawsuit. PLDS and its president must continue to cooperate with the CFPB in any further investigations or litigation that arise from the actions related to the Order. Significantly, by virtue of the Order, PLDS becomes an entity subject to CFPB supervision and examination for a period of two years. This includes the maintenance of records, customer files, complaints, training materials, and marketing materials during this two year supervisory period.

This action is the first of what will likely be many joint lawsuits between the CFPB and state attorneys general. Title X of the Dodd-Frank Act provides protection for state consumer financial laws, including when such laws provide greater protections to consumers than Title X. State attorneys general not only may enforce their own state consumer financial laws, but they may also enforce Title X and its regulations with regard to state-chartered entities.[5] Through the National Association of Attorneys General, the CFPB has developed a working relationship with several state attorneys general and has expressed its intent to engage in coordinated investigations and enforcement actions, such as the action against PLDS. In furtherance of this goal, the Dodd-Frank Act requires the CFPB to share its consumer complaint database with state agencies.[6]

As the CFPB will certainly continue to collaborate with state attorneys general in investigations and enforcement actions, state-chartered financial service entities must take care to monitor their activities for compliance with state consumer protection statutes or else face the potential of joint state and federal enforcement proceedings.

V. Proposed Changes to Rule on Remittance Transfers and Postponed Effective Date

A. The Original Rule

Section 1073 of the Dodd-Frank Act amended portions of the Electronic Fund Transfer Act in an effort to increase consumer protection for international remittance transfers. The CFPB published a final rule on February 7, 2012, followed by a supplemental rule on August 20, 2012, implementing Section 1073.[7] In general, remittance transfer providers must provide to customers certain pre- and post-transaction information regarding their remittance transfers.

B. The Proposed Changes

In response to industry concerns about the feasibility of complying with certain of the disclosure rules, and the likelihood of remittance transfer providers leaving the market because of the difficulty of complying with the new requirements, on December 21, 2012, the CFPB published proposed changes to the remittance transfer rules.[8] To ease the difficulty of calculating actual amounts to be received by recipients, as originally required by the final rule, the proposed changes allow providers to use estimated figures for unknown variables and no longer require them to include sub-national taxes. When using estimates, providers must use the highest possible tax or fee that could be imposed, notify the sender that the amount to be received is estimated, disclose the estimated figures, and base the estimates on fee schedules, prior transfers, or other reasonable sources. Reasonable sources include competitor fee schedules, surveys, and information from the recipient institution's regulator. Alternatively, the provider can rely on the sender's representations of any figures.

Additionally, to reduce industry concerns of increased fraud, the proposed changes revise the error resolution process. The proposed changes modify the definition of "error" by excepting instances where the sender provides an incorrect account number. Consequently, if the sender provides an incorrect account number, the provider must still make reasonable attempts to recover the funds, but is no longer liable if unsuccessful. What constitutes a "reasonable attempt" is purposefully undefined in the proposed changes. Furthermore, if the sender provides incorrect or insufficient information other than an incorrect account number, the provider must still resend the amount,

5 Section 1042(a)(2) of the Dodd-Frank Act also permits state attorneys general to enforce CFPB regulations against national banks and federal savings associations.

6 Dodd-Frank Act § 1013(b)(3)(D).

7 Electronic Fund Transfers, 77 Fed. Reg. 6194 (Feb. 7, 2012) (final rule); Electronic Fund Transfers, 77 Fed. Reg. 50244 (Aug. 20, 2012) (supplemental rule).

8 Electronic Fund Transfers, 77 Fed. Reg. 77188 (Dec. 31, 2012) (proposed changes to final rule).

but need not treat the resend as an entirely new transfer that requires written disclosures. Instead, the provider may issue oral disclosures.

C. Postponed Effective Date

On January 22, 2013, the CFPB announced that the effective date of the final rule, including the above proposed changes, was being indefinitely postponed pending finalization of the proposal.[9]

VI. Qualified Mortgages

On January 10, 2013, the CFPB issued its final Ability-to-Repay and Qualified Mortgage rule, amending Regulation Z and implementing Sections 1411 and 1412 of the Dodd-Frank Act. Sections 1411 and 1412 require lenders to assess consumers' ability to repay home loans before extending credit. The final rule becomes effective January 10, 2014.

The intent of the final rule is to ensure that creditors give appropriate consideration to consumers' ability to repay home loans when making lending decisions, and to strengthen the underwriting practices in the credit industry that contributed to the recent recession. Thus, the final rule focuses on establishing factors for ability-to-repay determinations and uniform baselines for underwriting standards.

Currently, Regulation Z, as amended by the Federal Reserve in 2008, prohibits creditors from extending higher-priced mortgage loans without regard for the consumer's ability to repay. The Ability-to-Repay and Qualified Mortgage rule extends application of this requirement to all loans secured by dwellings, not just higher-priced mortgages. Creditors must, at a minimum, consider eight specified factors while making a reasonable and good faith determination that the consumer has a reasonable ability to repay the loan before entering any consumer credit transaction secured by virtually any dwelling. The factors include information such as the consumer's income, debt obligations, credit history, and monthly payments on the loan.

Additionally, the rule establishes a safe harbor and presumption of compliance with the ability-to-repay requirement for so-called "qualified mortgages," restricts the application of prepayment penalties, and requires the retention of evidence of compliance with the ability-to-repay requirement for three years. Arnold & Porter LLP will provide a more detailed review of the rule in a subsequent advisory.

Arnold & Porter is available to respond to questions regarding the CFPB's recent activities. For further information, please contact your Arnold & Porter attorney or:

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9 Electronic Fund Transfers, 78 Fed. Reg. 6025 (Jan. 29, 2013) (final rule).

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Deadline Approaching for Foreign Banks on Living Wills

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During 2013, foreign banks with US$50 billion or more in global assets, and a branch or agency in the United States, will be required to submit resolution plans (often called "living wills") to U.S. federal banking regulators. Resolution plans of foreign banks with less than US$100 billion in U.S. non-bank assets are due by year-end 2013, but a notice must be filed by April 5, 2013, if the institution wishes to use a simplified "tailored" resolution plan. Resolution plans of foreign banks with between US$100 billion and US$250 billion in U.S. non-bank assets must be submitted by July 2013. Foreign banks with US$250 billion or more in U.S. non-bank assets were required to submit resolution plans in 2012.[1]

The Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC) in November 2011, adopted regulations requiring certain U.S. and foreign banks, and nonbank financial companies supervised by the FRB pursuant to a systemic risk determination by the Financial Stability Oversight Council, to submit and periodically update resolution plans, describing how they can be resolved in an orderly manner under the U.S. Bankruptcy Code in the event of material financial distress or failure. The regulations, which implement Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), require each "covered company" to submit a resolution plan. The term "covered company" is defined to include foreign banks and companies that are, or are treated as, bank holding companies under Section 8(a) of the International Banking Act of 1978, *and* that have US$50 billion or more in global consolidated assets. This advisory describes the resolution plan requirements for foreign-based covered companies and the process for seeking a limited exception to the requirements. For further information on the preparation of resolution plans, please see our prior Arnold & Porter advisory on the topic.

I. Timeframe for Submission

The required timeframe for submission of the initial resolution plan depends on the size of the company's U.S.-based nonbank[2] operations as of November 30, 2011, which

1 *See* 12 C.F.R. §§ 243, 381. A separate resolutions plan rule applies to FDIC-insured banks with US$50 billion or more in assets. *See* 12 C.F.R. § 360. The Board of Governors of the Federal Reserve System has also separately proposed (but not yet adopted) rules that will require foreign banks with US$50 billion or more in global assets to submit risk-management, liquidity, and certain other plans, and impose certain other risk management and planning requirements on all foreign banks with a U.S. branch, agency, subsidiary U.S. bank, or Edge corporation.

2 The term "U.S. nonbank assets" generally refers to assets held outside the foreign bank's U.S. branch, agency, U.S. commercial lending company, or depository institution subsidiary.

was the effective date of the regulation. While the largest covered companies were required to submit a resolution plan last summer, the vast majority of foreign-based covered companies must submit their resolution plans later this year. The two remaining deadlines for the submission of resolution plans by foreign-based covered companies are as follows:

- **July 1, 2013** for foreign-based covered companies with US$100 billion or more (but less than US$250 billion) in total U.S. nonbank assets; and
- **December 31, 2013** for foreign-based covered companies with less than US$100 billion of U.S. nonbank assets.

For foreign-based covered companies with less than US$100 billion of U.S. nonbank assets, April 5, 2013, is the deadline for submission of an application requesting permission to submit a less comprehensive, "tailored," resolution plan.

II. Informational Content of a Resolution Plan

Foreign-based covered companies and foreign banking organizations[3] are generally required to submit a resolution plan that contains the following information with respect to its subsidiaries, branches, agencies, critical operations, and core business lines that are domiciled in the United States or conducted in whole or material part in the United States:

- Executive summary
- Strategic analysis
- Corporate governance relating to resolution planning
- Organizational structure and related information
- Management information systems
- Interconnections and interdependencies
- Supervisory and regulatory information
- Contact information

In addition, they must provide a detailed explanation of how such resolution planning is integrated into the company's overall resolution or other contingency planning process.

III. Tailored Resolution Plans

The regulation permits smaller, less complex foreign-based covered companies that operate in the United States predominately through one or more insured depository institutions, branches, or agencies to elect to file a tailored resolution plan that focuses only on resolution of the company's U.S. nonbank operations and material business operations that are subject to resolution under the U.S. Bankruptcy Code, and the interconnections of such operations with those of its U.S. insured depository institution(s), branches, and agencies.

A foreign-based covered company may elect to file a tailored resolution plan, and is considered an "eligible covered company" for those purposes if, as of the end of the prior calendar year:

(1) it had less than US$100 billion in total U.S. nonbank assets, and

(2) the assets of its U.S. insured depository institution operations, branches, and agencies comprised 85% or more of its U.S. total consolidated assets.

An eligible covered company that intends to submit a tailored resolution plan must provide the FRB and FDIC with notice of its intent and eligibility no later than 270 days prior to the date on which it is required to submit its resolution plan. Thus, as noted above, the deadline for such notice by foreign-based covered companies with less than US$100 billion of U.S. nonbank assets is April 5, 2013.

The FRB and FDIC have wide discretion to approve an application for a tailored resolution plan or require a covered company to submit a resolution plan that meets some or all of the requirements of a full resolution plan. Thus, it is advisable for an eligible covered company to start consulting with the FRB and FDIC as soon as possible regarding the content of its application and in order to maximize its chances of being permitted to submit a tailored resolution plan.

3 The regulations define a foreign banking organization as a foreign bank (and its parent) that (a) operates a branch, agency or commercial lending subsidiary in the U.S.; (b) controls a bank in the U.S.; or (c) controls an Edge corporation acquired after March 1987. Thus, a foreign bank maintaining only a representative office in the United States does not bring a company within the definition of a "foreign banking organization" potentially subject to the resolution plan requirements. However, a foreign bank with only a representative office in the United States but other substantial U.S. nonbank assets could become subject to the resolution plan requirements if designated as systemically important by the Financial Stability Oversight Council under Section 113 of Dodd-Frank.

IV. Preparing a Resolution Plan

Covered companies are required to submit resolution plans and annually update them. The process of creating and obtaining FRB approval for a plan will require extensive staff time and involvement by the board of directors and senior management. The FRB and FDIC have indicated that resolution planning is an iterative process. Each covered company must develop its own plan, designed to address its own business and organizational structure. Covered companies with US$250 billion or more in total nonbank assets were required to submit resolution plans last summer. Although the FRB and FDIC have not yet approved those plans, the public portions of those plans may nevertheless provide some guidance to smaller covered companies in the preparation of their resolution plans.

Covered companies are well advised to decide as soon as possible whether they intend to file an application for permission to submit a tailored resolution plan. It may benefit covered companies to start working with the FRB and FDIC to determine the appropriate level of detail for such an application to submit a tailored resolution plan. It may also benefit them to start, if they have not already done so, creating teams and defining tasks in connection with the creation of the plan.

Arnold & Porter LLP is available to provide advice on the preparation of a tailored resolution plan application and with the preparation of such a plan or a full resolution plan. For further information, please contact your Arnold & Porter attorney or:

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The Consumer Financial Protection Bureau's Ability-to-Repay and Qualified Mortgage Rule

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On January 10, 2013, the Consumer Financial Protection Bureau ("CFPB") issued its final Ability-to-Repay and Qualified Mortgage rule, amending Regulation Z and implementing Sections 1411 and 1412 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1] Sections 1411 and 1412 require lenders to assess consumers' ability to repay home loans before extending credit and provide a safe harbor and a presumption of compliance with the ability-to-repay requirement for so-called "qualified mortgages." The final rule becomes effective January 10, 2014.[2]

I. OVERVIEW

The intent of the final rule is to ensure that creditors give appropriate consideration to consumers' ability to repay home loans when making lending decisions, and to strengthen the underwriting practices in the credit industry that are often cited as a cause of the recent recession. Thus, the final rule focuses on establishing factors for ability-to-repay determinations and uniform baselines for underwriting standards.[3]

Currently, Regulation Z, as amended by the Board of Governors of the Federal Reserve System in 2008, prohibits creditors from extending higher-priced mortgage loans without regard for the consumer's ability to repay. The final rule extends application of this requirement to all loans secured by dwellings, not just higher-priced mortgages. Creditors must, at a minimum, consider eight factors while making a determination that the consumer has a reasonable ability to repay the loan before entering any consumer

1 Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act, Final Rule, 78 Fed. Reg. 6408 (Jan. 30, 2013) (to be codified at 12 C.F.R. Part 1026).

2 We note that a recent decision by the DC Circuit Court of Appeals has raised questions regarding the constitutionality of the President's recess appointment of Richard Cordray as Director of the CFPB. If his appointment were successfully challenged, certain rules issued during his tenure, including this qualified mortgage rule, could potentially be invalidated. Although a number of intervening events could avert such a result, the Dodd-Frank Act provides that the statutory qualitative mortgage provisions become effective as of January 21, 2013 in the absence of a rulemaking. As such, the qualitative mortgage provisions of the Dodd-Frank Act would become immediately effective if the final rule were to be invalidated.

3 Contrary to a widely held misconception among industry observers, the final rule does not prohibit creditors from extending adjustable-rate loans, interest-only loans, and negative amortization loans. However, with limited exceptions, adjustable rate loans that result in an increase in principal balance, allow the consumer to defer repayment of principal, or result in balloon payments cannot be qualified mortgages.

credit transaction secured by virtually any dwelling.[4] The factors include information such as the consumer's income, debt obligations, credit history, and monthly payments on the loan. Additionally, the final rule establishes a safe harbor and a presumption of compliance with the ability-to-repay requirement for so-called "qualified mortgages," restricts application of prepayment penalties, and requires retention of evidence of compliance with the ability-to-repay requirement for three years.[5]

II. ANALYSIS

The final rule adds Section 1026.43 to Regulation Z. Section 1026.43 applies to any consumer credit transaction secured by a dwelling ("covered transaction"), including all residential mortgage loans such as home purchase, refinancing, home equity, first lien, and subordinate loans. "Dwelling" encompasses principal residences, second homes, vacation homes, one-to four-unit residences, condominiums, cooperatives, mobile homes, and manufactured homes. Section 1026.43 does not apply, however, if the loan is for a business, commercial, or agriculture purpose, even if secured by a dwelling. Open-end lines of credit, covered by Section 1026.40, are specifically excluded from Section 1026.43.

A. The Ability-to-Repay Requirement

Before extending a loan covered by Section 1026.43, a creditor must make a "reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms."[6] The determination depends on the facts and circumstances that the creditor knows or should have known at the time of consummation. Indicators of a reasonable and good faith determination include the consumer's timely repayment, the use of underwriting standards that historically result in low default rates, and use of underwriting standards based on demonstrably sound models. Conversely, defaults shortly after consummation, inconsistent use of underwriting standards, use of standards ineffective at determining repayment ability, and insufficient residual income all suggest the determination was not reasonable or in good faith.

When making the ability-to-repay determination, creditors must use third-party records to verify all information on which they rely, and consider at least the following eight factors:

(i) The consumer's current or reasonably expected income or assets, other than those used to secure the loan;
(ii) The consumer's current employment status, if "income" is used as a basis for determination;
(iii) The consumer's expected monthly payment on the covered transaction;
(iv) The consumer's monthly payment on any simultaneous loans;
(v) The consumer's monthly payment of mortgage related obligations;
(vi) The consumer's current debt obligations, alimony, and child support;
(vii) The consumer's debt-to-income ratio or residual income; and
(viii) The consumer's credit history.

When evaluating these eight factors, creditors may rely on their own definitions and underwriting standards except for the underwriting standards the rule provides for calculating monthly payments on the loan and debt-to-income ratios. The final rule provides that, when calculating the monthly payment under factor (iii), creditors must use the greater of the fully indexed rate or any introductory rate, and substantially equal, fully amortizing monthly payments. Loans with balloon payments, interest-only loans, and negative amortization loans require similar calculations. The

4 12 C.F.R. § 1026.43(c).

5 We note that a "qualified mortgage" should not be confused with the related but distinct concept of a "qualified residential mortgage." The term "qualified residential mortgage" ("QRM") relates to the credit risk retention requirements introduced by Section 941(b) of the Dodd-Frank Act, which generally require the securitizer of asset-backed securities ("ABS") to retain at least five percent of the credit risk of the assets collateralizing the ABS. This requirement does not apply, however, if all of the assets that collateralized the ABS are QRMs. The Dodd-Frank Act links the concepts of QRMs and qualified mortgages by providing that the definition of QRM may be "no broader than" the definition of qualified mortgages. The CFPB and other agencies proposed a definition for "QRM" in a separate rulemaking issued on April 29, 2011, which has remained in proposed form pending the finalization of the definition of a "qualified mortgage."

6 12 C.F.R. § 1026.43(c)(1).

"fully indexed rate" is the rate that will apply after the loan "recasts," which is the expiration of any introductory, interest-only, or negative amortization payment period. The result of this provision is to require creditors to consider whether or not a consumer will be able to make payments if the highest possible rate applies throughout the life of the loan.

With respect to factor (vii), creditors must calculate a consumer's debt-to-income ratio using the consumer's total monthly debt obligations and total monthly income. "Total debt obligations" is the sum of payments on the loan, simultaneous loans, mortgage-related obligations, current debt obligations, alimony, and child support. "Total monthly income" is the sum of current and "reasonably expected" income, and can include income from assets. The creditor, however, can determine the appropriate ratio that will support a reasonable determination of a consumer's ability to repay.

The final rule requires creditors to retain evidence of compliance with the ability-to-repay requirement for three years.

1. Exemption from the Ability-to-Repay Requirement: Refinancing Non-standard Mortgages

To encourage refinancing of certain mortgages, the final rule exempts from the ability-to-repay requirement the refinancing of non-standard mortgages into standard mortgages. The rule targets three non-standard loans: adjustable-rate loans, interest-only loans, and negative amortization loans. In order for the exemption to apply, creditors must consider whether the consumer is likely to default when the existing loan is recast, and whether refinancing will likely prevent the default. If so, the exemption applies as long as the following conditions are met:

(i) the creditor is the current holder of the non-standard mortgage;
(ii) the standard mortgage monthly payment will be materially lower than the non-standard mortgage payment;
(iii) the creditor receives the consumer's written application no later than two months after the non-standard mortgage recast;
(iv) the consumer did not make more than one payment more than thirty days late during the preceding twelve months of receipt of the application;
(v) the consumer did not make any payment more than thirty days late during the preceding six months of receipt of the application; and
(vi) if the non-standard mortgage was consummated on or after January 10, 2014, it was made in accordance with the ability-to-repay requirement.

Whether or not a new standard mortgage payment meets the "materially lower" standard of factor (ii) depends on the facts and circumstances surrounding the loan. However, the CFPB's official interpretations of the final rule provide that any refinancing that results in a ten percent payment reduction will satisfy the materially lower standard. The final rule prescribes methods for calculating payments in order to facilitate comparison of the non-standard and standard payments. The methods are similar to those under the ability-to-repay requirement in that they establish a substantially equal monthly payment using the fully indexed rate under the terms of the loan.

B. Qualified Mortgages

The final rule establishes a safe harbor and a presumption of compliance with the ability-to-repay requirement for certain qualifying loans. If a covered transaction satisfies the requirements of a qualified mortgage, outlined below, and *is not* a higher-priced mortgage,[7] then the creditor is deemed to have complied with the ability-to-pay requirement and is entitled to the safe harbor provided by Section 1026.43(e) of Regulation Z.

Alternatively, if the covered transaction satisfies the requirements of a qualified mortgage and *is* a higher-priced mortgage, then there is a rebuttable presumption that the creditor complied with the ability-to-repay requirement. This presumption is overcome when the consumer proves that despite meeting the requirements of the definition of qualified mortgage, the creditor did not make a reasonable and good

7 Higher-priced mortgages have an annual rate exceeding the average prime offer rate by 1.5 percentage points or more for a first-lien transaction, or 3.5 percentage points or more for a subordinate-lien transaction.

faith determination of the consumer's ability to repay. The consumer must show that his debt obligations, alimony, child support, and monthly payments on the covered transaction and simultaneous loans would leave him with insufficient income to meet living expenses. However, the longer a consumer continues to pay after the loan recasts, the more likely it is the creditor made a reasonable and good faith determination. Consumers will encounter this presumption when bringing actions seeking special statutory damages for violation of the ability-to-repay requirement, and when raising violation of the ability-to-repay requirement as a defense in foreclosure actions.

1. General Requirements

The Dodd-Frank Act specified minimum requirements for a qualified mortgage, and gave the CFPB discretion to supplement those requirements as it saw fit. A qualified mortgage is a credit transaction secured by a dwelling:

(i) that provides for regular, periodic, and substantially equal payments that do not result in an increased principal balance, allow consumer to defer repayment of principal, or result in balloon payment;
(ii) that does not exceed thirty years;
(iii) that does not have points and fees exceeding a specified cap;
(iv) where the creditor underwrites using the maximum interest rate applicable during the first five years of the loan, and payments that will repay the loan within term;
(v) where the creditor considers and verifies consumer's reasonably expected income or assets, debt obligations, alimony, and child support in accordance with Appendix Q to Regulation Z; and
(vi) where the consumer's debt-to-income ratio does not exceed forty-three percent, as determined under Appendix Q.

Notably, these requirements are similar to the ability-to-repay factors but establish a higher threshold of compliance to justify both the safe harbor and presumption of compliance provisions. Essentially, creditors must meet a higher underwriting standard for qualified mortgages than those needed to satisfy the ability-to-repay requirement.

The definition of qualified mortgage requires a specific debt-to-income ratio, a limit on the term of the loan, and a cap on the points and fees assessed. Qualified mortgages also exclude negative amortization loans, interest-only loans, and non-rural balloon-payment loans.[8] If one or more payments are applied solely to interest, then the payment counts as a deferment and thus disqualifies the loan. Lastly, for requirements (v) and (vi), Appendix Q to Part 1026 contains a detailed list of additional requirements for qualified mortgages that are unnecessary to meet the ability-to-pay requirement. For example, Appendix Q requires the creditor to verify employment from the previous two years, as well as to assess the likelihood of employment continuing for the first three years of the loan.

2. Temporary Alternate Definition of Qualified Mortgage

Concerned with the possible initial reluctance of creditors to extend loans that are not qualified mortgages, the final rule includes a temporary alternate definition of qualified mortgages with a more flexible underwriting requirement. Under this temporary definition, transactions are qualified mortgages if they meet the first three requirements listed above, and are at least one of the following:

(i) eligible for purchase by Fannie Mae or Freddie Mac;
(ii) eligible to be insured by the U.S. Department of Housing and Urban Development;
(iii) eligible to be guaranteed by U.S. Department of Veterans Affairs;
(iv) eligible to be guaranteed by the U.S. Department of Agriculture; or
(v) eligible to be insured by the Rural Housing Service.

8 Loans that include a balloon payment may still be a qualified mortgage if the loan satisfies applicable parts of the definition of qualified mortgage, the creditor determines the consumer can make all scheduled payments under legal obligation, the creditor operates in predominantly rural or underserved areas, and the loan is not subject to a commitment to be acquired by a non-rural creditor. If sold, assigned, or otherwise transferred, the loan will lose its qualified status unless certain specified conditions apply.

Importantly, the named departments and agencies need not actually purchase, guarantee, or insure the loans. Nor does the creditor actually need to sell the loan. The loans must simply be eligible. The temporary definition expires on the effective date of a rule issued by the named agencies which redefines "qualified mortgage," or on January 10, 2021.

C. Other Provisions

The final rule permits a narrow and restrictive use of prepayment penalties. Covered transactions cannot include a prepayment penalty unless otherwise permitted by law and the loan has an annual percentage rate that cannot increase, is a qualified mortgage, and is not a higher-priced mortgage. The penalty must not apply after three years following consummation and must not exceed a listed percentage of the outstanding balance. Additionally, if a creditor offers a loan containing a prepayment penalty, it must also offer an alternative loan without a penalty and have a good faith belief that the consumer is likely to qualify for the alternative. This restriction on prepayment penalties does not apply if the loan is not a covered transaction.

The final rule also contains an evasion provision. The provision states that a creditor cannot structure a loan as an open-end plan in order to avoid the requirements of Section 1026.43 when the credit is secured by a consumer's dwelling.

III. CONCLUSION

Under the new regulations, for all consumer credit transactions secured by a dwelling, a creditor must determine that the consumer has the ability to repay the loan. The creditor must base its determination on at least the eight prescribed factors using information verified by third-party records. If the creditor satisfies the higher threshold required for qualified mortgages, the creditor will be deemed to have complied with the ability-to-repay requirement, unless it is a "higher-priced mortgage loan," in which case there is a rebuttable presumption that the creditor complied with the ability-to-repay requirement. Although negative amortization, interest-only, and non-rural balloon payment loans cannot be qualified mortgages, creditors may still offer these products as long as they satisfy the ability-to-repay requirement.

Arnold & Porter LLP is available to respond to questions raised by the final rule. We also can assist you in complying with the ability-to-repay requirement and making loans that meet the definition of a qualified mortgage for the safe harbor and presumption of compliance protections. For further information, please contact your Arnold & Porter attorney or:

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Resolution Plan Deadlines Approaching for Insured Depository Institutions and Holding Companies

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The deadline is approaching for depository institutions and holding companies with US$50 billion or more in aggregate assets to submit resolution plans (living wills) to federal banking regulators. Resolution plans for depository institution holding companies having less than US$100 billion in total consolidated assets, are due by year-end 2013, but a notice must be filed by April 5, 2013, if the company wishes to use a simplified “tailored” resolution plan. Nonbank financial companies designated by the Financial Stability Oversight Counsel (FSOC) as being systematically important (SIFIs) will also be required to submit resolution plans, although as of this writing no SIFI designations have yet been issued.

Insured depository institutions with US$50 billion or more in assets, whose parent companies, as of November 30, 2011, had total consolidated assets between US$100 billion and US$250 billion, are required to submit resolution plans by July 1, 2013. Other insured depository institutions with US$50 billion or more in total assets must submit resolution plans by December 31, 2013.

This advisory describes the resolution plan requirements for domestic covered companies and covered insured depository institutions. For further information on the preparation of resolution plans, please see our prior Arnold & Porter advisory on the topic.

I. Section 165(d) Resolution Plans for Holding Companies

A. Overview

Regulations of the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC), codified at 12 C.F.R. § 381, implement Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The regulations require “covered companies” to submit and periodically update resolutions plans, describing the companies’ strategy for a quick and orderly resolution under the Bankruptcy Code in the event of material financial distress or failure (Section 165(d) resolution plans). "Covered companies" include bank holding companies that have US$50 billion or more in total liquidated assets and nonbank financial companies that have been designated by the FSOC as being systematically important.

B. Timeframe for Submission

Submission dates for resolution plans are determined by the size of the covered company. Large covered companies, with total consolidated assets of more than US$250 billion, were required to submit a resolution plan by July 1, 2012. Mid-sized and smaller domestic covered companies are required to submit their plans by the following deadlines:

- **July 1, 2013** for domestic covered companies that have total consolidated assets between US$100 billion and US$250 billion; and
- **December 31, 2013** for domestic covered companies with less than US$100 billion in total consolidated assets.
- For institutions that become covered companies after November 30, 2011, **no later than the July 1** following the date that the institution becomes a covered company, provided that it has been a covered company for at least 270 days.

As discussed below, certain covered companies with less than US$100 billion in total consolidated assets, whose banking assets comprise 85% or more of total assets, may be eligible to submit "tailored resolutions plans." Companies that intend to submit such a plan must submit written notice to the FRB by **April 5, 2013**.

C. Informational Content of a Resolution Plan for a Holding Company

A domestic covered company is generally required to include the following information in its resolution plan with respect to its subsidiaries, and operations that are domiciled in the United States as well as its foreign subsidiaries, offices, and operations:

- Executive summary;
- Strategic analysis;
- Corporate governance relating to resolution planning;
- Organizational structure and related information;
- Management information systems;
- Interconnections and interdependencies;
- Supervisory and regulatory information; and
- Contact information.

In preparing the resolution plan, a covered company must explain how the company plans to liquidate in the event of material financial distress or failure under the baseline, adverse, and severely adverse economic conditions provided by the FRB pursuant to 12 U.S.C. § 5365(i)(1)(B). In its initial resolution plan, however, a covered company is required only to submit a plan assuming the baseline conditions. A covered company is prohibited from relying on extraordinary governmental support, U.S. based or otherwise, among its resolution plan assumptions.

D. Tailored Resolution Plans

Smaller, and less complex, domestic covered companies are permitted to submit a "tailored" resolution plan, which focuses on the covered company's nonbank operations and the interconnections between the bank and nonbank operations of the company. A covered company is eligible to submit such a plan if, as of December 31 of the prior calendar year, the company:

(1) Had less than US$100 billion in total U.S. nonbank assets; and

(2) The assets of its insured depository institution(s) comprised 85% or more of its total consolidated assets.

A domestic covered company that intends to submit a tailored plan must provide the FRB and the FDIC with written notice no later than 270 days prior to the covered company's required date of submission (April 5, 2013). Within 90 days of receiving such notice, the agencies may jointly determine that the covered company must submit a plan that meets some or all of the requirements in the "full" resolution plan. For institutions that become covered companies after November 30, 2011, resolution plans must be submitted by the July 1 following the date the institution became a covered company, provided the company has been a covered company for at least 270 days. To be eligible to submit a tailored plan, the covered company must file notice of its intent to submit such a plan 270 days prior to its required date of submission.

II. Covered Insured Depository Institution Resolution Plan

The FDIC rule, codified at 12 C.F.R. § 360.10, requires covered insured depository institutions (CIDIs) – those with US$50 billion or more in total assets – to submit and periodically update a plan for resolution of the institution in the event of its failure. The resolution plan must outline how the FDIC, as receiver, may resolve the CIDI, under Sections 11 and 13 of the Federal Deposit Insurance Act, 12 U.S.C. §§ 1821, 1823, in a manner that will ensure, in the event of the institution's failure: (1) that depositors will receive access to their insured funds within one business day (or two business days if the failure occurs on a day other than Friday); (2) that the net present value return from the sale or disposition of the institution's assets is maximized; and (3) that the potential loss to be realized by the institution's creditors is minimized. The CIDI's resolution plan may incorporate data and other information from a resolution plan filed by its parent company pursuant to Section 165(d) of the Dodd-Frank Act.

The resolution plan should include, among other things, a detailed description of the depository institution's critical services, interconnectedness with its parent company, and strategies to separate from the parent company or to sell or dispose of the deposit franchise, business lines, and assets.[1] The plan is divided into a public portion and a confidential portion. Generally for its annual submissions, the CIDI must consider that its failure may occur under the baseline, adverse, or severely adverse conditions provided by the FRB. A CIDI's initial plan, however, may assume failure under the baseline condition only.

The timeframes for submission of the CIDI resolution plans are similar to those for the Section 165(d) resolution plans. CIDIs whose parent company, as of November 30, 2011, had US$250 billion or more in total nonbank assets were required to submit a resolution plan by July 1, 2012. CIDI's of midsized and smaller parent companies are required to submit their plans by the following deadlines:

- **July 1, 2013** for CIDI's whose parent company, as of November 30, 2011, had total consolidated assets between US$100 billion and US$250 billion; and
- **December 31, 2013** for CIDI's whose parent company, as of November 30, 2011, had less than US$100 billion in total consolidated assets.
- For institutions that become CIDIs after April 1, 2012, **no later than the July 1** following the date that the institution becomes a CIDI, provided that it has been a CIDI for at least 270 days.

After submission, the regulators will review the plan, ask questions, request supporting data and may speak with personnel at the institution to assess the plan. The regulators may send the plan back to the institution for revisions before accepting the plan.

III. Conclusion

Domestic covered companies are required to submit resolution plans to the FDIC and FRB annually. These plans require significant planning and documentation. Covered companies should immediately decide whether they intend to submit a tailored resolution plan as the deadline is rapidly approaching. It may be beneficial for covered

1 A complete list of the resolution plan's elements is as follows: executive summary; organization structure; critical services; interconnectedness to parent company's organization and potential barriers or material obstacles to orderly resolution; strategy to separate from parent company's organization; strategy for the sale or disposition of deposit franchise; strategy for the sale or disposition of deposit franchise; least costly resolution method; asset valuation and sales; major counterparties; off-balance sheet exposures; collateral pledged; trading, derivatives, and hedges; unconsolidated balance sheet of CIDI and material entity financial statements; payment, clearing, and settlement systems; capital structure and funding sources; affiliate funding, transactions accounts, exposures, and concentrations; systematically important functions; cross-border elements; management information systems, software licenses, and intellectual property; corporate governance; assessment of resolution plan; and any other material factor.

companies to begin creating teams and assigning tasks to develop the resolution plan. It may also be beneficial for them to start working with the FDIC and FRB to ensure that their resolution plans conform with requirements of the regulations and the regulators' expectations.

Arnold & Porter LLP is available to provide advice on the preparation of Section 165(d) and CIDI resolution plans. For further information, please contact your Arnold & Porter attorney or:

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The CFPB Finalizes New Mortgage Servicing Rules

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On January 17, 2013, the Consumer Financial Protection Bureau (CFPB) finalized rules implementing the mortgage loan servicing requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The final rules amend Regulation X, which implements the Real Estate Settlement Procedures Act of 1974 (the RESPA Amendments) and Regulation Z, which implements the Truth in Lending Act (the TILA Amendments). The amendments will provide borrowers with detailed information regarding their loans, ensure that mortgage servicers do not unexpectedly assess borrowers with charges and fees, and ensure that borrowers are informed of alternatives to avoid foreclosure. Furthermore, the final rules will provide borrowers with more timely and accurate responses to their complaints by requiring servicers to follow certain error resolution procedures. The rules become effective January 10, 2014.

I. RESPA Amendments

A. Scope

The RESPA Amendments apply to any "mortgage loan," with certain exceptions. For example, the RESPA Amendments do not apply to open-end lines of credit, such as home equity plans, small servicers,[1] mortgages serviced by qualified lenders,[2] or reverse mortgage loans.

B. Error Resolution Procedures

The RESPA Amendments require servicers to follow certain procedures when a borrower asserts that a "covered error" has occurred on his or her mortgage loan account by

1 Small servicers are defined as those servicers who service fewer than 5,000 mortgages in a calendar year, which are all owned or originated by that servicer or its affiliates as well as servicers who qualify as a Housing Finance Agency, as defined in 24 C.F.R. § 266.5. Generally, small servicers are exempt from the RESPA Amendments' requirements, however, three rules are applicable. First, small servicers are prohibited from making the first notice or filing for any judicial or non-judicial foreclosure during the pre-foreclosure review period (as defined below). Second, small servicers must not file a first notice or filing for any judicial or non-judicial foreclosure if a borrower is performing his or her obligations under a loss mitigation agreement. Lastly, small servicers must comply with certain force-placed insurance requirements (as described below).

2 Qualified lender is defined as a "(1) [s]ystem institution, except a bank for cooperatives, that makes loans as defined in this section; and (2) [e]ach bank, institution, corporation, company, credit union, and association described in section 1.7(b)(1)(B) of the Act (commonly referred to as another financing institution), but only with respect to loans discounted or pledged under section 1.7(b)(1)." *See* 12 C.F.R. § 617.7000.

submitting a notice (notice of error). Covered errors include, among other things, failures to: accept conforming payments; apply or credit payments properly; pay taxes, insurance, or others fees; or provide accurate information regarding loss mitigation options and foreclosures. Covered errors also include the imposition of fees or charges without a reasonable basis. Servicers may designate an address where borrowers can send error notices.

Within five business days (excluding holidays) of a borrower submitting a "notice of error," the servicer must provide the borrower with a written response acknowledging its receipt. The servicer must also send a separate notice that states the final disposition of the notice of error – whether an error has been found, a different or additional error has been detected, or if the error has been corrected. As an alternative, the servicer may request additional information from the borrower to further assist it in investigating the error.

Generally, the servicer is required to inform the borrower of the final disposition of the "notice of error" within 30 days of its receipt. If, however, the "notice of error" asserts a failure to provide an accurate payoff balance upon the borrower's request, the servicer must update the borrower of the status of the "notice of error" no later than seven days after receiving it. Additionally, if the "notice of error" asserts an error that involves a notice or filing of foreclosure, the servicer must send its notice before the foreclosure due date or within 30 days of receiving the "notice of error," whichever is earlier. Under certain circumstances, if the servicer informs the borrower in writing the servicer may extend the time period for responding to the borrower.

Servicers are also required to follow similar guidelines when a borrower makes a written request for information regarding his or her account. One difference is that if a borrower requests the identity of, and contact information for, the owner or assignee of his or her mortgage loan, servicers must respond to this request within ten days. Servicers are not required to follow these notice requirements if a borrower sends a duplicate notice of error, an untimely notice, or an overly broad notice of error in which the servicer is unable to reasonably determine the specific error asserted.

C. Force-placed Insurance

The RESPA Amendments also prohibit servicers from charging a borrower for force-placed insurance[3] unless there is a reasonable basis to believe that such a borrower has not complied with the mortgage contract's requirement to maintain hazard insurance. In addition, a servicer may not purchase force-placed insurance if it can continue a borrower's current insurance, even if the servicer must advance the funds.[4]

Upon establishing a reasonable basis to purchase force-placed insurance, the servicer must send an initial notice to the borrower 45 days before the servicer assesses a fee. The notice must include the date of the notice, the servicer's and borrower's contact information, a physical description of the property, and a request that the borrower provide proof of hazard insurance. The notice must also, among other things, inform the borrower that hazard insurance is required, and, if applicable, provide a statement explaining that hazard insurance has been purchased, the coverage of the insurance may be less than if purchased by the borrower, and may cost significantly more than if purchased by the borrower.

In addition to the initial notice, servicers must also send a reminder notice to borrowers at least 15 days prior to charging the borrower for force-placed insurance. Among other things, the notice must contain the information provided in the initial notice and inform the servicer that the reminder notice is the second and final notice before a charge for force-placed insurance will be assessed. The servicer must also provide the borrower with the annual premium or a reasonable estimate of the force-placed insurance. All charges related to the force-placed insurance must be bona fide and reasonable. Insurance regulated by states as "the business of insurance" or charges authorized

3 Forced-placed insurance is defined as "hazard insurance obtained by a servicer on behalf of the owner or assignee of a mortgage loan that insures the property securing the loan." *See Mortgage Servicing Rules Under the Real Estate Settlement Act (Regulation X)*, 78 Fed. Reg. 10880 (Feb. 14, 2013) (to be codified at 12 C.F.R. § 1024.37).

4 Generally, small servicers are exempt from the RESPA Amendments. Small servicers, however, must comply with this prohibition unless the force-placed insurance purchased by the small servicer is less expensive than the amount the servicer would have advanced to continue the borrower's current insurance.

by the Flood Disaster Protection Act are considered per se reasonable. Before renewing or replacing existing force-placed insurance, a servicer must comply with similar notice requirements, except that a reminder notice is not required. If the borrower provides proof of hazard insurance coverage, the servicer must cancel the force-placed insurance and return any premiums for the period during which coverage has overlapped.

D. General Servicing Policies and Procedures

The RESPA Amendments also require servicers to establish and maintain policies and procedures that would achieve certain objectives set by the CFPB, which include assessing and providing timely and accurate information, properly evaluating loss mitigation applications, facilitating oversight of, and compliance by, service providers, facilitating the transfer of information during service transfers, and processing information requests and error notifications. Servicers may adopt policies that take into account the size, nature, and scope of their operations. Additionally, servicers are required to retain certain records and information regarding a borrower's mortgage loan until one year after the loan is discharged or transferred to another servicer. The documents must be maintained in a manner that will facilitate the servicer compiling a service file within five days. A servicer's failure to comply with these requirements does not provide borrowers with a private right of action.

E. Early Intervention Requirements for Certain Borrowers

Servicers are required to make a good faith effort to establish live contact within 36 days of a borrower's delinquency to inform him or her of loss mitigation procedures, if applicable. The delinquency period begins on the first day that a payment sufficient to cover principal, interest, and escrow is not paid when due, regardless of any grace period afforded to the borrower. The servicer must also provide a written notice within 45 days of a borrower's delinquency that encourages the borrower to contact the servicer. The notice must contain the servicer's contact information, a brief description of loss mitigation options, and instructions on how to obtain more information about the loss mitigation options. The notice must also include the CFPB's website to access either the CFPB list or the United States Department of Housing and Urban Development (HUD) list of homeownership counselors or counseling organizations. In addition, servicers must provide HUD's toll-free number so that borrowers can access the HUD list of homeownership counselors or counseling organizations.

F. Continuity of Contract

In addition to early intervention for delinquent borrowers, servicers must also provide assigned representatives who are responsible for answering a borrower's inquiries and assisting the borrower through the loss mitigation process until two consecutive payments in accordance with the loss mitigation contract have been received in a timely manner. The assigned representative must be made available to the borrower by the time the borrower receives the written notice described above, but in any event, no later than 45 days of the borrower's delinquency.

G. Loss Mitigation Procedures

The RESPA Amendments also require servicers to follow certain procedures during the loss mitigation process. If a servicer receives a loss mitigation application at least 45 days before a foreclosure sale, the servicer must, within five days, acknowledge receipt of the application and promptly review the application to ensure it is complete and, if not, inform the borrower of what documents or information are necessary for completion. The servicer must also inform the borrower that he or she should contact servicers of any other mortgage loans secured by the same property to discuss available loss mitigation options. Furthermore, the servicer must disclose the time period in which it must receive the necessary documentation or information – on the 120th day of the borrower's delinquency, 90 days before the foreclosure date, or 38 days before a foreclosure sale, whichever date is earliest.

A servicer must evaluate a completed loss mitigation application for all loss mitigation options and provide a written notice of those options within 30 days of receipt if the application is received at least 37 days before a foreclosure sale. If the application remains incomplete for a significant period of time and the servicer exercised due diligence to obtain the information necessary to complete the information, the servicer may evaluate and offer loss mitigation options based upon the incomplete application. If the borrower fails to submit an application at least 37 days before a foreclosure sale, the servicer may proceed with the foreclosure process.

If a servicer denies a loss mitigation application, it must state the specific reasons for the determination, inform the borrower that he or she has a right to appeal the servicer's decision, and explain the appeal process, if applicable. A borrower may only appeal the servicer's decision if the application was submitted at least 90 days before the foreclosure sale or during the pre-foreclosure review period (as defined below). On appeal, the application must be reviewed by different personnel than those responsible for denying the application. The servicer must provide a written notice of its decision on the appeal within 30 days. If the servicer offers the borrower loss mitigation options, it may require that the borrower accept an option within 14 days after receiving the notice.

The RESPA Amendments also prohibit "dual tracking." Specifically, servicers are prohibited from initiating a foreclosure action unless the borrower is at least 120 days delinquent. This 120-day period is known as the "pre-foreclosure review period." If a loss mitigation application is submitted during the pre-foreclosure review period, the servicer may not initiate foreclosure unless the application is denied and either: (1) the borrower has not taken advantage of an appeal or his or her appeal has been denied, (2) the borrower has rejected all of the loss mitigation options offered, or (3) the borrower failed to comply with the loss mitigation agreement. If the servicer has initiated the foreclosure process and the borrower submits a loss mitigation application at least 37 days prior to the foreclosure sale, the servicer may not move for a judgment or order of sale or conduct a foreclosure sale unless the three requirements above have been satisfied. Although small servicers are generally exempt from the RESPA Amendments, small servicers are prohibited from initiating the foreclosure process if the borrower is less than 120 days delinquent or is complying with the terms of a loss mitigation agreement.

II. TILA Amendments

A. Periodic Statements For Residential Mortgage Loans

1. Scope

The TILA Amendments impose a new requirement for Loan Holders[5] to provide certain residential mortgage loan borrowers with periodic billing statements that clearly explain the details of the borrower's loan. The statements must be mailed or delivered within a reasonably prompt time after the payment is due or after any courtesy period afforded to the borrower.

The TILA Amendments provide exemptions for certain Loan Holders and types of mortgages. Small Loan Holders (those who service fewer than 5,000 mortgages in a calendar year, which are all owned or originated by that Loan Holder or its affiliates as well as Loan Holders who qualify as a Housing Finance Agency, as defined in 24 C.F.R. § 266.5) are exempt from the requirements. Statements are also not required for reverse mortgages or timeshare plans. In addition, fixed rate loans are exempt if Loan Holders provide borrowers with coupon books that contain most of the information that is required to be included in the periodic billing statement, as described below. The Loan Holder must also provide delinquency information to the borrower, in writing, during the billing cycle stating that the borrower is more than 45 days delinquent to qualify for the exemption.

2. Content

The periodic statement must contain detailed information concerning a borrower's mortgage account. Loan Holders are required to provide the disclosures set forth below.

- Payment Information. Loan Holders must provide information regarding the borrower's past and currently due payments. The information must include the amount due, the due date, an explanation of any late payment fees that may be assessed, and an explanation of how

5 For purposes of providing periodic statements only, the term "servicer" includes creditors and assignees if such parties own the mortgage loan or the mortgage servicing rights (Loan Holder). Although each Loan Holder is subject to the rule, only one statement per billing cycle is required to be sent to the borrower. If more than one party is subject to the rule, the parties may choose among themselves who will be responsible for complying with the rule.

payments are applied to principal, interest, and escrow. Where a borrower has multiple payment options, information for each option must be provided on whether the borrower's payments will increase, decrease, or remain the same. If a partial payment is received, the Loan Holder must also explain what actions the borrower must take to have the funds applied to the loan.

- Transaction Activity. The periodic statement must include all the transaction activity that has occurred since the last billing statement. Transaction activity is defined as any account activity that causes a debit or credit to the amount due.
- Account Information. Loan Holders must provide the borrower with account information, such as the principal balance, the current interest rate of the loan, the date of any interest rate change, and any prepayment penalty fees. The statement must also include information about a website where borrowers can access either the CFPB's or HUD's list of homeownership counselors and counseling organizations and the HUD toll-free number where the borrower may access the HUD contact information for homeownership or counseling organizations.
- Contact Information. The periodic statement must contain the Loan Holder's toll-free number and, if applicable, an email address where a borrower may obtain information about his or her account.
- Delinquency Information. If a borrower's payment is more than 45 days delinquent, the statement must contain, among other things, the date of delinquency, an explanation of the risks that may be incurred if the delinquency is not resolved, and the amount needed to bring the account current. If applicable, the statement must also indicate any loss mitigation programs that the borrower has agreed to and whether the Loan Holder has initiated the foreclosure process. The Loan Holder may elect to send this information in a separate letter instead of including it in the periodic statement.

B. Interest Rate Adjustment Notices

1. Rate Adjustments with a Corresponding Change in Payment

The TILA Amendments also amend the current rules by adding to the disclosures required for rate adjustments with a corresponding change in payment. Creditors, assignees, and servicers are required to provide borrowers who have adjustable rate mortgages (ARMs) with disclosures in connection with this type of interest rate increase. An ARM is defined as "a closed-end consumer credit transaction secured by the borrower's principal place of dwelling in which the annual percentage rate may increase after consummation."[6] Creditors, assignees, and servicers are not required to send notices for ARMs with terms of one year or less. Such parties are also not required to make disclosures for the first initial rate adjustment if (1) the loan's first payment at the adjusted level is due 210 days after the loan is consummated; (2) the creditor, assignee, or servicer disclosed the new rate at the time the loan was consummated; and (3) the rate disclosed was not an estimate.

The timing of the required disclosures varies under certain conditions. Generally, creditors, assignees, and servicers must send notices at least 60 days, but no more than 120 days, before the first payment at the adjusted level is due. For ARMs with uniformly scheduled payments that occur every 60 days or more frequently, notices must be delivered at least 25 days, but no more than 120 days, before the first payment is due at the adjusted level. This timing requirement also applies to ARMs, with look back periods of less than 45 days if originated prior to January 10, 2015. For ARMs where the first adjustment occurs within 60 days after the loan's consummation and the servicer disclosed the new interest rate (which was not an estimation) at time of consummation, notices must be delivered as soon as practicable, but not less than 25 days before the payment at the adjusted level is due. The notices must include the following information:

6 *Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z)*, 78 Fed. Reg. 11004 (Feb. 14, 2013) (to be codified at 12 C.F.R. § 1026.20(c)(1)(i)).

- An estimate of the new interest rate if the new interest rate is unknown at the time the notice is sent;
- The date the creditor, assignee, or servicer sent the notice to the borrower;
- A statement explaining that the borrower's current interest rate is ending, the new terms of the ARM, and the effective date of the new terms;
- A table displaying the current and new interest rates, the current and new payment, the date the payment is due, and for interest-only or negatively amortizing loans, a statement explaining the allocation of the current and new payment to principal, interest, taxes, and insurance, as applicable;
- Any limits on interest rates or any payment increases at each interest rate adjustment, as applicable;
- An explanation of how the new payment and interest rate is determined;
- If applicable, a statement that the new payment will not pay the loan principal or reduce the loan balance; and
- An explanation of any prepayment penalties.

2. Initial Rate Adjustment Disclosures

In addition to adding the disclosures required above, the TILA amendments eliminate the annual notice requirement for interest rate adjustments that occur without a corresponding change in payments. Instead, the rules impose a new requirement on creditors, assignees, and servicers (who currently own either an ARM or the servicing rights of an ARM) to provide borrowers with disclosures regarding the initial rate adjustment of the loan. This requirement does not apply to ARMs with terms of one year or less. Loan modifications and conversions are also exempt from the disclosure requirements, unless, pursuant to a modified contract, the rate is adjusting for the first time. Notices must be delivered or mailed between 210 and 240 days prior to the date the first payment at the adjusted level is due. If the first payment is due within the first 210 days after the loan is consummated, the disclosures must be made at the loan's consummation.

With the exception of a few technical requirements within each content category, the content of the initial rate adjustment notices is very similar to the disclosures required for rate adjustments that result in a corresponding change in payment. In addition to the informational requirements described above, creditors, assignees, and servicers must also provide borrowers with:

- A telephone number of the creditor, servicer, or assignee for borrowers to call if they anticipate that they will not be able to make the payments;
- An explanation of alternatives to not paying the new rate, such as refinancing the loan, selling the property and using the funds to pay the mortgage in full, modifying the terms of the loan and arranging for payment forbearance; and
- Website information so that borrowers will have access to either the CFPB's or HUD's list of homeownership counselors and counseling organizations, HUD's toll-free number to access the HUD list of homeownership counselors and counseling organizations, as well as the CFPB's website to access contact information for state housing finance authorities.

C. Prohibited Mortgage Servicing Acts and Practices

The TILA Amendments prohibit certain acts and practices in connection with transactions of credit secured by a dwelling. With the exception of nonconforming payments or situations where a delay in crediting a payment will not result in the imposition of a fee or a negative report to a consumer reporting agency, servicers must credit periodic payments to a borrower's loan account on the date of receipt. Periodic payments are defined as a payment sufficient to pay the principal, interest, and escrow (if applicable) for any billing cycle. For a payment to qualify as a periodic payment, it is not necessary for the payment to cover late fees, non-escrow payments, or other fees.

If a servicer receives a partial payment (any payment less than a periodic payment) from a borrower and retains it in a suspense or unapplied funds account, the servicer must disclose to the borrower on a periodic statement the amount held in such an account. Once the servicer has accumulated funds in the suspense or unapplied funds account sufficient to cover a periodic payment, those funds must be applied to the borrower's loan account. Furthermore, if a servicer provides a borrower with written instructions for making payments and then accepts a nonconforming payment, the servicer must credit the payment within five days of receipt of the payment.

III. Conclusion

The RESPA and TILA Amendments impose strict requirements on servicers to provide detailed information regarding a borrower's mortgage loan and options to avoid foreclosure. The final rules are aligned with the CFPB's goals to ensure that borrowers have access to timely and accurate information when dealing with mortgage servicers. Although the rules become effective January 10, 2014, they will require servicers to implement significant software, training, and other changes. Therefore, creditors, servicers, and assignees should start preparing now for compliance with the final rules.

Arnold & Porter LLP is available to answer questions raised by the final rules. We can also assist you in complying with the requirements of the final rules. For further information, please contact your Arnold & Porter attorney or:

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I. BACKGROUND

On January 20, 2013, the Consumer Financial Protection Bureau (CFPB) issued its final rule (the Final Rule) regarding mortgage loan originator compensation and qualification requirements[1] under the Truth in Lending Act (TILA), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The Final Rule modifies existing compensation and qualification requirements under Regulation Z.[2] It prohibits a creditor from compensating a loan originator based on a term of a transaction or a "proxy" for a term of a transaction. It also codifies the existing ban on "dual compensation," in which a loan originator receives compensation from the consumer and an additional party other than the originator's organization, but creates an exception allowing a loan originator organization to pay its employees or contractors a commission provided that the commission is not based on a term of a loan. The Final Rule provides a complete exemption from the statutory ban on the consumer payment of upfront points and fees. The Final Rule also includes requirements regarding loan originator qualifications, licensing, and recordkeeping, and implements statutory provisions regarding mandatory dispute resolution and the financing of credit insurance in connection with a residential mortgage loan.

The Final Rule is designed to protect consumers, who generally rely on the services of mortgage brokers or loan officers to secure a mortgage loan, from being "steered" to loans with unnecessarily high interest rates or other "unfavorable" terms. Individual loan originators are most commonly compensated by commission, which is correlated to the amount of the loan.[3] Prior to 2010, and particularly during the rapid expansion of the mortgage market in the early-to-mid 2000s, commissions paid to loan originators varied considerably and were often higher in the case of high-interest loans.[4] Accordingly, due to

1 Loan Originator Compensation Requirements Under the Truth in Lending Act (Regulation Z), Final Rule, 78 Fed. Reg. 11,280 (Feb. 15, 2013) (to be codified at 12 C.F.R. Part 1026).

2 12 C.F.R. § 1026, *et seq.* (2013).

3 As noted by the CFPB, a number of other compensation structures also exist. For example, some loan officers are paid a salary plus a bonus, which is based on overall loan volume. *See* Final Rule at 11,286.

4 This form of compensation is commonly referred to as a "yield spread premium" (YSP). While interpretations and use of the YSP vary, a YSP loan's interest rate is traditionally greater than the market

the presence of financial incentives, concerns were raised about the practice of steering consumers to loans with high interests rates and/or significant upfront fees and charges. The Final Rule is the latest in a series of actions taken by lawmakers and regulators to address this practice and further regulate the qualifications of loan originators and the services they provide to consumers.[5]

II. STATUTORY FRAMEWORK AND PRIOR RULEMAKING ACTIVITY

The Dodd-Frank Act granted the CFPB jurisdiction over the "consumer financial protection functions" previously vested in other federal agencies, including the authority to issue regulations under TILA. Prior to the transfer of TILA jurisdiction to the CFPB, the Board of Governors of the Federal Reserve System (the Board) issued a number of regulations pertaining to loan originator compensation practices under its then-existing TILA authority.[6] The CFPB's Final Rule was necessary to implement a number of TILA amendments enacted through the Dodd-Frank Act[7] and to provide additional official interpretations of these regulations. The Final Rule contains select modifications to the rule as originally proposed by the CFPB[8] and provides additional analysis in response to comments submitted by the public.

rate that the consumer could otherwise obtain. The difference between interest payments is then either shared with the consumer to defray a portion of his or her closing costs or retained by the loan originator as additional compensation.

5 The CFPB has recently implemented other mortgage-related provisions of Title XIV of the Dodd-Frank Act by finalizing rules that impose new requirements on lenders (when assessing a consumer's ability to repay a mortgage loan) and on mortgage servicers (when providing information to consumers about their loans). Arnold and Porter LLP has issued advisories on the CFPB's ability-to-repay and qualified mortgage rule and its mortgage servicing rules. These advisories are available at http://www.arnoldporter.com/resources/documents/ADV213TheCFPBsAbilityToRepayAndQualifiedMortgageRule.pdf and http://www.arnoldporter.com/resources/documents/ADV413TheCfpbFinalizesNewMortgageServicingRules.pdf.

6 Truth in Lending, Final Rule, 75 Fed. Reg. 58,509 (Sep. 24, 2010) (codified at 12 C.F.R. Part 226) (subsequently transferred to the CFPB's jurisdiction and codified at 12 C.F.R. Part 1026). The Board also issued a series of disclosure regulations aimed at informing consumers about loan originator compensation practices under authority granted by the Real Estate Settlement Procedures Act of 1974, 12 U.S.C. § 2601, *et seq.* (2012).

7 Dodd-Frank Act §§ 1401-03, 1414; 15 U.S.C. § 1602, *et seq.* (2012).

8 Truth in Lending Act (Regulation Z), Loan Originator Compensation, Proposed Rule, 77 Fed. Reg. 55,272 (Sep. 7, 2012) (Proposed Rule).

The majority of the Final Rule becomes effective January 10, 2014. However, the rule's prohibition on mandatory arbitration clauses and waivers of certain consumer rights became effective on June 1, 2013. The rule's ban on the financing of single-premium credit insurance in connection with a consumer credit transaction secured by a dwelling was originally intended to also take effect on June 1, 2013, but recent CFPB amendments have delayed its effective date until January 10, 2014.[9]

III. ANALYSIS OF THE FINAL RULE

A. Definitions and Scope

The Final Rule clarifies or redefines a number of important terms that serve to establish the Final Rule's reach. Most notably, the Final Rule adopts a broad definition of "loan originator" in order to establish consistency with the definition of "mortgage originator" under TILA, as amended by the Dodd-Frank Act. The CFPB's stated objective in aligning the meaning of these terms is to ensure consistent regulation of any person who, early in the loan origination process, may have financial incentives to steer consumers to loans with particular terms. Accordingly, the Final Rule defines a "loan originator" as a "person who takes an application, offers, arranges, assists a consumer in obtaining or applying to obtain, negotiates, or otherwise obtains or makes an extension of consumer credit for another person."[10] Therefore, under the Final Rule, "loan originators" include not only individual loan originators, loan originator organizations, mortgage brokers, and many creditors,[11]

9 12 C.F.R. § 1026.36(i) (2013). On May 29, 2013, the CFPB issued an amendment to the Final Rule which finalized the new effective date of the provision as January 10, 2014. The CFPB has indicated that the delay will provide time to further consider the application of the provision and for covered individuals and entities to comply with any clarifications.

10 Final Rule at 11,298.

11 Creditors are generally excluded from the term "mortgage originator" under Section 103(cc)(2)(F) of TILA (amended by Section 1401 of the Dodd-Frank Act). However, the exclusion does not apply to creditors that make use of "table funding," which occurs when a creditor does not supply the funds for the credit transaction out of its own resources, but rather from an existing line of credit or from deposits. *See id.* at 11,415 (comment 36(a)-1.ii). Moreover, under the Final Rule, all creditors that engage in loan origination activities will be defined as "loan originators," which reflects the broader definition of the term in the Final Rule as compared to the statutory definition of "mortgage originator."

but also those engaging in certain referral actions, certain seller financers,[12] and those assisting with several aspects of a credit transaction.[13] The definition of a "loan originator," however, expressly excludes certain persons and functions, including those who perform purely administrative or clerical tasks or real estate brokerage activities.

The CFPB's approach to establishing the scope of covered transactions mirrored its approach to determining covered persons and entities. Rather than exclude specific credit products from the rule,[14] the CFPB adopted a broad definition of covered transactions, which includes any "closed-end consumer credit transaction secured by a consumer's principal dwelling."[15] The Final Rule noted that no underlying statute provided for different treatment based on transaction type, and therefore the CFPB declined to do so in its rulemaking.

B. Prohibition on Compensation Based on a Term of a Transaction

The Board's 2010 final rule amended Regulation Z to generally prohibit compensation based on a transaction's terms. The CFPB's Final Rule further amends Regulation Z by implementing Section 1403 of the Dodd-Frank Act, which created Section 129B(c) of TILA.[16] This new provision produces an important distinction between the two rules: under the CFPB's Final Rule, compensation restrictions apply to *all* residential mortgage loans, whereas under the Board's 2010 rule the restrictions apply only to compensation arising from transactions in which any person other than the consumer pays the loan originator. The CFPB's Final Rule, unlike the Board's rule, provides no exception for loan originators when receiving compensation directly from the consumer. Additionally, the CFPB has further clarified the components of the ban, including the method for determining its application to compensation based on a "proxy" for a term of the transaction.

A "term" of a transaction is defined as "any right or obligation of the parties to a credit transaction."[17] Several methods of compensation are, however, deemed not to be based on a transaction's terms and are therefore permissible. For example, compensation paid directly to a loan originator by a consumer is not barred simply because that compensation is itself a term of the transaction. Additionally, compensation in the form of a fixed percentage of the amount of credit extended is permitted, as is compensation based on a loan originator's overall dollar volume across a number of credit transactions. The Final Rule also clarifies what constitutes a "proxy" for a term or factor of a transaction by providing a two-prong methodology. A term or factor will be a "proxy" if (1) it consistently varies with a factor or term over a significant number of transactions, and (2) the loan originator has the ability to manipulate (*e.g.*, add, remove, or change) the factor.

The CFPB provided a number of additional clarifications regarding the application of these prohibitions after receiving significant inquiry from commenters. First, as mentioned above, the Final Rule sets out a number of illustrative examples of compensation that is not based on the terms of a transaction and is also not subject to proxy analysis.[18] Second, the CFPB noted that the Final Rule applies to compensation

12 Seller financers have not traditionally been defined as "creditors" under Regulation Z. Congress, under Section 1401 of the Dodd-Frank Act, and the CFPB, under its Final Rule, generally preserve this definition, but with conditions. A seller financer is excluded from the definition of "loan originator" if the person finances three or fewer properties in any twelve month period, does not construct a residence on the property, and provides fully amortizing financing based on a good faith determination that the consumer has a reasonable ability to repay the loan. *See* 12 C.F.R. § 1026.36(a)(4) (2013). Similar conditions for seller financers of a single property are set forth in 12 C.F.R. §1026.36(a)(5) (2013).

13 For example, collecting certain information from the consumer for submission to a creditor would fall within the scope of activities of a covered "loan originator."

14 Commenters suggested, for example, that the CFPB exclude prime, traditional, and government credit products as well as those developed by housing finance agencies from the scope of the regulations.

15 12 C.F.R. § 1026.36(b) (2013).

16 Under Section 129B(c)(1) of TILA, "[f]or any residential mortgage loan, no mortgage originator shall receive from any person and no person shall pay to a mortgage originator, directly or indirectly, compensation that varies based on the terms of the loan (other than the amount of the principal)." Dodd-Frank Act § 1403, 15 U.S.C. § 1639b(c)(1) (2012).

17 12 C.F.R. § 1026.36(d)(1)(ii) (2013). The CFPB noted that it believes that Congress intended the term "credit transaction" to fall within the statutory definition of "residential mortgage loan" under TILA, as amended. *See* Final Rule at 11,322.

18 Permissible methods of compensation include, for example, an hourly wage paid for actual hours worked and compensation based on the long-term performance of the originator's loans.

that is directly or indirectly based on the terms of a single transaction from a single loan originator, the terms of multiple transactions from a single loan originator, and the terms of multiple transactions from multiple loan originators. Thus, with certain exceptions, compensation based on profits derived from mortgage-related business would be subject to the Final Rule. For example, the Final Rule permits contributions paid to, and benefits derived from, designated tax-advantaged plans, provided that such contributions are not based on the terms of the individual loan originator's transactions.[19] Additionally, compensation under a non-deferred profits-based compensation plan is permitted if the compensation paid does not exceed 10% of the loan originator's "total compensation" *or* if the loan originator served in that role for ten or fewer transactions during the twelve-month period preceding the date in which compensation is determined.[20] Third, the Final Rule extends Regulation Z's prohibition on compensation in connection with a pricing concession, which is generally a reduction in compensation based on a change in a transaction's terms, out of a concern that the practice could lead to increased originator compensation in connection with higher interest-rate loans. The Final Rule, however, provides an exception for circumstances in which a pricing concession is offered to defray unexpected increases in settlement costs.

C. Prohibition Against Dual Compensation

Regulation Z contains a prohibition on "dual compensation." Specifically, it bars loan originators from receiving compensation in connection with a transaction from both the consumer and another person, typically a creditor. The Final Rule generally preserves this prohibition.[21] However, under current regulations, if a loan originator receives direct payment from a consumer, that person is prohibited from receiving any form of payment from another person, such as a commission from a creditor. Commenters contended this prohibition was economically infeasible because of the practical challenges associated with paying individual loan originators a salary or an hourly wage. In an effort to create flexibility for both loan originators and consumers, the CFPB responded in the Final Rule by permitting a loan originator organization to compensate individual loan originators (*e.g.*, offer a commission) provided that neither party's compensation is based on the terms of the underlying transaction. In addition, the Final Rule contains guidance on circumstances in which payments by a consumer are not deemed to be "compensation received directly from a consumer" for purposes of the rule.[22]

D. Waiver of Prohibition on Consumer Payment of Upfront Points and Fees

A component of the TILA provision underlying the ban on dual compensation permits a loan originator to receive "an origination fee or charge" from a person other than the consumer on the condition that the loan originator does not receive any compensation directly from the consumer and the consumer does not make an upfront payment of discount points, origination points, or fees.[23] However, TILA, as amended by the Dodd-Frank Act, also authorizes the CFPB to waive or create exceptions from the statutory prohibition on the payment of upfront points and fees when doing so "is in the interest of consumers and in the public interest."[24] Under this authority, and in response to a wide variety of criticism from commenters, the CFPB decided in its Final

19 These conditions may vary in practice. For example, contributions to a defined contribution plan or benefits from a defined benefit plan are permitted *even if* such contributions are directly or indirectly based on the terms of *multiple* transactions from *multiple* loan originators.

20 Commenters expressed concern over the methods proposed by the CFPB for determining circumstances in which a profits-based compensation plan creates a substantial risk of "steering." The CFPB proposed doing so through a "revenue test" and subsequently considered a "profitability test" before rejecting those methods and adopting a "total compensation" test in the Final Rule. "Total compensation" includes the sum of all reportable wages and tips and all contributions to accounts in designated tax-advantaged plans. *See id.* at 11,420-21 (comment 36(d)(1)-3.v.A).

21 "No loan originator shall receive compensation, directly or indirectly, from any person other than the consumer in connection with the transaction; and [n]o person who knows or has reason to know of the consumer-paid compensation…shall pay any compensation to the loan originator…." 12 C.F.R. § 1026.36(d)(2)(i)(A)(1)-(2) (2013).

22 For example, payments received by a loan originator resulting from increased interest rates are not considered to be compensation received directly from the consumer.

23 Discount points are payments made by the consumer to the loan originator for the purpose of obtaining a lower interest rate. Origination points or fees are typically presented to the consumer as charges associated with applying for a loan and can come in a variety of forms.

24 Dodd-Frank Act § 1100A, 15 U.S.C. § 1601, *et seq.* (2012).

Rule to adopt a complete exemption from the statutory ban on consumer payment of upfront points and fees.

The CFPB initially proposed a partial exemption to the above statutory prohibition[25] out of concern that implementation of the statutory ban would (a) produce higher mortgage interest rates as a result of creditors' inability to recover significant origination costs through consumer payment of points and fees, and (b) limit the range of pricing options available to consumers, ultimately curtailing access to credit. The CFPB determined, however, that its proposed alternative to the statutory ban suffered from design flaws and its operation and effectiveness was uncertain. Accordingly, the Final Rule notes that the CFPB intends to further study the issue and conduct consumer testing to determine the full effect of the complete exemption and whether additional action might be warranted.[26]

E. Prohibition on Steering; Loan Originator Qualification and Identifier Requirements

Regulation Z currently prohibits loan originators from "steering," or directing a consumer to execute a transaction based on the fact that doing so will result in higher compensation for the originator as paid by the creditor. Current regulations also provide a safe harbor for the loan originator if certain "loan options" are presented to the consumer. The Final Rule provides additional guidance on a loan originator's qualification for the safe harbor. Specifically, for each type of transaction in which the consumer has expressed interest, the loan originator must present the consumer with loan options for which the loan originator has a good faith belief that the consumer is likely to qualify. Those options include, generally:

(1) the loan with the lowest interest rate;

(2) the loan with the lowest interest rate without negative amortization, a prepayment penalty, interest-only payments, a balloon payment in the first seven years of the life of the loan, a demand feature, shared equity, or shared appreciation; and

(3) the loan with the lowest total dollar amount of discount points or origination points or fees.

The Final Rule also contains a number of non-compensation-oriented requirements pursuant to the Dodd-Frank Act[27] that require mortgage originators to be "qualified" and appropriately licensed and registered.[28] Accordingly, under the Final Rule, loan originator organizations must comply with existing state and federal law, particularly with respect to requirements for legal existence and those that authorize the organization to transact business in a state. Additionally, loan originator organizations and all those employed by the organization (including independent contractors) must comply with the licensing, registration, and other regulatory provisions of the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act).[29] For employees not required to be licensed and registered under the SAFE Act or associated state implementing laws,[30] the Final Rule requires employing loan originator organizations to obtain a state and national criminal background check, a credit report, and information from the National Mortgage Licensing System and Registry (NMLSR) regarding any administrative, civil, or criminal findings by any government agency involving those employees. Furthermore, the Final Rule establishes standards for review of the information obtained by loan originators for purposes of determining whether an employee is qualified in the same manner as a SAFE Act-compliant loan originator. These standards are generally consistent with those that apply when SAFE Act-covered employees apply for a license. The Final Rule

25 Proposed § 1026.36(d)(2)(ii) would have required that before a creditor or loan originator could impose upfront points or fees on a consumer, the creditor must have made available to the consumer a comparable alternative loan with no upfront points and fees.

26 Specifically, the CFPB stated in the preamble to the Final Rule that it is concerned about consumers' understanding of the trade-off between the payment of upfront points and fees and the interest rate associated with the transaction.

27 *See* Dodd-Frank Act § 1402(a)(2), 15 U.S.C. §1639b (2012).

28 In addition to expressly imposing registration and licensing requirements, TILA § 129B(b)(1)(A) authorizes the CFPB to issue regulations that help ensure that mortgage originators are "qualified," which is a term of art to be interpreted by the CFPB.

29 Pub. L. No. 110-289, 122 Stat. 2810 (codified at 12 U.S.C. § 1501, *et seq.* (2012)).

30 For example, SAFE Act requirements do not apply to loan originators who are employees of "bona fide" non-profit organizations.

also requires periodic training to ensure that non-SAFE Act employees possess sufficient knowledge and skill, as well as an understanding of the legal requirements that apply to the individual's loan origination activities.

Finally, loan originators that are primarily responsible for the origination of a loan are required under the Final Rule to include both their NMLSR identification numbers and their names on all loan documents to assist consumers in their evaluation of the risks associated with transacting with the loan originator.

F. Prohibition on Mandatory Arbitration Clauses and Single Premium Credit Insurance

The Dodd-Frank Act amended TILA to add Section 129C(e)(1), which prohibits consumer credit transactions secured by a dwelling from containing terms that mandate arbitration as the prescribed method of dispute resolution, and further provides that no agreement related to the transaction may be applied to bar a consumer from seeking judicial relief in connection with a violation of federal law.[31] The Final Rule implements this statutory prohibition. The CFPB was careful to note that neither the statute nor the rule is interpreted to ban all settlement agreements. Rather, a consumer and a creditor are permitted to agree to settle a dispute or claim, provided that the settlement agreement does not bar the consumer from pursuing a judicial remedy for any subsequent disputes that arise if he or she chooses to do so.

Under Section 129C(d) of TILA, created pursuant to Section 1414 of the Dodd-Frank Act, creditors are prohibited from financing any premiums or fees for credit insurance in connection with a closed-end consumer credit transaction secured by a dwelling. This prohibition does not apply to credit insurance[32] for which premiums are calculated and paid in full on a monthly basis. As stated above, the prohibition on mandatory arbitration clauses became effective June 1, 2013. The CFPB originally intended for restrictions on the financing of credit insurance premiums to become effective on the same date, but it delayed the effective date of this provision to January 10, 2014 to further consider its applicability to transactions other than those in which a lump-sum premium is added to a loan amount at closing and to provide the mortgage industry with sufficient time to comply with any clarifications.

G. Recordkeeping and Miscellaneous Provisions

Regulation Z currently requires that creditors maintain evidence of compliance with the regulation and sets out standards for doing so. However, certain provisions of the Dodd-Frank Act imposed statutory changes[33] that prompted the CFPB to expand upon these recordkeeping requirements in its Final Rule for purposes of achieving consistency with the statutory law. Therefore, the Final Rule extends the length of the recordkeeping requirement under Regulation Z and mandates that creditors and loan originators maintain evidence of compliance for three years after the date of payment. The Final Rule applies to both creditors and loan originator organizations, while individual loan originators are excluded from compliance. The Final Rule also provides guidance on the substantive elements of its recordkeeping requirements.[34]

IV. CONCLUSION

The CFPB's Final Rule implements a number of statutory requirements that build upon the existing regulation of mortgage loan originators' compensation and business practices. The Final Rule will impact the operations of creditors, loan originator organizations, and individual loan originators in a variety of ways, including training, registration, licensing, and the structuring of compensation and benefit plans, as well as other aspects of the loan origination process, such as recordkeeping. Creditors, individual loan originators, loan originator organizations,

31 *See* Dodd-Frank Act § 1414, 15 U.S.C. §1639 (2012).

32 "Credit insurance" includes credit life, credit disability, credit unemployment, or credit property insurance as well as other payments used for debt cancellation, suspension agreements, or for contract purposes. *See* 12 C.F.R. § 1026.36(i)(2)(i) (2013).

33 *See* Dodd-Frank Act § 1416(b), 15 U.S.C. § 1640(e) (2012) (providing for a three-year limitations period for civil actions arising under TILA).

34 For example, records are sufficient if they demonstrate "the nature and amount of the compensation; that the compensation was paid, and by whom; that the compensation was received, and by whom; and when the payment and receipt of compensation occurred." Final Rule at 11,414 (comment 25(c)(2)-1.i).

and those employed by or under contract with loan originator organizations should carefully review the Final Rule's requirements and, when applicable, its exceptions, and should start making the necessary modifications to policies, procedures, and systems to implement appropriate changes.

Arnold & Porter LLP is available to answer questions raised by the Final Rule. We can also assist you in complying with the requirements of the Final Rule. For further information, please contact your Arnold & Porter attorney or:

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Federal Banking Agencies Issue Final Rule to Implement Basel III and Otherwise Revise the Financial Regulatory Capital Framework

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On July 2, 2013, the Board of Governors of the Federal Reserve System (Board) adopted a final rule establishing a comprehensive capital framework that will revise and replace the Board's current capital rules (the final rule).[1] One week later, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) (together with the Board, the agencies) adopted an interim final rule and a final capital rule, respectively, that are identical in substance to the final rule issued by the Board.[2] The agencies also issued a joint proposed rule that would apply a supplementary leverage ratio to the largest banking organizations.[3] The final rule and joint proposed rule will update the agencies' general risk-based and leverage capital requirements to incorporate agreements reached by the Basel Committee on Banking Supervision (BCBS) in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" and certain other revisions to the Basel capital framework in response to the global financial crisis. They also implement Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which calls for new leverage and risk-based capital requirements, as well as other provisions of the Act.[4] The largest banking organizations, referred to herein as advanced approaches banking organizations, must begin compliance with the final rule on January 1, 2014. Other banking organizations must begin compliance on January 1, 2015.

Summary of the Final Rule

Broadly, the final rule will:

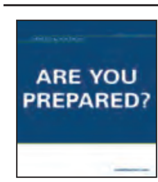
- Implement a new common equity tier 1 minimum risk-based capital requirement, a higher minimum tier 1 risk-based capital requirement, and a modified tier 1 leverage ratio;

1 Press Release, Board of Governors of the Federal Reserve System (July 2, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm.

2 Press Release, FDIC Board Approves Basel III Interim Final Rule and Supplementary Leverage Ratio Notice of Proposed Rulemaking (July 9, 2013), *available at* http://www.fdic.gov/news/news/press/2013/pr13060.html; Press Release, OCC Approves Final Rule on Regulatory Capital; Proposes Doubling Leverage Ratio for the Largest Banks (July 9, 2013), *available at* http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-110.html.

3 Press Release, Agencies Adopt Supplementary Leverage Ratio Notice of Proposed Rulemaking (July 9, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20130709a.htm.

4 Section 171 of the Dodd-Frank Act is codified at 12 U.S.C. § 5371. *See also* Section 616 of the Dodd-Frank Act, codified at 12 U.S.C. § 1467b.



- For only advanced approaches banking organizations, implement a supplementary leverage ratio that incorporates a broader set of exposures in the denominator, as well as a countercyclical capital buffer requirement;[5]
- Establish consolidated capital requirements for savings and loan holding companies (SLHCs) that do not meet the final rule's exemptions for certain SLHCs;
- Implement a capital conservation buffer composed of common equity tier 1 capital (plus a countercyclical capital buffer in the case of the largest banking organizations);
- Apply limits on a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not maintain the applicable capital conservation buffer;
- Establish more conservative standards for including an instrument in regulatory capital;
- Revise and harmonize the agencies' rules for calculating risk-weighted assets to enhance risk sensitivity; and
- Establish alternatives to credit ratings for calculating risk-weighted assets consistent with section 939A of the Dodd-Frank Act.

Although the final rule reflects many aspects of the capital treatment in the agencies' proposed capital rules,[6] it also addresses many of the concerns raised by the financial industry in commentary submitted to the agencies on the proposals. In particular, the final rule:

- Does not adopt the agencies' original proposal to significantly alter the risk-weighting of residential mortgage exposures;
- Allows all but the largest banking organizations to make a one-time election not to recognize unrealized gains and losses on available-for-sale debt securities in regulatory capital; and
- Declines, at this point, to apply the regulatory capital framework to SLHCs with substantial insurance underwriting or commercial activities, although SLHCs that do not qualify for the final rule's exemptions will be subject to the capital framework.

These issues and other major aspects of the final rule are highlighted below.

Application of the Final Rule

The agencies' revised general regulatory capital framework and "Standardized Approach Rule" for calculating risk-weighted assets will apply to all banking organizations that are currently subject to minimum capital requirements (including national banks, state member banks, state nonmember banks, state and federal savings associations, industrial loan companies, industrial banks, top-tier bank holding companies domiciled in the United States not subject to the Board's Small Bank Holding Company Policy Statement (12 C.F.R. part 225, Appendix C)), and certain non-exempt SLHCs as discussed below (together, banking organizations). The additional "advanced approaches rule" would apply, in general, to banking organizations with consolidated total assets of US$250 billion or more or consolidated total on-balance sheet foreign exposure of US$10 billion or more, and those electing to follow the advanced approaches rule (advanced approaches banking organizations).[7]

Explicitly reflecting considerable commentary from SLHCs on the difficulties entailed in applying bank-centric capital rules to SLHCs with substantial insurance underwriting or commercial activities, the following SLHCs are exempt from the final rules:

- A top-tier SLHC that is an insurance underwriting company;
- A top-tier SLHC that held 25% or more of its total consolidated assets in subsidiaries that are insurance

5 The agencies have also issued a proposal to require an even higher supplementary leverage ratio for the eight largest, most systemically significant U.S. banking organizations. This proposal is discussed in more detail below.

6 *See* Arnold & Porter LLP, *Proposed Federal Banking Agency Regulations Implementing Basel III Standards Would Substantially Revise Capital Requirements* (June 25, 2012).

7 As in the proposed rules, a banking organization subject to the advanced approaches rule would be required to calculate its risk-based capital ratios under both the general standardized approach rule and the advanced approaches rule (incorporating the agencies' market risk capital rules as applicable) and use the lower of each of the relevant capital ratios to determine whether the banking organization meets the minimum risk-based capital requirements.

underwriting companies (other than assets associated with insurance for credit risk) as of June 30 of the previous calendar year;[8] and

- A top-tier SLHC that is a grandfathered unitary SLHC (as defined in section 10(c)(9)(A) of the Home Owners' Loan Act) that derived 50% or more of its total consolidated assets or 50% of its total revenues on an enterprise-wide basis (as calculated under GAAP as of June 30 of the previous calendar year) from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act.

In the final rule, the Board stated its intent to issue separate capital rules for SLHCs that are not subject to the final rule by the time other SLHCs must comply with the final rule in 2015. Consistent with Section 626 of the Dodd-Frank Act, this separate framework will include a mechanism for creating and applying capital requirements to intermediate holding companies for those SLHCs with substantial commercial activities. The framework may also include a proposal for applying capital requirements to SLHCs with substantial insurance activities, or the Board may address these SLHCs in a separate release.

Compliance Dates

A banking organization's required compliance date will depend on its size:

- Beginning January 1, 2014, advanced approaches banking organizations that are not SLHCs must begin compliance with the revised definitions of regulatory capital; the new minimum regulatory capital ratios; and the regulatory capital adjustments and deductions according to the transition provisions. These organizations must also begin calculating risk-weighted assets under the advanced approaches rule on this date. Advanced approaches organizations, which also must calculate assets under the standardized total risk-weighted assets approach applicable to all banking organizations (the standardized approach rule), must begin compliance with the standardized approach rule beginning January 1, 2015.
- Beginning January 1, 2015, non-advanced approaches banking organizations must be in compliance with the revised definitions of regulatory capital; the new minimum regulatory capital ratios; and the regulatory capital adjustments and deductions according to the transition provisions. There is no phase-in period for the new minimum capital ratios; non-advanced approaches banking organizations must be fully compliant with the final rule's elevated ratios on January 1, 2015. These organizations must also begin calculating risk-weighted assets in accordance with the standardized approach rule on this date.
- Beginning January 1, 2016, the capital conservation buffer and countercyclical capital buffer will be phased in over a three-year period.

The proposed supplementary leverage ratio would go into effect January 1, 2018.

Minimum Capital Requirements

The final rule requires banking organizations to maintain the following minimum regulatory capital ratios on a consolidated basis:

- A common equity tier 1 risk-based capital ratio of 4.5%, which is the ratio of common equity tier 1 capital to total risk-weighted assets;
- A tier 1 risk-based capital ratio of 6%, which is the ratio of tier 1 capital to total risk-weighted assets;
- A total risk-based capital ratio of 8%, which is the ratio of total capital to total risk-weighted assets; and
- A leverage ratio of 4%, which is the ratio of tier 1 capital to average consolidated assets (i.e., on-balance sheet assets as reported in the banking organization's regulatory report, without being risk-weighted), net of amounts deducted from tier 1 capital.

In addition, advanced approaches banking organizations must meet a supplementary leverage ratio of 3%, which

8 The company must calculate total consolidated assets for the purposes of this calculation in accordance with Generally Accepted Accounting Principles (GAAP). If the company does not calculate its total consolidated assets under GAAP for any regulatory purpose (including compliance with applicable securities laws), the company may estimate its total consolidated assets, subject to review and adjustment by the Board.

is the ratio of tier 1 capital to total leverage exposure. Total leverage exposure includes not only on-balance sheet assets but also off-balance sheet assets, which are calculated as the sum of potential future exposures associated with derivative contracts, 10% of the notional amount of unconditionally cancellable commitments, and the notional amount of all other off-balance sheet exposures (other than the first two types of exposures and off-balance sheet exposures arising from securities lending, securities borrowing, and reverse repurchase transactions).

The common equity tier 1 risk-based capital ratio is a new requirement. Tier 1 capital is composed of common equity tier 1 capital and additional tier 1 capital, and the minimum tier 1 risk-based capital ratio is increased from 4% to 6%. The minimum leverage ratio is 4% for all banking organizations, including those with a supervisory composite rating of 1 and currently subject to a 3% leverage ratio requirement.

Separately, on July 9, 2013, the U.S. federal banking agencies issued a proposal to require the eight largest, most systemically significant U.S. banking organizations to maintain higher leverage ratios. Specifically, bank holding companies with more than US$700 billion in consolidated total assets or US$10 trillion in assets under custody would be required to maintain a supplementary leverage ratio exceeding 5%, or become subject to restrictions on capital distributions and discretionary bonus payments. Insured depository institution subsidiaries of these bank holding companies must maintain a supplementary leverage ratio of 6% to be considered "well capitalized" for prompt corrective action purposes. Unlike the capital surcharge that the Basel Committee has proposed for globally systemically important banks, which would use risk-weighted assets in the denominator, the additional capital requirement that the U.S. federal banking agencies have proposed for the largest banks is a higher leverage ratio, which would use total leverage exposure in the denominator.

Capital Conservation Buffer

The final rule requires a banking organization to maintain a capital conservation buffer above the new minimum capital requirements in an amount greater than 2.5% of total risk-weighted assets. The capital conservation buffer must be composed of common equity tier 1 capital. The buffer is measured as the lowest of: (a) the amount by which the banking organization's common equity tier 1 risk-based capital ratio exceeds 4.5%, (b) the amount by which its tier 1 risk-based capital ratio exceeds 6%, and (c) the amount by which its total risk-based capital ratio exceeds 8%. As a result, to avoid the limitations described above, a banking organization must maintain a common equity tier 1 risk-based capital ratio greater than 7%, a tier 1 risk-based capital ratio greater than 8.5%, and a total risk-based capital ratio greater than 10.5%.

A banking organization that fails to maintain the capital conservation buffer, measured on a quarterly basis, will become subject to the following limitations on capital distributions and discretionary bonus payments to executive officers:[9]

- If a banking organization had a capital conservation buffer of 0.625% or less at the end of the previous calendar quarter, it may not make any capital distributions or discretionary bonus payments to executive officers during the current quarter.
- If it had a capital conservation buffer greater than 0.625% but no greater than 1.25%, capital distributions or discretionary bonus payments to executive offices during the current quarter are limited to 20% of its eligible retained income, which is defined as the organization's net income for the preceding four calendar quarters (net of any such distributions and payments) as reported in the quarterly regulatory reports.

9 For purposes of these limitations, "executive officer" is defined as a person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line, and other staff that the board of directors of the banking organization deems to have equivalent responsibility. A "discretionary bonus payment" is defined as a payment made to an executive officer of a banking organization, where (1) the banking organization retains discretion as to whether to make, and the amount of, the payment until the payment is awarded to the executive officer; (2) the amount paid is determined by the banking organization without prior promise to, or agreement with, the executive officer; and (3) the executive officer has no contractual right, whether express or implied, to the bonus payment.

- If the buffer is greater than 1.25% but no greater than 1.875%, the limit is 40% of eligible retained income.
- If the buffer is greater than 1.875% but no greater than 2.5%, the limit is 60%.

Countercyclical Capital Buffer

The final rule also requires an advanced approaches banking organization to maintain a countercyclical capital buffer. The countercyclical capital buffer must be composed solely of common equity tier 1 capital. If a banking organization has private sector credit exposures (i.e., credit exposure to a private sector entity that is included in credit risk-weighted assets) in more than one national jurisdiction, the amount of the buffer is determined by calculating the weighted average of the countercyclical capital buffer amounts established by each of the national jurisdictions. The weight assigned to a jurisdiction's countercyclical capital buffer amount is calculated as the ratio of the total risk-weighted assets for the organization's private sector credit exposures located in the jurisdiction to the total risk-weighted assets for all of the organization's private sector credit exposures.

In the United States, the initial countercyclical capital buffer amount is set at zero. The agencies may increase it to 2.5% of total risk-weighted assets, however, depending on credit market condition.

The countercyclical capital buffer is an extension of the capital conservation buffer. Accordingly, an advanced approaches banking organization must maintain a capital conservation buffer in an amount greater than 2.5% of total risk-weighted assets, plus the required countercyclical capital buffer. Otherwise, it will be subject to restrictions on capital distributions and discretionary bonus payments to executive officers.

Prompt Correction Action

The final rule also changes the definitions of capital categories for insured depository institutions for purposes of the Prompt Corrective Action statute as follows:

- To be well capitalized, an insured depository institution must have a common equity tier 1 risk-based capital ratio of at least 6.5%, a tier 1 risk-based capital ratio of at least 8%, a total risk-based capital ratio of at least 10%, and a leverage ratio of at least 5%.
- To be adequately capitalized, an insured depository institution must have a common equity tier 1 risk-based capital ratio of at least 4.5%, a tier 1 risk-based capital ratio of at least 6%, a total risk-based capital ratio of at least 8%, and a leverage ratio of at least 4%.
- An insured depository institution is undercapitalized if it has a common equity tier 1 risk-based capital ratio less than 4.5%, a tier 1 risk-based capital ratio less than 6%, a total risk-based capital ratio less than 8%, or a leverage ratio less than 4%.
- An insured depository institution is significantly undercapitalized if it has a common equity tier 1 risk-based capital ratio less than 3%, a tier 1 risk-based capital ratio less than 4%, a total risk-based capital ratio less than 6%, or a leverage ratio less than 3%.
- An insured depository institution is critically undercapitalized if it has a tangible equity (now defined as tier 1 capital plus non-tier 1 perpetual preferred stock) to total assets of 2% or less.

An advanced approaches depository institution must also have a supplementary leverage ratio of at least 3% to be adequately capitalized. As noted, under a proposal that the federal banking agencies issued on July 9, 2013, an insured depository institution that is a subsidiary of a bank holding company with more than US$700 billion in consolidated total assets or US$10 trillion in assets under custody must maintain a supplementary leverage ratio of 6% to be considered well capitalized for prompt corrective action purposes. The largest U.S. bank holding companies need their bank subsidiaries to remain well capitalized to maintain their "financial holding company" status. Without that status, they would have to change business models significantly, including divestiture of many securities activities.

Regulatory Capital Components

The final rule introduces a new capital component, namely, common equity tier 1 capital, which consists of common stock instruments that meet the eligibility criteria in the rule, retained earnings, accumulated other comprehensive income as reported under U.S. generally accepted accounting principles, and common equity tier 1 minority interest (subject to limitations discussed below). As a result, tier 1 capital has two components: common equity tier 1 capital and additional tier 1 capital. The final rule also revises the eligibility criteria for inclusion in additional tier 1 capital and tier 2 capital. Each capital component is subject to certain limitations, adjustments, and deductions, as discussed below.

Grandfathering of Trust Preferred Securities and Cumulative Perpetual Preferred Stock

Under the final rule, trust preferred securities and cumulative perpetual preferred stock no longer qualify as tier 1 capital and must be phased out. However, the final rule grandfathers such capital instruments issued before May 19, 2010 that are included in the tier 1 capital of depository institution holding companies with less than US$15 billion in total consolidated assets as of December 31, 2009 and banking organizations that were mutual holding companies as of May 19, 2010.[10] These institutions may continue to count the grandfathered capital instruments as additional tier 1 capital, up to 25% of tier 1 capital (excluding the grandfathered instruments and after deductions and adjustments). Furthermore, trust preferred securities that are phased out of tier 1 capital may not meet the criteria for tier 2 capital, but the final rule allows non-advanced approaches banking organizations to include it in tier 2 capital permanently.

Unrealized Gains and Losses on Available-for-Sale Securities

For advanced approaches banking organizations, unrealized gains and losses on all available-for-sale securities flow through to common equity tier 1 capital (specifically, accumulated other comprehensive income or AOCI). Other banking organizations may make a one-time election not to recognize unrealized gains and losses on available-for-sale debt securities in regulatory capital, as under the current capital rules. If a top-tier depository institution holding company makes this opt-out election, each consolidated subsidiary must make the same election.

Limits on Minority Interests

The final rule limits the amount of minority interest (i.e., equity interests not owned by the parent company) in consolidated subsidiaries that may be included in the regulatory capital of the parent company. Such interest may be included in the common equity tier 1, additional tier 1, or total capital of the parent company only if the underlying capital instrument meets the eligibility criteria for that capital component. In addition, only capital instruments issued by a depository institution or foreign bank that is a consolidated subsidiary of a parent holding company may be included in the common equity tier 1 capital of the parent company.

Furthermore, if a consolidated subsidiary has regulatory capital in excess of the sum of its minimum capital requirement plus the required capital conservation buffer, the minority interest that contributes to the excess is not includable in the parent company's regulatory capital.[11] Stated another way, a banking organization may include minority interest in regulatory capital only to the extent of the minority investors' contribution to the consolidated subsidiary's minimum regulatory capital requirement plus its capital conservation buffer. The rationale stated in the preamble is that the bank subsidiary is not required to maintain the excess capital, so that excess capital may not be available to absorb losses in other parts of the consolidated parent organization. For a consolidated subsidiary that is not subject to the same regulatory capital requirements as the parent holding company, it must be treated as if it were subject to such requirements.

The preamble to the final rule specifically discusses under what circumstances preferred stock issued by consolidated

10 A mutual holding company likely means a savings and loan holding company organized to be the holding company of a savings association previously in mutual form pursuant to 12 U.S.C. § 1467a(o), although the final rule does not specifically state so.

11 For example, if a bank subsidiary of a bank holding company has a common equity tier 1 capital ratio of 8%, which is one percentage point higher than the sum of its minimum common equity tier 1 capital requirement of 4.5% plus the 2.5% capital conservation buffer, and minority shareholders own 30% of the common equity of the bank subsidiary, then the bank subsidiary has excess common equity tier 1 capital in the amount of 1% of risk-weighted assets, 30% of which is contributed by the minority shareholders of the bank. This 30% of the excess is not includable in the regulatory capital of the parent bank holding company.

subsidiaries that are real estate investment trusts (REITs) is eligible for inclusion in tier 1 minority interest and thus additional tier 1 capital. First, REIT preferred stock can be included in the regulatory capital of the parent banking organization only if the REIT is an operating entity, which is defined as a company established to conduct business with clients with the intention of earning a profit in its own right. Second, preferred stock issued by a REIT that does not have the ability to declare a consent dividend (i.e., a dividend that is not actually paid to the shareholders but that the shareholders have consented to treat as if paid in cash and include in gross income for tax purposes) or otherwise cancel cash dividends does not qualify as tier 1 capital, but such preferred stock may meet the eligibility criteria for tier 2 capital.

Deductions from Common Equity Tier 1 Capital

The final rule requires a banking organization to make the following deductions from its common equity tier 1 capital:

- Good will and other intangible assets other than mortgage servicing assets, net of deferred tax liabilities (DTLs).
- Deferred tax assets that arise from operating losses and tax credit carryforwards net of valuation allowances and DTLs.
- After-tax gain-on-sale associated with a securitization exposure.
- Defined benefit pension fund net assets held by a depository institution holding company, net of DTLs, except that, with supervisory approval, a company would not be required to deduct defined benefit pension fund assets to which the company has unrestricted and unfettered access.
- Outstanding equity investments (including retained earnings) in financial subsidiaries of banks or investments by a federal savings association in a subsidiary that engages in activities not permissible for a national bank.
- Certain deductions relating to shortfalls in loss reserves for an advanced approaches banking organization.

Adjustments to Common Equity Tier 1 Capital

In addition to adjustments that a non-advanced banking organization makes, pursuant to a one-time election, to exclude certain components of AOCI (most significantly, unrealized gains and losses on available-for-sale securities) from common equity tier 1 capital, a banking organization must exclude any change in the fair value of a liability that results from changes in its own creditworthiness.

Deductions Related to Investments in Capital Instruments

The final rule requires the following deductions related to investments in the capital instruments of financial institutions:

- A banking organization must deduct the amount of its investments in its own capital instruments, whether held directly or indirectly.
- A banking organization must deduct reciprocal cross-holdings in the capital instruments of financial institutions. A reciprocal cross-holding results from an arrangement between two financial institutions to hold each other's capital instruments.
- If the aggregate amount of a banking organization's non-significant investment in the capital of unconsolidated financial institutions, net of DTLs, exceeds 10% of the banking organization's common equity tier 1 capital, the banking organization must deduct the excess. Non-significant investments in the capital of unconsolidated financial institutions are investments where a banking organization owns 10% or less of the issued and outstanding common shares of an unconsolidated financial institution.
- Significant investments in the capital of unconsolidated financial institutions that are not in the form of common stock, net of DTLs, must be deducted. A significant investment is an investment where the banking organization owns more than 10% of the issued and outstanding common shares of the unconsolidated financial institution.

The deductions related to investments in capital instruments must be made using the corresponding deduction approach. Under this approach, if the capital instrument for which deductions are made qualifies for a certain capital component if issued by the banking organization itself, then the deductions must be made from that capital component of the banking organization. If a banking organization does not have a sufficient amount of a specific capital component for the deductions, the shortfall must be deducted from the next higher component of regulatory capital. For example, if there is not enough additional tier 1 capital, then deductions must be made from common equity tier 1 capital to the extent of any shortfall.

Deductions of Certain Assets Exceeding Thresholds

If the amount of any of the following assets, net of DTLs, individually exceeds 10% of the common equity tier 1 capital of the banking organization (before deductions related to such assets), the banking organization must deduct the excess from its common equity tier 1 capital:

- Deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks (net of valuation allowances).
- Mortgage servicing assets.
- Significant investments in the capital of unconsolidated financial institutions in the form of common stock.

In addition, if the aggregate amount of the above three items, after the deductions made for individual items that exceed the 10% threshold, exceeds 15% of the banking organization's tier 1 common equity capital (before deductions related to such assets), the excess must be deducted from its common equity tier 1 capital.

The amount of the above three items not deducted from common equity tier 1 capital receives a 250% risk-weight.

With respect to deductions of amounts of significant investments in the capital of unconsolidated financial institutions, the agencies note that their proposal to implement the Volcker Rule would require deducting from tier 1 capital the aggregate value of certain investments of a banking organization in hedge funds and private equity funds that the banking organization organizes and offers. The agencies indicate that they intend to integrate this capital requirement of the Volcker Rule into the regulatory capital framework.

Risk-Weighted Assets

In addition to revising the elements of regulatory capital (the numerator of a banking organization's capital ratios), the final rules also make certain revisions to the method under which banking organizations must calculate risk-weighted assets. Once aggregated, a banking organization's calculation of risk-weighted assets forms the denominator of its risk-based capital ratios. The standardized approach rule, applicable to all banking organizations, would alter the method under which the organizations must calculate risk-weighted assets.

Broadly, the proposed standardized approach rule is the agencies' effort to make the calculation of risk-weighted assets more risk-sensitive, to better account for risk-mitigation techniques, and to create substitutes for credit ratings (as required by section 939A of Dodd-Frank). The standardized approach rule also includes additional exposure categories as compared with current rules.

The final rule's methodology uses a series of standardized risk-weights for on-balance sheet exposures, over-the-counter (OTC) derivatives contracts, off-balance sheet commitments (which are calculated using credit conversion factors), trade and transaction-related contingencies, guarantees, repo-style transactions, financial standby letters of credit, and forward agreements. The calculations for the risk-weights of several other exposures, including unsettled transactions, cleared transactions, default fund contributions, securitization exposures, and equity exposures other than equity derivative contracts, are more complex.

Although a number of asset classes will be risk-weighted differently under the proposed standardized approach rule than under current law, the agencies did respond to industry comments in some cases, such as residential mortgage exposures, as described below.

Residential Mortgage Exposures

The proposed rules would have substantially altered the risk-weighting framework for residential mortgage exposures. All residential mortgage exposures would have been classified as either Category 1 or Category 2, with all but those loans with the most standard terms becoming subject to Category 2 treatment. The proposed rules would then have applied risk-weights ranging from 35% to 200% based on the loan-to-value ratio of a particular exposure, with Category 2 loans generally being subject to higher risk-weights. After substantial industry comment on the potential effects of the proposed rules' approach, the agencies have decided to retain the current risk-weight treatment of residential mortgage exposures. Under the final rule, as under current rules, all residential mortgage exposures will be subject to either a 50% risk-weight (for prudently underwritten, owner-occupied first liens that are current or less than 90 days past due) or 100% risk-weight (for all other residential mortgage exposures).

Mortgage-Backed Securities and Other Securitization Exposures

The agencies also proposed a new risk-weighting framework for mortgage-backed securities and other securitization exposures. The new framework, which the final rule adopts, would remove credit ratings as required by the Dodd-Frank Act and increase the risk-weight assigned to certain exposures. Under the standardized approach, there are three ways to assign risk-weights to these exposures. First, a banking organization may use the simplified supervisory formula approach (SSFA), which is a formula that starts with the capital requirements that would have applied to the underlying exposures if they had not been securitized, and then assigns risk-weights based on the subordination level of an exposure (i.e., securities in a junior tranche are assigned a higher risk-weight). The SSFA applies a 1250% risk-weight to securitization exposures that absorb losses up to the amount of capital required for the underlying exposures if they had not been securitized (which would be the equity tranche of a securitization). The minimum risk-weight is 20% under the SSFA. Second, a banking organization that is not subject to the market risk rule may use the gross-up approach, which is a mathematically simpler formula that results in a higher amount of risk-weighted assets for an exposure if there is a larger amount of exposures in more senior tranches. This approach may result in a maximum effective risk-weight of 1250% for the equity tranche.[12] The minimum risk-weight under the gross-up approach is also 20%. Between the SSFA and the gross-up approach, a banking organization generally must choose one and apply it consistently to all its securitization exposures. Third, a banking organization may assign a 1250% risk-weight to any securitization exposure.

Treatment of Other Assets

The final rule also preserves the 120-day safe harbor provided under current capital rules for credit enhancing representations and warranties made by banking organizations on assets they have sold. The treatment of many other asset classes, including mortgage servicing assets, unused lines of credit with term of under one year, and high volatility commercial real estate assets, in the final rule is substantially as proposed by the agencies.

Disclosures

The standardized approach rule and the advanced approaches rule also establish disclosure requirements for certain banking organizations. In general, a banking organization with total consolidated assets of US$50 billion or more that follows the standardized approach rule would be required to make extensive disclosures of the banking organization's capital ratio calculations and risk-weighted assets (on an asset-by-asset basis) on a quarterly basis. Banking organizations would be encouraged to provide these disclosures on their public websites, and in any event, the disclosures must be available to the public for three years (or twelve quarters) after the initial disclosure. To reduce some of the burden on banking organizations required to disclose, the proposed rules note that portions of the disclosure requirement may be met by relying on similar disclosures made in accordance with existing SEC mandates.[13]

12 In the event that the gross-up approach results in an effective risk-weight higher than 1250%, the banking organization may choose to assign a 1250% risk-weight.

13 Information that would be exempt from public disclosure under the "commercial or financial information" exemption of the Freedom of Information Act (FOIA) would also be protected from disclosure, although the banking organization must provide a general statement about the information withheld and include the reason for withholding it.

Conclusion

The final rule will affect each banking organization differently. We are happy to assist in determining the practical consequences of the final rules for the business operations of a banking organization and preparing for compliance.

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

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SEC Eliminates the Ban on General Solicitation, and Disqualifies Participation by "Bad Actors," in Certain Private Securities Offerings

On July 10, 2013, the Securities and Exchange Commission (SEC) adopted final rules (Final Rules) eliminating the ban on general solicitation and general advertising for private securities offerings under Rule 506 of Regulation D under the Securities Act (Regulation D) and Rule 144A under the Securities Act (Rule 144A). The Final Rules also make Rule 506 unavailable for offerings if the issuer or any related "covered person" is a "bad actor" (i.e., has engaged in a "disqualifying event"). The adoption of these rules by the SEC was required under Section 201(a) of the Jumpstart Our Business Startups Act (JOBS Act) and Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), respectively. The Final Rules will go into effect 60 days after publication in the Federal Register.

In connection with the adoption of the Final Rules, the SEC also proposed certain rule amendments that, if adopted, would impose significant new requirements on Regulation D offerings. These proposed amendments stem from concerns raised by commentators and SEC commissioners that permitting general solicitation and general advertising in private securities offerings, without additional protections, is inconsistent with the goal of investor protection and will result in an increase in fraudulent activity in the private placement market.

The adoption of the Final Rules represents a significant shift from the SEC's longstanding view that securities only be sold pursuant to SEC registration, or otherwise privately, with substantially no solicitation or advertising. This advisory summarizes the Final Rules and proposed rules and discusses some of the more important practical effects of the Final Rules — particularly permitting general solicitation and general advertising — on market participants, including start-up and emerging companies, private funds, registered broker-dealers and issuers and underwriters who engage in concurrent U.S. and offshore private securities offerings.

Elimination of Ban on General Solicitation for Certain Rule 506 Offerings

Background

An issuer who seeks to offer and sell securities in the United States must either register the offering under the Securities Act of 1933 (Securities Act) by filing a registration statement with the SEC or rely on an exemption from the registration requirements of the Securities Act. Section 4(a)(2) of the Securities Act (formerly Section 4(2) of the Securities Act) exempts securities offerings by issuers that do not involve a "public offering." The courts and the SEC have

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developed a substantial body of judicial interpretations and administrative guidance interpreting the phrase "not involving a public offering." One factor is whether the issuer engaged in any general solicitation or general advertising relating to the securities being offered and sold. Examples of general solicitation and general advertising include advertisements published in newspapers and magazines, communications broadcast over television and radio, information available on unrestricted websites, and seminars where attendees have been invited by means of general solicitation or general advertising. Forms of general solicitation and general advertising that may find more utilization after effectiveness of the Final Rules include social media, forms of short-term static advertising such as kiosks, and offers to potential investors who have no "preexisting, substantive relationship" with the issuer or its agent.[1]

The SEC adopted Regulation D in 1982 to provide issuers with a non-exclusive safe harbor from the registration requirements of the Securities Act. An issuer that makes a securities offering in compliance with Regulation D can be confident that the offering does not in fact "involve a public offering," and is therefore exempt from the registration requirements of the Securities Act. In addition, because the Regulation D safe harbor has historically been non-exclusive, the issuer could rely on the registration exemption under Section 4(a)(2) of the Securities Act even if the offering failed to satisfy all of the requirements of Regulation D.

Prior to the effectiveness of the Final Rules, Regulation D included three available safe harbors from the registration requirement of the Securities Act, as follows:

- for offerings up to US$1 million under Rule 504 of Regulation D;
- for offerings up to US$5 million under Rule 505 of Regulation D; and
- for offerings without regard to dollar amount under Rule 506 of Regulation D.

Historically, issuers have relied on the Rule 506 safe harbor most frequently, which permitted an issuer to offer and sell an unlimited amount of securities without registration under the Securities Act if (among other things):

- the issuer sells the securities to an unlimited number of "accredited investors" (as defined in Rule 501(a) of Regulation D);
- the issuer sells the securities to not more than 35 investors who are not accredited investors but meet certain requirements for being sophisticated investors; and
- neither the issuer nor any person acting on its behalf offers or sells the securities through any form of general solicitation or general advertising.

In April 2012, Congress passed the JOBS Act, which required, among other things, that the SEC eliminate the ban on general solicitation and general advertising in private securities offerings under Rule 506 of Regulation D. The intention underlying this mandate in the JOBS Act is to facilitate capital raising by permitting issuers to use previously unavailable solicitation and advertising methods to seek investors and thereby encourage the creation of new jobs.

New Rule 506(c) of Regulation D Permitting Use of General Solicitation

On July 10, 2013, the SEC adopted new Rule 506(c) of Regulation D, which will provide an additional safe harbor from the registration requirements of the Securities Act for issuers that use general solicitation or general advertising to seek investors.[2] Issuers will be permitted to use general solicitation and general advertising to offer securities under new Rule 506(c) of Regulation D if:

- all of the purchasers of the securities are accredited investors (or reasonably believed to be accredited investors at the time of sale); and
- the issuer takes "reasonable steps to verify" that the purchasers are accredited investors.

Whether an issuer has taken "reasonable steps to verify" that an investor is an accredited investor will depend on the particular facts and circumstances of each investor and transaction. Factors include the nature of the investor and the type of accredited investor that the investor claims to

1 The SEC staff has offered guidance through no-action letters that an offer to a potential investor will not constitute a "general solicitation" if the issuer or its agent has a "preexisting, substantive relationship" with the potential investor at the time the offer is made. *See, e.g.*, Mineral Lands Research and Marketing Corp., SEC No-Action Letter (Dec. 4, 1985); E.F. Hutton & Co., SEC No-Action Letter (Dec. 3, 1985).

2 *See* SEC Release No. 33-9415, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, *available at* http://www.sec.gov/rules/final/2013/33-9415.pdf.

be (e.g., an individual, an investment company or a broker-dealer), the amount and type of information that the issuer has about the investor and the nature of the offering (e.g., the minimum investment amount). The SEC also identified four non-exclusive, non-mandatory methods of verifying accredited investor status for natural persons that, if used, will be deemed to satisfy the verification requirements of new Rule 506(c):

- reviewing a copy of an Internal Revenue Service form that reports income of the purchaser for the two most recent years and obtaining a written representation from the purchaser that he or she reasonably expects to reach the necessary income level during the current year;
- reviewing certain listed types of documentation, dated within the prior three months, showing assets and liabilities and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed;
- relying on a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, an attorney or a certified public accountant regarding the purchaser's accredited investor status; or
- relying on a certification from an existing investor who previously invested in the issuer's Rule 506(b) offering prior to the effective date of new Rule 506(c).

Issuers that conduct offerings without general solicitation and general advertising under the existing Rule 506(b) exemption need not comply with the new verification requirements.

In adopting new Rule 506(c), the SEC confirmed that private funds will be permitted to engage in general solicitation and general advertising in compliance with the requirements of Rule 506(c) without losing the exclusion from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, which requires, among other things, that an issuer relying on either exclusion not make a public offering of its securities.

Additional Proposed Rules that Would Apply to Regulation D Offerings

In connection with its adoption of new Rule 506(c) of Regulation D, the SEC also proposed rule amendments that would apply to Regulation D offerings. These amendments are intended to enhance the SEC's ability to monitor the private placement market after lifting the ban on general solicitation and general advertising and to address investor protection concerns related to the use of general solicitation and general advertising.[3] The proposals include, among other things:

- requiring issuers to file a Form D with the SEC at least 15 calendar days before general solicitation or general advertising begins in reliance on new Rule 506(c) and a closing amendment to Form D no later than 30 days after the closing of a Rule 506 offering;
- expanding the disclosure required on Form D;
- requiring legends in written general solicitation materials that would inform potential investors of certain risks and the requirement that sales are limited to accredited investors;
- requiring a private fund that includes information about past performance in its written general solicitation materials to include in its materials information on the limitations on the usefulness of that information;
- temporarily requiring issuers to submit to the SEC written general solicitation materials;
- disqualifying any issuer from eligibility to rely on Rule 506 in future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply within the last five years with Form D filing requirements in a Rule 506 offering; this disqualification would end one year after required Form D filings are made; and
- extending the antifraud guidance contained in Rule 156 under the Securities Act to the sales literature of private funds. Rule 156 provides guidance regarding when information in sales literature by an investment company registered with the SEC could be fraudulent or misleading for purposes of the federal securities laws.

These proposals are subject to an initial 60-day public comment period, and significant changes may be made to the proposed rule amendments prior to adoption of any final rules. Although many of the SEC commissioners appear to support the imposition of additional restrictions to protect investors following the elimination of the ban on general solicitation and advertising, it remains to be seen if these rule amendments (as proposed or modified) will be adopted.

3 *See* SEC Release No. 33-9416, Amendments to Regulation D, Form D and Rule 156 under the Securities Act, *available at* http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

Elimination of Ban on General Solicitation for Rule 144A Offerings

Section 4(a)(1) of the Securities Act (formerly Section 4(1) of the Securities Act) exempts from the registration requirements of the Securities Act transactions by any person "other than an issuer, underwriter, or dealer." Rule 144A is a non-exclusive safe harbor from the registration requirements of the Securities Act pursuant to Section 4(a)(1) of the Securities Act. The Rule 144A safe harbor permits persons other than the issuer to resell securities without registration if the transaction meets certain specified conditions. Prior to the effectiveness of the Final Rules, one of the conditions was that the securities be "offered or sold" only to persons the seller and any person acting on the seller's behalf reasonably believe are qualified institutional buyers (QIBs). As a result, Rule 144A effectively prohibited general solicitation and general advertising.

By its terms, Rule 144A is available solely for resale transactions. However market participants frequently use Rule 144A to facilitate capital-raising by issuers through a primary offering of debt or equity securities to one or more financial intermediaries (commonly called "initial purchasers") in a transaction exempt from registration requirements pursuant to Section 4(a)(2) of the Securities Act or Regulation S under the Securities Act, followed by the immediate resale of these securities by the initial purchasers to QIBs in reliance on Rule 144A.

Section 201(a)(2) of the JOBS Act directed the SEC to revise Rule 144A to permit offers to persons other than QIBs, if the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Upon the effectiveness of the Final Rules, revised Rule 144A will no longer refer to "offers" and "offerees" in the conditions to be met under paragraph (d)(1) of Rule 144A. Thus, sellers will be able to rely on revised Rule 144A even if the securities are offered to non-QIBs, and even if there has been general solicitation or general advertising, if the securities are sold only to QIBs or persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

"Bad Actors" and Rule 506 Offerings

Section 926 of the Dodd-Frank Act required the SEC to issue rules disqualifying certain felons and other "bad actors" from Rule 506 offerings. Section 926 further provided that the new rules must be "substantially similar" to the disqualification provisions set forth in Rule 262 of Regulation A under the Securities Act, but must also include certain other disqualifying events (including certain state regulatory orders and bars).

"Bad Actor" Disqualification from Reliance on Rule 506 of Regulation D

On July 10, 2013, the SEC adopted new Rule 506(d) of Regulation D.[4] Under new Rule 506(d), an issuer cannot privately place its securities in reliance on Rule 506 of Regulation D if the issuer or any other "covered person" engaged in a "disqualifying event" after the effective date of new Rule 506(d). New Rule 506(d) will apply to all offerings intended to comply with Rule 506, including those that do not use general solicitation or general advertising.

The definition of "covered persons" under new Rule 506(d) is substantially the same as under Rule 262, with some exceptions, including the following:

- the beneficial ownership threshold was raised from 10% to 20% so that the definition of "covered persons" under new Rule 506(d) includes any beneficial owner of 20% or more of the issuer's outstanding voting equity securities; and
- the definition of "covered persons" under new Rule 506(d) includes any investment manager to an issuer that is a pooled investment fund and any person compensated (directly or indirectly) for soliciting investors on behalf of the issuer.

"Disqualifying events" under new Rule 506(d) generally include securities-related bad acts, such as criminal convictions in connection with the sale or purchase of any security, bars by certain federal or state regulators from engaging in the business of securities, insurance or banking or from savings association or credit union activities, certain cease-and-desist and other orders by the SEC and certain suspensions, expulsions or bars from association with a registered national securities exchange. The "look-back" periods for disqualifying events generally cover the past five or ten years, although for certain events, the injunction, order, investigation or similar event must be in effect and continuing at the time of the Rule 506 sale.

4 *See* SEC Release No. 33-9414, Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, *available at* http://www.sec.gov/rules/final/2013/33-9414.pdf.

An issuer will not be disqualified if it establishes that it did not know and, in the exercise of "reasonable care" could not have known, that a disqualifying event existed. To exercise "reasonable care," an issuer must have engaged in a factual inquiry, and facts and circumstances affect the steps an issuer should take in its factual inquiry. Examples of steps an issuer may take to exercise "reasonable care" include the use of questionnaires or certifications, contractual representations and warranties and/or searches of publicly available databases (e.g., Financial Industry Regulatory Authority, Inc.'s (FINRA's) BrokerCheck). In addition, in offerings made on a continuous basis under Rule 506, such as offerings by hedge funds, "reasonable care" will require updating the factual inquiry on a reasonable basis, depending on the facts and circumstances. Unless the issuer is aware of facts that would merit closer monitoring (e.g., the issuer has notice that a "covered person" is the subject of an applicable judicial or regulatory proceeding), periodic updating should be sufficient.

Rule 506(d) includes a waiver provision, under which the Director of the SEC's Division of Corporation Finance may waive disqualification upon a showing of good cause. Additionally, any court or regulatory authority entering an order, judgment or decree that would cause an actor to be disqualified under the rule may advise in writing that disqualification should not arise as a consequence of the order, judgment or decree, and as a result, disqualification will not arise.

Mandatory Disclosure of "Disqualifying Events" That Existed Before Effectiveness of the "Bad Actor" Disqualification Rule

If any "disqualifying event" existed before the effective date of new Rule 506(d), then new Rule 506(e) will require the issuer offering securities under Rule 506 to disclose the "disqualifying event" to investors within a reasonable time prior to sale. In the view of the SEC, any failure to provide adequate disclosure of a pre-existing "disqualifying event" is not an "insignificant" deviation from the requirements of Regulation D and could result in the loss of the exemption. However, an issuer may rely on Rule 506 if it establishes that it did not know, and in the exercise of "reasonable care" could not have known, of the existence of the undisclosed matter or matters. Like the "reasonable care" exception to disqualification, this "reasonable care" exception to mandatory disclosure will require factual inquiry.

Effect of the Final Rules

The elimination of the prohibition against general solicitation and general advertising in Rule 506 and Rule 144A offerings will permit issuers, including start-up and emerging companies, to use a number of previously unavailable solicitation and advertising methods. For example, issuers who previously would only offer securities to a potential investor with which the applicable issuer has a "preexisting, substantive relationship" — or would be required to engage a financial intermediary or solicitor to offer its securities to potential investors with which the financial intermediary or solicitor has a "preexisting, substantive relationship" — to avoid engaging in a general solicitation may, after effectiveness of the Final Rules, use other methods of offering securities to different and larger pools of potential investors (e.g., purchasing from third parties' pre-screened lists of potential investors that are accredited investors and meet other eligibility criteria and cold calling and/or communicating with new clients or contacts (including from purchased pre-screened lists)). However, the utility of this change to most issuers' capital raising efforts will likely be somewhat limited.

First, the SEC has the power to impose additional obligations on issuers relying on the private placement safe harbor of Regulation D, and, as evidenced by the SEC's proposals on July 10, 2013, it appears that the SEC will adopt additional obligations that will be particularly burdensome on issuers using general solicitation and general advertising in offerings under Rule 506(c) of Regulation D.

Secondly, the SEC has made clear that the ban on general solicitation and general advertising remains a condition for reliance on the statutory registration exemption under Section 4(a)(2) of the Securities Act. Accordingly, if an issuer engages in any general solicitation or general advertising in an offering that is intended to be made in compliance with the requirements of Rule 506(c) of Regulation D, but the offering loses the safe harbor under Rule 506(c) because of a significant compliance failure, the issuer will also be unable to rely on the statutory exemption under Section 4(a)(2) of the Securities Act.

Thirdly, engaging in any general solicitation or general advertising in an issuer's private securities offering will preclude reliance on "self-executing" exemptions under many state Blue Sky laws and may therefore increase the costs and expenses associated with the offering. Although securities issued in Rule 506 offerings are exempt from registration requirements under state Blue Sky laws, issuers are subject to notice filing requirements under applicable state Blue Sky laws. Many state Blue Sky laws also provide exemptions for certain *de minimis* offerings that do not require a filing with the applicable state securities commissioner, but these exemptions are often available only for securities offered without the use of general solicitation or general advertising. Therefore, securities offered under new Rule 506(c) in certain states will no longer be eligible to rely on this exemption, and the only available exemption will require a notice filing (and the payment of related fees).

The Final Rules adopted by the SEC on July 10, 2013 will have additional effects on certain types of market participants, including private funds, registered broker-dealers and issuers and underwriters who engage in concurrent U.S. and offshore private securities offerings.

Effect on Private Funds

Under current law, private funds and their investment advisers are subject to significant regulatory requirements, and these requirements likely limit the ability of many private funds and their investment advisers to take advantage of the new rules and engage in any general solicitation or general advertising in connection with private securities offerings. First, many private funds that invest in or trade commodity interests (including swaps) rely on the exemption from registration as a commodity pool operator under Commodity Futures Trading Commission (CFTC) Rule 4.13(a)(3), and the continued availability of this exemption is conditioned on, among other things, the private funds not being "marketed to the public in the United States." In the absence of any new guidance from the CFTC, the use of general solicitation and general advertising in a private securities offering by a private fund that relies on CFTC Rule 4.13(a)(3) may be prohibited. Secondly, an investment adviser who wishes to be exempt from the registration requirements under applicable state law or the Investment Advisers Act of 1940 (Advisers Act) must generally not hold itself out to the public as an investment adviser. If such an investment adviser engages in general solicitation or general advertising to offer and sell securities of a private fund that it manages, it may be deemed to be holding itself out to the public as an investment adviser, thereby requiring such investment adviser to register with the SEC or one or more states. Thirdly, all investment advisers (whether registered or unregistered) remain subject to anti-fraud provisions, and therefore, additional care must be given to the scope and content of any general solicitation or general advertising materials used by an investment adviser on behalf of the private fund that it manages to ensure compliance.[5]

If an investment adviser is considering offering and selling securities of a private fund it manages under new Rule 506(c) (once it becomes effective), including by offering securities to potential investors with which neither it nor any placement agent or solicitor has a "preexisting, substantive relationship," then it should also consider the following:

- Investment advisers that are registered with the SEC are only permitted to charge performance fees to investors who are "qualified clients" (as defined in Rule 205-3 under the Advisers Act), and such investment advisers should consider whether the proposed method of general solicitation or general advertising is likely to attract prospective investors who are "qualified clients" (which would be a smaller subset of investors than accredited investors due to the higher net worth requirements).
- In addition, in advance of effectiveness of the Final Rules, investment advisers should adopt appropriate policies and procedures to engage in the required factual inquiry (and periodic updates) to detect and monitor whether each of their private funds and the related "covered persons" (including placement agents, compensated solicitors and promoters) have engaged in any disqualifying event that may cause any of such private funds to become ineligible to offer securities in reliance on Rule 506(b) or 506(c) of Regulation D.

Effect on Broker-Dealers

For securities broker-dealers, the Final Rules and proposed rules have several implications. First, any broker-dealer that seeks to rely on the Final Rules should carefully examine how a relevant offering would fit into its overall compliance program. Broker-dealers remain subject to laws, regulations and FINRA rules that require communications with the public to be fair and balanced, to be based on principles of fair dealing and good faith, and to provide a sound basis for evaluating the

5 *See, e.g.*, Rule 206-4(8) under the Advisers Act.

facts in regard to any particular security or type of security. In addition, broker-dealers should carefully review the procedures and techniques that they employ in order to ascertain that an investor meets the required qualification standards.

Finally, the SEC's release announcing the proposed rules notes that the staff will "execute a comprehensive work plan" to review the effects of eliminating the general solicitation ban. This work plan will involve all of the SEC's core divisions and offices, including the Office of Compliance Inspections and Examinations and the Division of Enforcement. It will examine, among other things, investor qualification and verification practices, the form and content of promotional materials and statements, and whether non-accredited investors end up with inappropriate investments. Accordingly, broker-dealers that seek to rely on new Rule 506(c) should expect a high degree of focus from regulators in the future.

Effect on Issuers Who Engage in Concurrent U.S. and Offshore Unregistered Securities Offerings, Including Issuers in the High-Yield Bond Markets and Offshore Private Funds

Issuers conducting concurrent Regulation S/Rule 144A offerings should not be affected by the rule change allowing general solicitation. Under the Regulation S safe harbor, offers and sales of securities outside of the United States are exempt from the registration requirements of the Securities Act, provided that: (i) the securities are sold in an offshore transaction; (ii) there are no directed selling efforts in the United States or to U.S. persons; and (iii) with respect to certain types of securities offerings, other offering and transaction restrictions are imposed to prevent the flow back of the offered securities into the United States.

In its adopting release, the SEC confirmed that the use of general solicitation and general advertising in a Rule 506(c) or Rule 144A offering will not cause a concurrent offshore offering under Regulation S of the Securities Act to be integrated with the Rule 506(c) or Rule 144A offering. Although not expressly stated, it appears that general solicitation conducted in compliance with the Final Rules for the U.S. offering would not constitute "directed selling efforts" in the U.S. that would jeopardize a concurrent Regulation S offering in which the issuer or its underwriters use existing traditional methods to qualify sales to non-U.S. persons under Regulation S.

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

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Revised Proposal Conforms Qualified Residential Mortgage Definition to Definition of Qualified Mortgage

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Introduction

On September 20, 2013, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the U.S. Securities and Exchange Commission (SEC), the Federal Housing Finance Agency (FHFA), and the Department of Housing and Urban Development (HUD) (collectively, the Agencies), jointly published in the *Federal Register* a reproposal of credit risk retention rules (Reproposed Rule) in order to, among other changes, conform the definition of a Qualified Residential Mortgage (QRM) to the definition of a Qualified Mortgage (QM).[1] This change in the definition of a QRM is in response to concerns raised regarding the Agencies' original proposed QRM definition by industry participants, consumer advocacy groups, and members of the U.S. Congress. Comments on the Reproposed Rule are due by October 30, 2013.

Background

The Reproposed Rule is a revision of the Agencies' April 2011 Credit Risk Retention Proposed Rule (Original Proposed Rule). The Original Proposed Rule implemented the credit risk retention requirements of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Congress added Section 941 to provide incentives for securitizers to engage in securitization transactions backed by quality assets. The credit risk retention requirements mandate that a securitizer of an asset backed security (ABS) must retain at least 5% of the credit risk in the asset that it securitizes. An exemption from this requirement, however, applies to the securitization of QRMs. Section 941 requires the Board, the OCC, the FDIC, and the SEC jointly to implement credit risk retention rules, and the Agencies (including FHFA and HUD) to define a QRM. Section 941 also requires that the definition of QRM be no broader than the definition of QM, which is the standard for determining whether a safe harbor or a rebuttable presumption exists to the Ability to Repay standard of Section 1412 of the Dodd-Frank Act, as implemented by

1 *See* Credit Risk Retention Proposed Rule, 78 Fed. Reg. 57928 (Sept. 20, 2013).

rules of the Consumer Financial Protection Bureau (CFPB). Additional credit risk retention rules and exemptions also apply to securitization of non-residential assets.

The Original Proposed Rule defined a QRM to encompass loans of "very high credit quality."[2] A QRM under the Original Proposed Rule would have had a loan-to-value ratio (LTV) no greater than 80% for purchase mortgages, and a lower threshold for refinance mortgages. The QRM borrower would have been required to have a debt-to-income ratio (DTI) of 36% for total monthly debt to monthly gross income, and 28% for monthly housing debt to monthly gross income. Also, the credit history of the borrower could not contain any current 30-day delinquencies, 60-day delinquencies in the past two years, or bankruptcies, repossessions, or foreclosures in the past three years. The asset securing the QRM would have been required to be subject to a written appraisal. Also, the terms of a QRM had to include servicing standards requiring loss mitigation within 90 days after the mortgage became delinquent.

The QRM standard of the Original Proposed Rule used the QM standard as a floor upon which to create greater restrictions for the QRM. Thus, the QRM of the Original Proposed Rule incorporated the QM standards, while adding additional restrictions. The following chart shows the distinction between the QM rule as finalized and the QRM of the Original Proposed Rule, with the distinctions of the Original Proposed Rule in red. As explained below, the chart also represents the distinctions between the QRM standards of the Reproposed Rule, and the QRM standards of the Original Proposed Rule:

2 *See* Credit Risk Retention Proposed Rule, 76 Fed. Reg. 24090, 24117 (Apr. 29, 2011).

Requirements	Qualified Mortgage (Final) & Qualified Residential Mortgage (Reproposed Rule) 12 C.F.R. §§1026.2(a) & 1026.43(e)	Qualified Residential Mortgage (Original Proposed Rule)
Inapplicable Mortgage Types	■ Home equity line of credit ■ Construction loans ■ Reverse mortgages ■ Bridge loans of less than one year ■ Timeshare plans	■ Home equity line of credit ■ Construction loans ■ Reverse mortgages ■ Bridge loans of less than one year ■ Timeshare plans ■ *Investment properties*
Impermissible Mortgage Product Features	■ Negative Amortization ■ Deferred payment of principal or interest ■ Balloon payments ■ Interest only payments ■ Subordinate liens ■ Payments that are not substantially equal regular periodic payments (except for adjustable rate and step-rate changes)	■ Negative amortization ■ Deferred payment of principal or interest ■ Balloon payments ■ Interest only payments ■ Subordinate liens ■ Payments that are not substantially equal regular periodic payments (except for adjustable rate and step-rate changes) ■ *Prepayment penalties* ■ *Assumability by a person that was not the borrower at closing*

Requirements	Qualified Mortgage (Final) & Qualified Residential Mortgage (Reproposed Rule) 12 C.F.R. §§1026.2(a) & 1026.43(e)	Qualified Residential Mortgage (Original Proposed Rule)
Term	■ May not exceed 30 years	■ May not exceed 30 years
Variable Rate	■ No specific requirement	■ Increase may not exceed 2% in any 12-month period ■ Increase may not exceed 6% over the life of the loan
Borrower Application	■ No specific requirement	■ Written application required
Points and Fees	■ May not exceed 3% of the total loan amount for loans of US$100,000 or more	■ May not exceed 3% of the total loan amount, *regardless of the loan amount*
Prepayment Penalties	■ Must not apply after the first 3 years of the mortgage ■ Must not exceed 3% in first year, 2% in second year, 1% in third year ■ Creditor must also offer an alternative transaction without a penalty	■ *Not permissible*
Maximum Debt to Income Ratios	■ Front end ratio (monthly housing debt to monthly gross income): No specific requirement ■ Back end ratio (total monthly debt to monthly gross income): 43%	■ *Front end ratio: 28%* ■ *Back end ratio: 36%*
Credit History	■ No specific requirement	■ *Current on all debts (no 30-day delinquencies)* ■ *No 60-day delinquencies in the past 2 years* ■ *No bankruptcies, repossessions, or foreclosures in the past 3 years*

Requirements	Qualified Mortgage (Final) & Qualified Residential Mortgage (Reproposed Rule) 12 C.F.R. §§1026.2(a) & 1026.43(e)	Qualified Residential Mortgage (Original Proposed Rule)
Loan-to-Value Ratio	■ No specific requirement	■ *Purchase: 80%* ■ *Rate and term refinance: 70%* ■ *Cash out refinance: 75%*
Cash Down Payment Requirements	■ No specific requirement	■ *20% of the purchase price or appraised value of the property, whichever is less, plus* ■ *Closing costs payable to the borrower, plus* ■ *Any amount of the purchase price that exceeds the appraised value of the property*
Appraisal	■ No specific requirement	■ *Written appraisal no more than 90 days prior to closing*
Default Mitigation	■ No specific requirement	■ *Mortgage originator must include terms in the mortgage transaction documents in which the creditor commits to have servicing policies and procedures to take loss mitigation actions within 90 days after a mortgage loan becomes delinquent*

The Agencies received a largely negative response to the proposed QRM definition during the Original Proposed Rule's comment period. Many commenters expressed concerns with consequences of the restrictive QRM definition on the availability of credit. These concerns extended to the ability of private capital to return to the securitization markets, as well as the ability of low-to-moderate income and first-time homebuyers to obtain a mortgage in light of the down payment, LTV, and DTI requirements for a QRM. The negative response actually placed many industry and consumer group commenters on the same side of this issue, a rare outcome in a rulemaking regulating the mortgage industry. Many members of Congress also submitted comments stating that the 20% down payment requirement was not part of the legislative intent of the Dodd-Frank Act credit risk retention rule.[3]

Reproposed Rule Revises QM

In consideration of the comments on the Original Proposed Rule, the Agencies reproposed the credit risk retention rule with a focus on reducing the restrictiveness of the QRM definition. The Agencies agreed with the sentiment of many of the commenters that a restrictive QRM definition may limit the availability of mortgage credit, particularly to low-to-moderate income, minority, and first-time homebuyers. In addition, the Agencies acknowledged that a QRM standard that is different from the QM standard could impose major indirect costs on the mortgage industry, as lenders and securitizers seek to underwrite and securitize loans under

3 *See, e.g.*, Comment Letter from Spencer Bachus and Scott Garrett, Members of the U.S. House of Representatives, to the Agencies (Aug. 2, 2011), *available at* http://www.fdic.gov/regulations/laws/federal/2011/11c62ad74.PDF; Comment Letter from Jim Hines et al., Members of the U.S. House of Representatives, to the Board, OCC, FDIC, and SEC (Jul. 29, 2011), *available at* http://www.fdic.gov/regulations/laws/federal/2011/11c171ad74.PDF.

two separate standards—one standard to limit liability risks under the ability to repay rules, and another standard to strengthen the liquidity of a mortgage security by ensuring that it meets QRM requirements.

New Proposed QRM Standard

In the Reproposed Rule, the Agencies propose to align the definition of a QRM with that of a QM. As proposed, QRMs will consist of loans that are QMs. Thus, a QRM is no longer proposed to contain requirements related to a minimum down payment, servicing standards, credit history, or a written appraisal requirement. Likewise, the DTI requirements for a QRM are now proposed only to apply to a total monthly debt to monthly gross income ratio that has been increased from 36% to 43%. Under this new definition, a QRM may be a loan securing any dwelling, not just a principal dwelling as set forth under the Original Proposed Rule.

In addition to conforming with the general QM requirements outlined above, a loan may qualify as a QRM by complying with any alternative definition of a QM included in the CFPB rules. For example, a mortgage that is eligible for purchase, guarantee, or insurance by a government sponsored enterprise (GSE), HUD, the Veterans Administration, the U.S. Department of Agriculture, or Rural Housing Service is a QM to the extent that it satisfies certain additional criteria used to limit loan terms considered by the CFPB to be risky.[4] An additional QM definition applies to lenders with assets under US$2 billion, who originated no more than 500 first-lien loans in the previous calendar year, and who primarily serve rural or underserved areas. These loans must be held by the lender for at least three years after consummation, but they may qualify as QRMs upon their eligibility for securitization upon the expiration of the three-year period. Also, the CFPB has distinguished the effect of a higher-priced QM relative to a QM that is not higher-priced.[5] A QM is higher-priced if it is either a first-lien mortgage with an annual percentage rate set at 1.5 percentage points or greater over the Average Prime Offer Rate (APOR), or a subordinate-lien mortgage with an APR set at 3.5 percentage points or more over the APOR. For purposes of defining a QRM, both higher-priced QMs and QMs that are not higher-priced will be eligible to be QRMs, and both types of QMs may be securitized within the same QRM pools.

Alternative QRM

Despite the newly proposed definition for QRM, the Agencies have also proposed an alternative definition for QRM which more closely approximates the QRM definition of the Original Proposed Rule. The Agencies expressed concern that equating QRM with QM could lead to a decrease in the availability of credit, as loans that are not QMs/QRMs become less available in the marketplace. Thus, under an alternative QRM definition, the Agencies incorporate some QM criteria as a starting point, and then incorporate additional standards to help reduce the risk of default, including credit history standards, and an LTV maximum requirement of 70% (actually more stringent than what was in the Original Proposed Rule). The Agencies have requested comment as to whether the alternative QRM definition might promote more non-QRM loans within the secondary mortgage marketplace, because the alternative definition does not directly equate to the QM definition.

Additional Changes to the Credit Risk Retention Rule

The Reproposed Rule also made additional changes to the Original Proposed Rule with regard to credit risk retention and nonresidential qualified loans. The most prominent of these changes is that the Board, OCC, FDIC, and SEC are simplifying the risk retention options for securitizers

4 This additional criteria include prohibitions on negative amortization, interest-only payments, and balloon payments. In addition, the loan term can be no more than 30 years, and points and fees are limited to 3% of the loan balance for loans of US$100,000 or more.

This alternative definition is effective until January 10, 2021, or, for GSE-sponsored QMs, until the GSEs exit federal conservatorship or receivership, whichever event occurs first. For QMs insured or guaranteed by a federal government agency, this alternative definition is effective until January 10, 2021 or until the time that the relevant government agency exercises its authority under the Dodd-Frank Act to define which loans among the ones it insures or guarantees should fit QM status, whichever date occurs first.

5 A higher-priced QM has a rebuttable presumption that the QM meets the CFPB's ability to repay standards. A QM that is not higher-priced has safe harbor protection from the ability to repay standards

that seek to retain at least 5% of the credit risk in a securitized pool. Under the Original Proposed Rule, a securitizer could retain credit risk through different options including retaining an interest in each class of security interests issued (vertical risk retention), retaining a first loss exposure to the credit risk of an entire securitization pool (horizontal risk retention), engaging in an equal combination of horizontal and vertical risk retentions (L-shaped risk retention), or retaining a randomly selected sample of a pool of assets designated for securitization (representative sample risk retention). The Reproposed Rule has combined the horizontal, vertical, and L-shaped risk retention options into a standard flexible option that would permit the retention of a vertical or horizontal interest, or a combination of the two in a total amount of at least 5% of the fair value of all ABS interests issued in a securitization transaction. Also, the Reproposed Rule eliminates the representative sample risk retention option entirely, as it was found to be too difficult to implement.

Comments regarding the Reproposed Rule must be received by October 30, 2013.

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

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Consumer Financial Protection Bureau Clarifies New Mortgage Servicing Rules

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The Consumer Financial Protection Bureau (CFPB) recently issued an interim final rule,[1] as well as an explanatory bulletin,[2] to further detail and clarify the requirements of the agency's mortgage servicing rules that were finalized in January 2013 (the Servicing Rules).[3] The Servicing Rules implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amending the Real Estate Settlement Procedure Act of 1974 (RESPA) and the Truth in Lending Act (TILA) to provide borrowers with more detailed information regarding their loans, ensure that borrowers are not unexpectedly assessed charges or fees, and inform borrowers of alternatives to foreclosures.

After issuing the final Servicing Rules, the CFPB received a large number of inquiries from servicers regarding how they can best comply with the Rules. The interim final rule and bulletin address many of the issues raised in those inquiries, including the permissible communications with successors-in-interest when a borrower dies, the appropriate procedures to contact delinquent borrowers, and the proper treatment of borrowers who have filed for bankruptcy or invoked the protections of the Fair Debt Collection Practices Act (FDCPA).

Home Retention Efforts After a Borrower Dies

Beginning in January 2014, the Servicing Rules will require servicers to implement policies and procedures to promptly identify and contact successors-in-interest upon notification of a borrower's death. This requirement is intended to promote home retention by ensuring that successors-in-interest are able to pursue assumption of a deceased borrower's loan or, if applicable, loan mitigation efforts. In its bulletin, the CFPB provides examples of practices that it would consider "reasonably designed" to achieve the objectives of the Servicing Rules, such as:

- Informing any person claiming to be a successor-in-interest of all documents and other evidence that the servicer requires to establish the death of the borrower and the identity

1 *Amendments to the 2013 Mortgage Rules under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z)*, 78 Fed. Reg. 62993 (Oct. 23, 2013).

2 Consumer Financial Protection Bureau, *Implementation Guidance for Certain Mortgage Servicing Rules*, CFPB Bulletin 2013-13 (Oct. 15, 2013) [hereinafter Bulletin].

3 *Mortgage Servicing Rules Under the Real Estate Settlement Act (Regulation X),* 78 Fed. Reg. 10695 (Feb. 14,2013) (to be codified at 12 C.F.R. § 1024.39); *Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z)*, 78 Fed. Reg. 10902 (Feb. 14, 2013).

and legal interest of the successor-in-interest. The information required by the servicer should be reasonable considering the laws of the relevant jurisdiction.

- Promptly providing successors-in-interest with information regarding the loan, including whether the loan is current or delinquent, whether there is a loss-mitigation option in place, and whether there is a planned or pending foreclosure proceeding. The servicer should also provide information regarding the successor-in-interest's eligibility to continue making payments on the loan, for loss-mitigation options, or to assume the loan.
- Providing employees with information regarding laws or other requirements that may affect the servicer's obligations following the death of a borrower.

In addition, the CFPB encourages servicers to consider whether they would postpone or withdraw any planned or pending foreclosure proceedings so that the successor-in-interest would have a reasonable opportunity to establish ownership rights and pursue assumption of the loan or loss-mitigation options, and whether they would promptly provide a successor-in-interest with information about the possible consequences of assuming the mortgage loan.

Early Intervention for Delinquent Borrowers

The CFPB has also clarified how servicers may comply with the early intervention requirements of the Servicing Rules, under which servicers must make good faith efforts to establish live contact with a delinquent borrower within 36 days of the delinquency to inform the borrower of the availability of the servicer's loss-mitigation options. The Servicing Rules provide that the servicer must attempt to contact the borrower each time he or she misses a payment. In its new bulletin, however, the CFPB explains that servicers have "significant flexibility in tailoring their contact methods to particular circumstances."[4] Examples of the types of approaches a servicer might take include establishing and maintaining ongoing contact with a borrower to complete a loss-mitigation application and evaluate loss-mitigation options, or combining contacts, such as adding a brief script to a collections call to inform borrowers of loss-mitigation options.

In the case of borrowers who are unresponsive to attempts at communication, the bulletin clarifies that with respect to those who become delinquent again after six or more consecutive delinquencies, the servicer might meet the requirements of the rule simply by "making a single telephone call or including a sentence requesting the borrower to contact the servicer with regard to the delinquencies in the periodic statement or in an electronic communication."[5] This policy may be most appropriate when home retention is a remote possibility, such as when all loss-mitigation options have been exhausted.

Interplay Between Bankruptcy Law, FDCPA, and the Servicing Rules

To address the possibility that the Servicing Rules might conflict with bankruptcy law and the FDCPA, the CFPB has exempted servicers from certain requirements of the Servicing Rules through the interim final rule, and provided an advisory opinion interpreting the FDCPA's "cease communication" requirement in relation to the Servicing Rules in the bulletin.

Specifically, the interim final rule exempts servicers from the periodic statement and early intervention requirements of the Servicing Rules for those borrowers who are in bankruptcy. In the interim final rule, the CFPB makes clear that in providing this exemption, it is not taking a position on whether intervention efforts violate the automatic stay or discharge injunction, and it encourages servicers to continue intervention efforts to the extent that bankruptcy law permits. Servicers are required to resume early intervention efforts after the first delinquency once the case is dismissed, closed, or the debt is discharged.

Additionally, the interim final rule exempts servicers from complying with certain provisions of the Servicing Rules when a borrower instructs the servicer to "cease communication" under the FDCPA. Specifically, servicers will not be required to contact borrowers under the early

4 Bulletin at 4.

5 *Id.* at 5.

intervention requirements or to send interest-rate adjustment notices. This exemption, however, does not apply to other communications required under the Servicing Rules. The CFPB has concluded in the bulletin that servicers who are deemed debt collectors under the FDCPA will not be liable, notwithstanding a "cease communication" instruction, if they, in compliance with the Servicing Rules, communicate with a borrower in regards to requests for loss-mitigation, information requests, error resolution, force-placed insurance, initial interest rate adjustment of adjustable-rate mortgages, and periodic statements. These communications are either specifically requested by the borrower (and therefore excluded from the cease-communication instruction) or mandated by the Dodd-Frank Act, which, according to the CFPB, "presents a more recent and specific statement of legislative intent regarding disclosures than the FDCPA."[6] With respect to information requested by the borrower, servicers may cease to comply with the requirements of the Servicing Rules to respond to the borrower's information requests if the borrower specifically withdraws the requests.

Comments on the interim final rule must be submitted by November 22, 2013. The relevant portions of the Servicing Rules become effective on January 10, 2014.

Arnold & Porter LLP is available to provide advice on compliance with the mortgage servicing rules. For further information, please contact your Arnold & Porter attorney or:

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6 *Id.* at 6-7.

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Financial Regulators Propose Joint Standards for Assessing Diversity Policies and Practices

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On October 23, 2013, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Consumer Financial Protection Bureau, and the Securities and Exchange Commission (collectively, the Agencies) proposed joint standards for assessing the diversity policies and practices of each agency's respective regulated entities.[1] The proposal implements Section 342 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires each agency to establish an Office of Minority and Women Inclusion and directs each to develop diversity assessment standards for all of the entities under the Agencies' jurisdiction.

The joint release proposes uniform standards for all of the Agencies in four areas: (1) organizational commitment to diversity and inclusion, (2) workforce profile and employment practices, (3) procurement and business practices (supplier diversity), and (4) practices to promote transparency of organizational diversity and inclusion. We expect the proposed standards to be made final shortly after the close of the 60-day comment period.

According to the release, the goal of the proposed standards is to promote transparency and awareness of diversity policies and practices. The standards are meant to serve as guides and do not impose specific requirements, and as such, the Agencies do not propose to use traditional examinations or other supervisory assessments to ensure compliance with the guidelines. The Agencies interpret the mandate of Section 342 to require only voluntary self-assessments and voluntary disclosures of the assessments to the Agencies and to the public. The Agencies will monitor any information voluntarily submitted and may periodically review information that is displayed on a regulated entity's public website. A model self-assessment will include a qualitative and quantitative evaluation of an entity's diversity and inclusion efforts. The proposal stresses that assessments should take into

1 Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Consumer Financial Protection Bureau, Securities and Exchange Commission, *Proposed Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies and Request for Comment, available at* http://www.fdic.gov/news/news/press/2013/pr13092a.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery.

consideration an entity's size and other characteristics such as total assets, number of employees, revenues, governance structures, and the number of members and/or customers, contract volume, geographic location, and community characteristics.

Overview of the Proposed Standards

A. Organizational Commitment To Diversity and Inclusion

To cultivate a culture that supports diversity and to promote diversity and inclusion in employment and contracting, the Agencies recommend the following:

- The regulated entity includes diversity and inclusion as part of its strategic plan for employment and contracting, such as hiring, recruiting, retention, and promotion;
- The regulated entity's diversity and inclusion policy is approved and supported by the senior leadership of the organization, including senior management and the board of directors. The organization appoints a senior official to direct and manage diversity efforts, such as a Chief Diversity Officer;
- The regulated entity regularly and periodically conducts educational programs and training on equal employment opportunity, diversity, and inclusion; and
- The entity takes proactive steps to promote a diverse pool of candidates, including its selection of board members, senior management, and other senior leadership positions.

B. Workforce Profile And Employment Practices

In addition to establishing standards that foster an organization's commitment to diversity, the Agencies have developed guidelines to evaluate an entity's diversity and inclusion programs and to identify areas of improvement. Recognizing that many entities that are subject to the reporting requirements of the Equal Employment Opportunity Commission (EEOC) and the Office of Federal Contract Compliance Programs (OFCCP) currently gather certain data with regards to gender, race, and ethnicity, the Agencies encourage such entities to use available data to evaluate their diversity and inclusion programs. The tools used in gathering the information may also serve as models of data analysis for those entities who are not subject to the reporting requirements of the EEOC and OFCCP. The Agencies have proposed the following standards to evaluate diversity efforts:

- Regulated entities that are required to file an annual EEO-1 Report pursuant to Title VII of the Civil Rights Act of 1964 or to prepare annual Affirmative Action Plans under Executive Order 11246 for the OFCCP (or those entities who track workforce data using other methods) are encouraged to use the data and plans to assess its workforce diversity and inclusion efforts.
- The entity should utilize metrics to evaluate its workplace diversity and inclusion efforts, such as recruitment, applicant tracking, hiring, promotions, separations, career development support, coaching, executive seminars and retention across all levels and positions of the organization.
- The regulated entity should hold management accountable for workplace diversity and inclusion efforts.
- The entity should implement policies and procedures that create diverse applicant pools, such as outreach to minority and women organizations and educational institutions that serve significant diverse populations. In order to do so, the proposed standards suggest that an entity participate in conferences and other events to attract minorities and women and inform them of career opportunities.

C. Procurement and Business Practices - Supplier Diversity

Another important component of the proposed standards is encouraging diversity and inclusion in an organization's procurement and business practices. The Agencies acknowledge that limited access to information on supplier diversity among regulated entities may present challenges in comparing supplier diversity practices and proposed the following standards:

- The entity has a supplier diversity policy that provides minority-owned and women-owned businesses with a fair opportunity to compete in the procurement of business and services;

- The entity develops methods to assess and evaluate its supplier diversity policy, which may include the following metrics: annual contract spending by the entity, percentage of contracts with minority-owned and women-owned sub-contracts, percentage of funds spent with diverse contractors, and the demographics of a contractor's or sub-contractor's workforce; and
- The regulated entity has practices and policies to promote diversity among suppliers, such as outreach to diverse contractors and representative organizations, participation in conferences and other events to attract firms owned by minorities and women and to inform them of contracting opportunities, and ongoing publication of procurement opportunities.

D. Practices to Promote Transparency of Organizational Diversity and Inclusion

The Agencies' standards also promote transparency of an entity's diversity and inclusion program. The Agencies believe that transparency and publicity create greater awareness, provide the public with information to assess an organization's diversity efforts, and can open new markets to new communities. An entity will meet the Agencies' transparency standard if it makes the following information available to the public on an annual basis through its website or other appropriate methods (such as promotional materials or annual reports): its diversity and inclusion strategic plan, its commitment to diversity and inclusion, and its progress in achieving its diversity and inclusion goals.

E. Open Questions

According to the release, "[t]he assessment envisioned by the Agencies is not one of a traditional examination or other supervisory assessment. Thus, the Agencies will not use the examination or supervision process in connection with these proposed standards." A threshold question is, in light of this statement, how and by what means will the Agencies determine whether an institution has adopted standards and engaged in an assessment that meets the requirements of the proposal? And what will be the consequences if an institution fails to conduct any assessment or take action in accordance with the standards, or conducts an assessment that the Agencies determine falls short of the statute's goals and objectives? In this regard, will diversity and inclusion become an issue that is taken into consideration in assessing management or other governance matters? Might the Agencies consider an institution's record of diversity and inclusion in acting on regulatory applications? Might an institution's less than satisfactory record of diversity and inclusion lead to an increase in discrimination claims?

However the Agencies choose to use the data "voluntarily" provided under the new guidelines, we believe that institutions, to the extent they have not already done so, should take steps now to address the issues raised by the proposal. As these issues are sorted out in the rulemaking process, it is important that all affected institutions act proactively to either develop appropriate diversity and inclusion programs, or to review their programs to assure that they comport with the proposed standards.

Arnold & Porter LLP is available to provide advice on the diversity and inclusion practices and methods for assessment. For further information, please contact your Arnold & Porter attorney or:

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ADVISORY

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The Volcker Rule: Impact on Banking Entities' Investments in Trust Preferred CDOs

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Background

On December 10, 2013, the Office of the Comptroller of the Currency (the OCC), the Federal Deposit Insurance Corporation (the FDIC), the Board of Governors of the Federal Reserve System (the FRB), the Securities and Exchange Commission (the SEC), and the Commodity Futures Trading Commission (collectively, the Agencies) released final rules (the Final Rules) to implement Section 619 of the Dodd-Frank Wall Street and Consumer Protection Act (the Dodd-Frank Act), commonly known as the "Volcker Rule." The Volcker Rule, among other things, prohibits banking entities from engaging in proprietary trading and from sponsoring, having an ownership interest in or having certain relationships with a hedge fund or private equity fund (referred to in the Final Rules as a covered fund), subject to certain exemptions.[1]

This advisory addresses the impact that the Final Rules may have on investments by banking entities in collateralized debt obligations (CDOs) backed by trust preferred securities (TruPS), which may constitute ownership interests in covered funds as those terms are defined in the Final Rules. Subsequent advisories will address other aspects of the Final Rules in greater detail.

Are TruPS CDOs Covered Funds under the Final Rules?

As a result of the Final Rules, banking entities, including community banks, will need to carefully review their investment portfolios to determine (i) whether they are holding any interests in issuers that are considered "covered funds" and (ii) whether any such interest constitutes an "ownership interest" as defined in the Final Rules.

The Final Rules define a "covered fund" to include any issuer that would be an investment company but for the exemptions set forth in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the Investment Company Act).[2] Sections 3(c)(1) and 3(c)(7) are

1 Under the Final Rules, a "banking entity" includes any insured depository institution, any company that controls an insured depository institution, a foreign bank that is treated as a bank holding company and any affiliate or subsidiary of any of the foregoing entities.

2 Section 3(c)(1) of the Investment Company Act provides an exemption for funds sold to 100 or fewer investors, and Section 3(c)(7) provides an exemption for funds sold only to "qualified purchasers."

exemptions based on the manner of sale of the securities by the issuer, rather than on the attributes of the assets that the issuer may invest in or the attributes of the securities issued by the entity. These two private placement type exemptions were typically relied on for many securitization transactions where the underlying assets consisted of securities or derivatives, including a significant majority of the TruPS CDO transactions in which many banking entities invested.

Transactions that rely on different exemptions from the Investment Company Act are not covered funds under the Final Rules. For example, many securitization issuers relied on Section 3(c)(5)(C) or on Rule 3a-7 under the Investment Company Act (for mortgage-backed securities and other types of traditional asset-backed securities) or on Rule 3a-5 under the Investment Company Act (for finance subsidiaries), and investments in such securitizations are not subject to the Final Rules. The Final Rules also specifically exclude securitizations where the underlying assets consist solely of loans and other assets related to the servicing, purchasing, acquiring or holding of such loans.[3] The Final Rules contain a broad qualitative definition of loans and specifically excludes securities from the definition. The preamble to the Final Rules lists certain types of loans that the Agencies expect to be included in the definition of loans: residential and commercial mortgage loans, automobile loans, credit card receivables and student loans. As a result, many traditional loan securitization transactions are likely to fall outside the scope of the Volcker Rule, but CDO and collateralized loan obligations structures will need to be evaluated under other Investment Company Act exemptions to determine whether they are covered funds.

On December 19, 2013, the FRB, the FDIC and the OCC (the Banking Agencies) issued a Frequently Asked Questions document to provide clarification and guidance to banking entities regarding investments in covered funds and whether TruPS CDOs could be determined to be covered funds under the Final Rules (the FAQs). The FAQs provide an overview of some of the key legal issues banking entities should consider in determining whether holdings of TruPS CDOs are subject to the Final Rules, including whether a TruPS CDO qualifies in its current form as a covered fund under the Final Rules, whether it can be restructured or otherwise conformed to the Final Rules by the end of the conformance period (i.e., by July 21, 2015) and whether the investment in the CDO constitutes an ownership interest.

The FAQs confirm that, under the Final Rules, an issuer that could have relied on an exemption from the definition of investment company under the Investment Company Act other than the Sections 3(c)(1) or 3(c)(7) exemptions will not be considered a covered fund so long as it satisfies the conditions of another Investment Company Act exemption. Therefore, even if a TruPS CDO is relying on the Section 3(c)(1) or 3(c)(7) exemptions as of the effective date of the Final Rules, it will not be considered a covered fund under the Final Rules (and divestiture will not be required) if it also satisfies the conditions of another Investment Company Act exemption.

Is the Investment in a TruPS CDO an "Ownership Interest" under the Final Rules?

The Final Rules defines an "ownership interest" as any equity, partnership or other similar interest. An "other similar interest" is defined as an interest that has <u>any</u> of the following characteristics:

- the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (other than the rights of a creditor to exercise remedies upon the occurrence of an event of default or similar rights arising due to an acceleration event);
- the right to receive a share of the income, gains or profits of the covered fund;
- the right to receive the underlying assets of the covered fund, after all other interests have been redeemed and/or paid in full;
- the right to receive all or a portion of excess spread;
- a provision that the amounts payable by the covered fund with respect to the interest could, under the terms

3 See Final Rule §__.10(c)(8).

of the interest, be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest; or

- the receipt of income on a pass-through basis from the covered fund, or a rate of return that is determined by reference to the performance of the underlying assets of the covered fund.

The rights provided to investors in a CDO structure may include certain of these elements, and the first and fifth characteristics noted above may be a particular concern. As a result, even though such interests are not typically considered "equity interests," given the breadth of the above characteristics, and in the absence of further regulatory guidance, banking entities need to carefully review their investments to determine whether any of the above rights or characteristics exist. In the preamble to the Final Rule, the Agencies have implied that investments in CDOs constitute ownership interests in covered funds under the Final Rules.[4] In addition, both the public commentary and the recent response of the Agencies described below evidence a consensus that TruPS CDOs, as currently structured, will fall within the definition of a "covered fund" and that the interests in the securities issued by the TruPS CDOs and held by banking entities are "ownership interests" under the Final Rules.

Recent Developments Relating to the Treatment of Investments in TruPS CDOs

On December 24, 2013, the American Bankers Association (ABA) filed lawsuits against the Banking Agencies in the United States District Court for the District of Columbia and the District of Columbia Circuit Court of Appeals objecting to the requirement that banks treat investments in TruPS CDOs as ownership interests in covered funds. On December 27, 2013, just three days after the lawsuits were filed, the Banking Agencies and the SEC issued a statement indicating that they are evaluating whether or not it is appropriate to subject pooled investment vehicles for TruPS, such as TruPS CDOs, to the prohibitions on the ownership of covered funds under the Volcker Rule. In issuing the statement, the agencies acknowledged the concerns raised by a number of community banking organizations that the Final Rules conflict with the Congressional determination under Section 171(b)(4)(C) of the Dodd-Frank Act to grandfather TruPS issued before May 19, 2010 by certain depository institution holding companies with total consolidated assets of less than US$15 billion, many of which were issued through TruPS CDOs, and that the investments and capital levels of a number of community banking organizations might be adversely affected if pooling vehicles formed for the purpose of holding TruPS are treated as covered funds. The agencies further indicated that they intend to address the matter no later than January 15, 2014 and that any actions in January 2014 that occur before the issuance of December 31, 2013 financial reports (including the FR Y-9C and the call report) should be considered by banking entities when preparing those financial reports. Further reports have emerged in recent days indicating that the Agencies are considering a blanket exclusion for all existing TruPS CDOs, but it is not clear whether the Agencies will attempt to use a qualitative approach leaving further interpretive questions, take a specific approach providing clear guidance or ultimately refrain from acting.

What Should Banking Entities Do Now?

As indicated above, based on the Final Rules and the recent FAQs and statement by the Banking Agencies, unless the Banking Agencies take further action to exempt investments in TruPS CDOs from the scope of the Volcker Rule, such investments are likely to be considered ownership interests in a covered fund that must be divested by the end of the conformance period. Accordingly, banking entities holding investments in TruPS CDOs, while keeping a close watch on any Agency action, should be reviewing their investments with counsel to determine whether the CDO is a "covered fund" and, if so, whether the interest held by the banking

4 See page 3 of the document titled "The Volcker Rule: Community Bank Applicability" released by the Banking Agencies on December 10, 2013, which notes that only a small number of banks own collateralized loan obligations or CDOs (including CDOs backed by TruPS) that meet the definition of covered funds in the Final Rules and that "if a community bank did not organize and offer the particular covered fund … the bank will have to divest in accordance with the conformance period in the Final Rule."

entity is an "ownership interest" as defined in the Final Rules. In particular, the structure of the transaction and the underlying offering documents will need to be carefully reviewed to identify whether the CDO issuers relied on the Section 3(c)(1) or 3(c)(7) exemptions or whether another exemption was used or is available, and to determine whether the terms of the interests held by the banking entity contain any of the rights or characteristics described above. The FAQs open the possibility that the TruPS CDO could be restructured to comply with another exemption from the Investment Company Act.[5]

If a banking entity determines that its investment in a TruPS CDO is an ownership interest that is required to be divested, the banking entity should consult with its independent auditors on whether the investment, if treated as held-to-maturity, should be reclassified as available-for-sale as of December 31, 2013 and then consider timing to divest of the investment.[6] Alternatively, as described in the FAQs, the banking entity may also evaluate whether there is a likelihood that the TruPS CDO could be restructured during the conformance period to avail itself of another exclusion or exemption under the Investment Company Act, such that, as restructured, the CDO is no longer a covered fund (and therefore the banking entity would not need to divest its investment), or whether there is likely to be a modification or change to the rights of the security held such that it no longer falls within the definition of an ownership interest. However, the restructuring of a substantial number of existing TruPS CDOs is problematic, primarily due to the difficulty in obtaining the consents needed from majority holders of the TruPS CDOs who may not be affected by the Volcker Rule (much of the CDO paper is not held by depository institutions) and may therefore have little incentive to consent to a restructuring of the transaction.

If a banking entity determines that an investment should be divested immediately, then it should consult with its accountants and counsel regarding the necessary accounting adjustments and the impact on its financial statements, as well as the related impact on its securities law disclosure and reporting obligations (i.e., as a result of the reclassification of the investment from held-to-maturity to available-for-sale and any required adjustment of the value of the investment to fair value through an other than temporary impairment (OTTI) charge to earnings).

Recommended Further Actions

In light of the foregoing, and the potential tremendous negative impact on the community banking industry and the TruPS CDO market of including investments in TruPS CDOs within the scope of the prohibitions of the Volcker Rule, we strongly recommend that community banks, directly or through counsel, communicate with the Agencies and their respective Congressional representatives, as well as continue to work with the various banking trade associations, to encourage the Agencies to exercise the discretion provided to them under the Dodd-Frank Act and the Final Rules to exclude these investments from the scope of the Volcker Rule.

The holding of such investments by banking entities is not inconsistent with the purposes and intent behind the Volcker Rule. The TruPS CDO structures are primarily single purpose entities with either limited or no ongoing investment discretion. The structures can be categorically divided into (a) static pools, where the initial investments in trust preferred securities are held and cash flow passed through to the security holders and (b) managed pools, where an investment manager can dispose of specific investments and reinvest proceeds into other trust preferred securities. Despite the managed aspect of these latter structures, the investment policy is likely limited, thus avoiding much

5 The FAQs also note that the Banking Agencies expect banking entities to undertake good faith efforts to engage in and resolve such analysis in a timely fashion during the conformance period. The FAQs also indicate that, if a banking entity initiates actions to restructure the CDO or otherwise conform its interests in and relationships with the CDO to the requirements of the Final Rules, the Banking Agencies expect the banking entity to develop a conformance plan that is appropriately specific regarding the entity's plans to bring its holdings in the TruPS CDOs into full conformance with the Final Rules.

6 Although the FAQs indicate that the Final Rules do not require banking entities that have holdings in TruPS CDOs to sell these holdings immediately, but instead may use the conformance period, which ends on July 21, 2015, to determine if the holdings can be brought into conformance by the end of that period, once a determination is made that the investment cannot be brought into conformance with the Final Rules, the banking entity would likely need to adjust the accounting treatment of the asset immediately.

of the risk the Volcker Rule was intended to address. The Volcker Rule very specifically prohibits banks from engaging in proprietary trading and the restriction on investing in covered funds is designed to prevent investment in entities that themselves engage in proprietary trading. At its core, the Volcker Rule and the Final Rules are intended to further promote a safe and sound banking system. It would appear well within the discretion given to the Agencies by the Volcker Rule to determine that TruPS CDOs do not constitute an unsafe or unsound banking practice and to deem such interests not to be covered funds and therefore permissible investments for banking institutions.

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

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Volcker Rule – Final Implementing Rules

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In December 2013, the federal banking agencies, SEC and CFTC adopted final rules implementing the "Volcker Rule." The Volcker Rule was enacted in 2010 as section 619 of the Dodd-Frank Act and is codified as section 13 of the Bank Holding Company Act (12 USC § 1851). The final implementing rules are codified at 12 C.F.R. §§ 44 (OCC), 248 (Federal Reserve), and 351 (FDIC), and 17 C.F.R. §§ 75 (CFTC) and 255 (SEC). The final implementing rules are effective April 1, 2014 and activities and investments must be conformed by July 21, 2015.

The Volcker Rule prohibits short-term proprietary trading in securities or derivatives by "banking entities." "Banking entities" include FDIC-insured depository institutions (banks, thrifts, industrial loan companies, credit card banks and certain other nonbank banks) and their parent companies, subsidiaries, sister affiliates and other companies under their common control. Also included are non-U.S. banks that have a U.S. branch, agency office, Edge Act or other commercial lending subsidiary or subsidiary U.S. bank. Non-depository trust companies are not "banking entities" unless they are affiliated with a "banking entity." Financial entities that have been designated as "systemically important" by the FSOC may be subject to some or all of the Volcker Rule at the discretion of the Federal Reserve.

The Volcker Rule also prohibits banking entities from "sponsoring," having an "ownership interest" in or engaging in certain "covered transactions" with, "covered funds." "Covered funds" are privately-placed issuers that rely on either the section 3(c)(1) (fewer than 100 beneficial owners) or section 3(c)(7) (beneficial owners limited to high net worth and institutional qualified purchasers) exemptions from the Investment Company Act. The Volcker Rule also limits the term of relationships between banking entities and covered funds, and imposes new disclosure obligations for covered funds serviced by banking entities.

The Volcker Rule contains detailed, highly technical exemptions that permit certain proprietary trading and covered funds activities by banking entities.

The Volcker Rule imposes corporate governance, compliance and control program, record keeping, regulatory reporting, training and audit requirements on banking entities. These requirements become more stringent and detailed based upon the size of the banking organization and scope and nature of its activities.

Proprietary Trading Restrictions

Under the Volcker Rule and the implementing regulations, subject to certain exemptions, banking entities are prohibited from "proprietary trading" in financial instruments (broadly, securities and derivatives, as described in detail below). The proprietary trading prohibition is essentially limited to short-term trading or trading that is designed to profit from short-term price movements.

The rules employ a complex approach that relies on a series of interwoven definitions to arrive at the final result, but in essence, the proprietary trading ban will apply when a banking entity acts as a principal in the following three situations:

- Where the position is a market risk capital rule covered position and a trading position (or is a hedge of such a position).
- Where the banking entity is a dealer in securities, swaps, or securities-based swaps, and the transaction is in connection with dealing activities (with an exemption for permitted underwriting and dealing book positions).
- Where the purpose of the transaction is to benefit from short-term trading (including hedging a short-term trade).

Long-term investments are still permitted (subject, of course, to the prohibition on investments in covered funds, as described below). In order to draw some distinction between short-term trades and long-term investments, the rules stipulate that if a position is held for fewer than 60 days, or if the risk of the position is substantially transferred within 60 days, there will be a rebuttable presumption that the trade is short-term. On the other hand, if a position is held for longer than 60 days, there is no presumption or safe harbor that that trade was *not* for short-term purposes.

The ban is limited to transactions in “financial instruments,” and defines that term so that certain instruments are excluded. Specifically, loans, spot-market commodities and spot-market foreign exchange or currencies are not deemed to be financial instruments subject to the trading ban. Physical real estate, 1934 Act section 3(a)(3) commercial paper, and bank deposits also generally are not “securities” or financial instruments for this purpose. On the other hand, securities (whether debt, equity or other securities), futures, swaps and options are all covered.

The rules further specify that the following types of transactions are not deemed to be “proprietary trading”:

- Purchases or sales under a repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty;
- Purchases or sales that arise under a transaction where the banking entity lends or borrows a security temporarily pursuant to written securities lending agreements;
- Purchases or sales of securities in accordance with a documented liquidity management plan;
- Purchases or sales in connection with clearing where the banking entity is a derivatives clearing organization or a clearing agency;
- Certain clearing activities by a banking entity that is a member of a clearing agency, derivatives clearing organization, or designated financial market utility;
- Purchases or sales to satisfy an existing delivery obligation of the banking entity or its customers (including to prevent or close out a failure to deliver), in connection with delivery, clearing, or settlement activity, or in satisfaction of an obligation of the banking entity in connection with a legal or similar proceeding;
- Purchases or sales where the entity acts solely as agent, broker, or custodian;
- Purchases or sales through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity, where the entity acts as trustee for the benefit of persons who are or were employees of the banking entity; and
- Purchases or sales in the ordinary course of collecting a debt, provided that the banking entity divests the financial instrument as soon as practicable, and not longer than may be permitted by regulators.

The final implementing rules also include certain exceptions from the ban on proprietary trading. Each of the exceptions is highly qualified, and requires extensive compliance structures designed to prevent the banking entity from straying into prohibited activities. Specifically, exceptions from the prohibition are provided for:

- Underwriting;
- Market making;
- Risk-mitigating hedging;
- Trading in domestic government securities;

- Trading in foreign government obligations;
- Trading on behalf of customers;
- Trading by regulated insurance companies; and
- Trading by foreign banking entities.

All of these exceptions are subject to three overarching limitations. Specifically, transactions and activities under the exceptions may not:

(1) Involve or result in a material conflict of interest with clients, customers, or counterparties (though conflicts may be addressed by use of effective disclosures, information barriers, or both);

(2) Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a "high-risk" trading strategy. "High-risk" assets and strategies are those that would significantly increase the likelihood of a substantial loss or pose a threat to U.S. financial stability; or

(3) Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

Covered Funds Restrictions

Subject to various specific exemptions and exclusions, the Volcker Rule prohibits a banking entity from "sponsoring," having an "ownership interest" in, or engaging in "covered transactions with" covered funds. "Covered funds" are privately offered funds or pools that either (i) rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act for an exemption from that Act, (ii) are commodity pools offered privately in reliance on exemptions in CFTC Rule 4.7 (or to certain types of investors specified in Rule 4.7), or (iii) are similar private foreign investment funds or pools.

There is a range of types of investment funds and pools that are not within the definition of a "covered fund." A fund or pool may be a non-covered fund outside the definition of "covered fund" under the Volcker Rule if: (i) it is not within the broad definition of "investment company" in Section 3(a) of the Investment Company Act and is not a private commodity pool; (ii) it is registered as an investment company or business development company with the SEC under that Act; (iii) it is able to rely from some exemption or exclusion from regulation other than Section 3(c)(1) or 3(c)(7) under that Act; or (iv) it is eligible for an exemption under the Volcker Rule.

These non-covered funds include investment companies and business development companies that are registered as such with the SEC, foreign investment companies that are publicly offered outside the United States, qualified U.S. pension and employee benefit plans and similar foreign pension and benefit plans, government pools excluded by Section 2(b) of the Investment Company Act, funds and pools that are not within the basic definition of an "investment company" in Section 3(a) of the Investment Company Act (generally do not hold themselves out as being engaged primarily in investing, reinvesting or trading in securities and have less than 40% of their assets invested in securities – whole property real estate partnerships and funds being an example) if they are not private commodity pools. In addition, non-covered funds include issuers that are excluded from regulation under the Investment Company Act by any provision other than Section 3(c)(1) or 3(c)(7) and that are not private commodity pools. Examples include entities exempt under Section 3(b) (by order or analysis – examples include certain partial-ownership conglomerates seen in Northern Europe and Asia), entities that have received an exemption from regulation from the SEC pursuant to an order issued under Section 6(c) of the Investment Company Act, oil, gas and mineral rights funds exempt under section 3(c)(9), and charitable investment pools, church plans, bank common and collective investment funds, pools of mortgages and real estate interests exempt under Section 3(c)(5)(C), swap dealers, banks, thrifts, insurance companies, finance companies and factors, and broker-dealers (each of which has a statutory exclusion from the definition of an "investment company" under that Act). Other exempt entities may rely on special rules adopted by the SEC under the Investment Company Act including Rules 3a-1 (which expands on the 60/40% asset test for certain types of business operations, but does not exempt merchant banks), 3a-2 (issuers that inadvertently and temporarily trip the 40% asset test in section 3a of the Investment Company Act), 3a-3 (subsidiaries of non-fund entities), 3a-4 (mini account advisory programs), 3a-5 (finance subsidiaries), 3a-6 (foreign banks and foreign insurance companies), 3a-7 (certain asset securitizations) and 3a-8 (research and development companies).

It is not uncommon for pools that might fit within certain of the above restrictions to also rely on either Section 3(c)(1) or 3(c)(7) of the Investment Company Act because those two "private fund" exemptions are often simpler to document and meet. If a pool or fund can and does meet some other exemption from the Investment Company Act, but also meets Section 3(c)(1) or 3(c)(7), it is not a "covered fund" under the Volcker Rule (unless it is a private commodity pool). However, it may be necessary to take additional steps to document and conform such a pool to the requirements of the other exemption that is available to it to escape Volcker Rule covered funds status. We anticipate that, in the future, new pools may more commonly seek to utilize these other exemptions if they are sponsored or advised by banking entities or are offered to banks for investment as principal.

The Volcker Rule and the final implementing rules provide a series of exclusions from the definition of a "covered fund" for some subsidiaries and joint ventures, qualified asset-backed commercial paper conduits, bank-owned life insurance (BOLI), insurance company separate accounts (an exemption for the insurance company as sponsor/issuer), foreign pension plans, foreign public investment funds, SBA-licensed small business investment companies (SBICs), historic tax-credit funds, low-income housing tax credit funds and other CRA/public welfare investment funds, and investment companies that are in process of becoming registered. Each of these exemptions has its own specific and detailed requirements. Also excluded are portfolio companies owned by SBICs or merchant banking subsidiaries of financial holding companies.

The Volcker Rule prohibits, subject to certain exemptions, a banking entity from acquiring or retaining as principal an "ownership interest" in a covered fund. "Ownership interest" is defined to include essentially any type of equity interest (other than certain carried interests used to receive performance allocations). In addition, "ownership interest" includes certain debt investments if they include certain equity-like features such as voting rights, power to replace trustees or directors of the fund, or include a participation in the earnings or returns of the fund. Interests owned by bank personnel in their private capacity are not attributed to the banking entity unless financed by the banking entity or the banking entity guarantees against loss the investment of the personnel.

The Volcker Rule excludes "covered funds" from the definition of "banking entity" in order to permit covered funds to engage in proprietary trading and invest in other covered funds. One downside to a bank-controlled fund being excluded from the definition of "covered fund" is that the fund, if "controlled" (within the meaning of the Bank Holding Company Act) by a banking entity, may itself be a banking entity that is subject to the proprietary trading and covered funds investment restrictions of the Volcker Rule. The Volcker Rule addresses this issue for some types of exempted entities such as qualified pension plans and SBICs, but leaves the issue unresolved for some other types of entities.

The Volcker Rule also, subject to certain exemptions, prohibits a banking entity from "sponsoring" a covered fund. "Sponsorship" is defined to include (i) sharing a name with the fund; (ii) serving as trustee, general partner or managing member of the fund; or (iii) controlling the election of (or having personnel who comprise) a majority of the directors or trustees or managers of a covered fund. Serving as commodity pool operator to a private commodity pool also constitutes "sponsorship."

Sponsorship does *not* include acting as an adviser, sub-adviser, placement agent, custodian, or administrator to a covered fund, or organizing and offering a covered fund.

The Volcker Rule and the final implementing rules provide a series of specific and technical exemptions or exclusions from the prohibitions on a banking entity having an ownership interest in and/or sponsoring a covered funds. These include an exemption permitting sponsorship of and limited investment in "fiduciary funds" established by a banking entity engaged in fiduciary activities for its "clients" in connection with those fiduciary activities (subject to a written plan as to how the fiduciary fund fits into the banking entity's provision of fiduciary services but reaching "clients" whose only receipt of fiduciary services is indirectly through investment in the fiduciary fund), and a similar exemption for certain asset securitizations sponsored by the banking entity (which is not limited to a fiduciary type fund). These two exemptions limit investments in such a fund relying upon this exemption by bank entity personnel only to those personally involved in providing services to the fund in which they invest and subject the investment by the banking organization to a cap of no more than 3% of the regulatory capital of the banking organization in the aggregate in all such funds and 3% (after a one-year ramp up period) of the fund equity of any one such fund, or up to 5% of the equity if required by the Dodd-Frank Act risk-retention requirement applicable to some asset securitizations. These two exemptions also include certain disclosures that must be made to investors. A capital haircut applies to investments held by a banking entity under these exemptions.

Notably, the prohibition on investment by non-involved banking entity personnel in a sponsored fund does not apply to their investment in a non-sponsored fund, even if advised and administered by the banking entity.

The Volcker Rule also provides an additional exemption that permits banking entities to invest in certain loan securitizations sponsored by others. There are a number of technical requirements to this exemption, including restrictions on the investment of cash and on investments in anything other than loans that may make determining and documenting compliance with this exemption for existing investments more complex. We anticipate that future loan securitization deals will be documented and structured to fit more clearly within this exemption.

The Volcker Rule contains an exemption permitting certain investments for risk-reducing hedging activities. This exemption has several conditions that make it narrower than might first appear to be the case.

The Volcker Rule imposes specific disclosure requirements and language which is designed to establish that the investors in covered funds are aware that they, and not the bank, bear the risk of loss on the investment, as well as disclosure obligations regarding the roles performed by the banking entity and potential conflicts of interest in those roles.

The Volcker Rule prohibits a banking entity from engaging in "covered transactions" (as defined in Section 23A of the Federal Reserve Act, 12 U.S.C. § 371c and Federal Reserve Regulation W, 12 C.F.R. § 223) with a covered fund that is advised or sponsored by the banking entity or its affiliates or with any covered fund controlled by such fund. Examples of covered transactions are loans and other extensions of credit, guarantees, derivatives transactions as principal, and asset purchases and investments in or with the covered fund. An exemption from this Volcker Rule covered transaction provision applies to investments by a banking entity if permitted under the fiduciary fund or sponsored asset securitization provisions. Certain prime brokerage relationships between a banking entity and a covered fund that is controlled by a covered fund advised or sponsored by the banking entity also may be eligible for an exemption from this prohibition. The "super 23A" prohibition in the Volcker Rule, unlike Section 23A itself, is a flat prohibition rather than a limit, and applies to any banking entity not just a bank and bank subsidiaries, in their transactions with a covered fund. Notably, this prohibition does not apply to transactions by a banking entity with a covered fund that is not sponsored or advised by the banking entity or its affiliates. The Volcker Rule also applies the "arms-length terms" requirements of Section 23B of the Federal Reserve Act and Regulation W to transactions by a banking entity involving a covered fund sponsored or advised by the banking entity or its affiliates.

The Volcker Rule also prohibits relationships with covered funds by a banking entity that involve material (undisclosed) conflicts of interest, or that pose material risks to the banking entity or the financial system. The final implementing rules provide a means to address conflicts of interest through disclosures to investors and information barriers within the banking organization.

Volcker Rule Covered Funds Provision Traps

There are a number of traps for the unwary in the Volcker Rule and its final implementing rules. Some arise from the fact that the Investment Company Act, with its very broad definitions of "company," "securities" and "investment company," may pick up asset participations or fractionalized ownership interests not commonly understood to be funds and require their tacit reliance upon the Section 3(c)(1) or 3(c)(7) exemptions. Thus, an investment may be a "covered fund" under the Volcker Rule without the investors realizing it is a fund at all. Similarly, the broad definition of "ownership interest" in the Volcker Rule to pick up some debt instruments will be an unhappy surprise in some cases, and the very detailed and picky requirements of some of the exemptions may not precisely fit existing investment structures or documentation of their compliance may be difficult. A great deal of effort will be required to parse existing investments to determine (1) whether they are subject to the Volcker Rule or are excluded or exempt, and (2) whether and how the investments can be conformed to the requirements of an exemption.

Similarly, for new investments, a great deal of attention will be needed to screen potential investments for potential "covered funds" status. Essentially, care will need to be taken with any investment that is privately offered or restricted as to transfer, even if it does not immediately appear to be a "fund."

Corporate Governance

The Volcker Rule requires board oversight of the Rule's compliance effort. Generally, this includes assignment to a board committee of oversight responsibility, designation of specific management officials by the board to conduct those trading and covered funds activities subject to the restrictions of the Volcker Rule, designation of a compliance officer for Volcker Rule activities, and a reporting line for management and reporting personnel to periodically provide reports to the board or a board committee regarding the compliance effort.

An organization chart, showing the business units involved, the specific personnel responsible, and a time and responsibility chart documenting a plan for conformance with the Rule, the steps to be taken, and demonstrated progress against the plan, would be important elements of the reports by management to a board or board committee.

We anticipate that the level and frequency of this reporting to the board is likely to be greatest during the period in which the compliance program is being developed and implemented, and existing activities are conformed or divested (essentially, between the present and July 2015).

For the largest of banking organizations – those with US$50 billion or more in consolidated assets or that have been notified by the regulators that they are subject to the enhanced requirements – the CEO of the banking organization must annually make certifications to the regulators regarding the existence and effectiveness of the Volcker Rule compliance and control program.

Mapping and Documentation

The Volcker Rule essentially requires banking entities, as part of the process of conforming existing activities and investments and building a compliance program, to map out existing trading and covered funds activities and investments, the trading desks, business units and legal entities in which they are conducted, and the personnel responsible for them. These activities and investments must be compared to the requirements of the Volcker Rule, a gap analysis done of whether the existing activities and investments meet the Volcker Rule's requirements and what aspects are in non-conformity, and a plan developed to conform, terminate or divest them within the conformance period.

The task involves comparing, in detail, those activities and investments that potentially are subject to the Volcker Rule against the exclusions and exemptions in the Rule.

For proprietary trading, particular attention should be given to any activities conducted at a trading desk, at a dealer entity within the organization or through a broker-dealer, swap dealer or other similar service provider or counterparty, involving derivatives, or that is shown on the financial statements or reports as reflecting trading activity or frequent transactions. For covered funds activities, particular attention should be given to anything that appears to be a private investment fund or asset pool, asset securitizations that are not registered with the SEC, fractionalized or participated assets, private insurance products, commodity pools not registered with the SEC, anything sold with a private placement memorandum or similar document, restricted as to transfer, or offered under SEC Rule 144A or that mentions Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

For activities and investments that are in compliance (or are exempt from) the Volcker Rule, documentation of that compliance or exemption should be created and maintained as part of the mapping process.

Conforming Activities and Investments

The final implementing rules provide a one-year extension to the statutory conformance deadline (which was July 21, 2014) and require all activities and investment to be brought into conformity with the Volcker Rule on or before July 21, 2015.

New activities and investments in the interim should be screened in advance for conformity, and should not be undertaken or commenced unless they are in conformance with the Volcker Rule.

The agencies have directed that banking entities should promptly bring trading activities into conformity with the Volcker Rule, rather than waiting until 2015.

Existing activities and investments in covered funds – particularly those involving illiquid assets or structures that require approvals from third parties to change or divest – may be difficult to alter within a short period of time. Banking entities that have not already done so should promptly commence the process of identifying covered funds activities that need to be conformed, and developing a plan to conform or divest them.

Because the restrictions on proprietary trading relate generally to short-term positions that will resolve themselves in the ordinary course well before 2015, conforming existing trading activities in some ways may be simpler than conforming covered funds investments and activities. As a result, the Volcker Rule provides authority for the Federal Reserve to grant certain extensions for the compliance date in its discretion to certain covered funds investments – particularly illiquid funds acquired prior to May 2010, and seed-money investments in fiduciary funds.

If a banking entity is to have any real hope of getting such an extension, it will need to demonstrate that it has been prompt and diligent in its efforts to conform or divest the position, and has not waited until late in the process to address the issue.

Compliance and Control Program

The final implementing rules set new compliance program requirements for almost all banking entities. The compliance program requirements come in four different tiers, with two additional components that can come into play for entities with significant assets, or that have significant amounts of proprietary trading or covered investments.

> *Tier 1: No Compliance Program*. If a banking entity has no investments in covered funds, and does not engage in proprietary trading (other than in domestic government obligations), it is not required to have a Volcker Rule compliance program. It would only be required to implement such a program before it engages in any covered activities. As a matter of best practices, however, even the smallest banking entity should implement some sort of simplified structure that would help to prevent it from wandering into restricted territory.

> *Tier 2: Limited Compliance Program*. The new regulations provide that banking entities with total consolidated assets of US$10 billion or less may satisfy the compliance program requirements by including in their existing policies and procedures appropriate references to the Volcker Rule and its final implementing rules.

> *Tier 3: General Compliance Program*. Most banking entities will be required to implement a generalized program to ensure and monitor compliance. The regulations require that programs must, at a minimum, include written policies and procedures, internal controls to monitor activities and prevent violations, a framework to delineate management responsibility and accountability, independent testing and audit of the compliance program, training, and recordkeeping.

> *Tier 4: Enhanced Compliance Program*. Where a banking entity has total consolidated assets of US$50 billion or more, or is subject to the reporting obligations for significant trading discussed below, or is directed by regulators, it will be subject to the most detailed and stringent compliance program requirements. In general, these requirements expand upon those specified for the general program (e.g., internal controls, training, management frameworks, etc.). For example, the CEO of a banking entity that falls under this program requirement will have to attest yearly in writing to regulators as to the maintenance of an appropriate compliance program.

As noted above, two additional components may come into play for entities with significant assets, or that have significant amounts of proprietary trading or covered investments.

Reporting for Significant Trading. A banking entity will have to report specific trading metrics to regulators when the average gross sum of its and its affiliates' trading assets and liabilities (not including those involving U.S. Treasuries and agency securities) exceed specific levels, or when it is directed to do so by regulators. These metrics include:

- risk and position limits and usage;
- risk factor sensitivities;
- value-at-risk and stress value-at-risk;
- comprehensive profit and loss attribution;
- inventory turnover;

- inventory aging; and
- customer facing trade ratio.

Reporting will be implemented on a rolling basis, so that the most active banking entities will be required to report first. Thus, as of June 30, 2014, the reporting threshold will be US$50 billion in trading assets and liabilities. Entities that reach this level will have to report data on a monthly basis. As of April 30, 2016, the threshold for reporting will fall to US$25 billion, and as of December 31, 2016, the threshold will fall again to US$10 billion. Entities that exceed these levels of trading will be required to report quarterly.

Investment Fund Documentation Requirements. For banking entities with more than US$10 billion in total consolidated assets, specific documentation will be required as to fund investments. Such banking entities will be required to document their legal conclusions that each fund sponsored by the banking entity (including all subsidiaries and affiliates) is not a covered fund. In addition, for a seeding vehicle that will become a registered investment company or SEC-regulated business development company, the banking entity will be required to create and preserve a written plan to document, among other things, the period of time during which the vehicle will operate as a seeding vehicle, and the banking entity's plan to market the vehicle to third-party investors and convert it into a registered investment company or SEC-regulated business development company. Other documentation requirements apply to U.S. banking entities with ownership interests in foreign public funds so that they do not exceed permissible amounts.

Training

Many recent rules issued by the federal banking agencies have mandated training for staff on compliance with the Rule. The final rules implementing the Volcker Rule follow this trend. The final implementing rules require compliance training for trading personnel and managers, as well as other appropriate personnel, as part of the basic compliance program requirements. Training should, of course, be documented in order to establish that it has been conducted for the relevant personnel.

Appendix B of the final implementing rules, which provides additional details for banking entities subject to the "enhanced" compliance program requirements, further requires that the banking entity provide adequate training to personnel and managers who are engaged in activities subject to the Volcker Rule and to other supervisory, risk, independent testing, and audit personnel. The training must be provided at intervals and times appropriate to the complexity of the entity's proprietary trading and covered fund activities.

Audit

The final implementing rules require a banking entity to undergo periodic independent testing and audit of the effectiveness of its compliance program (generally not less frequently than annually). The independent audit must be conducted either by qualified audit personnel of the banking entity or by an external auditor. Appendix B provides additional details on the requirements for an independent audit, for those banking entities subject to the enhanced compliance requirements.

The required independent testing includes evaluation of the adequacy and effectiveness of the compliance program, and review of whether the program contains all the required elements; effectiveness of internal controls, including review of any breaches; and effectiveness of management procedures.

Independent testing must be conducted by a qualified independent party, which may be the banking entity's own internal audit department, compliance personnel or risk managers independent of the organizational unit being tested, outside auditors, consultants, or other qualified independent parties. Appropriate action must be taken to remedy deficiencies and weaknesses in the compliance program. Any violations must be resolved.

Recordkeeping and Regulatory Reporting

The Volcker Rule requires banking entities to create and maintain detailed records for at least five years to document their compliance with the Rule's requirements.

In addition, for banking entities engaged in a large volume of proprietary trading, the final implementing rules impose regulatory reporting obligations that go into effect in stages, based upon the aggregate size of the banking organization's trading books. For those with the largest trading books – US$50 billion and over – proprietary trading reports will be due monthly beginning June 30, 2014. Organizations with trading books of more than US$25 billion, but less than US$50 billion, must file quarterly proprietary trading reports starting April 30, 2016. Organizations with trading books with US$10 billion, but less than US$25 billion, must file quarterly reports beginning December 31, 2016.

Time Extensions to Conform Activities and Investments

The final implementing rules extended the Volcker Rule's statutory conformity date by one year, to July 21, 2015. The Federal Reserve has statutory authority to grant further extensions of time for compliance with the Volcker Rule, by rule or individual order. The broadest authority is for extensions regarding divestitures of interests in illiquid covered funds acquired prior to May 2010, and initial "seed money" investments in fiduciary funds. The final implementing rules indicate that an applicant seeking a extension submit the application at least 90 days prior to the expiration of time. We recommend any such submission allow additional processing time in advance of the expiration of time to conform the investment and provide strong evidence of the ongoing, diligent efforts of the banking entity to bring the investment or activity into conformity.

Exemptive Authority

The agencies have authority to grant additional exemptions, by rule, from the prohibitions in the Volcker Rule, if determined to promote the safety and soundness of banking entities and the financial stability of the United States. The exemptive authority was utilized in January 2014 on an emergency basis by the agencies to adopt an interim rule exempting certain CDOs collateralized by trust preferred securities (TruPS) that had been adversely affected by the implementing rules in a way that had not been anticipated by the agencies.

In addition, the SEC has plenary authority pursuant to Section 6(c) of the Investment Company Act to grant exemptions by rule or order to anyone from any or all of that Act, if determined to be in the public interest. This Section 6(c) exemptive authority, by providing an issuer with an exemption other than Section 3(c)(1) or 3(c)(7) of the Investment Company Act, provides an effective means by which the SEC can grant an exemption from the covered funds prohibitions of the Volcker Rule.

Enforcement

The Volcker Rule provides the agencies with authority to order a banking entity to terminate an activity or investment deemed to be in violation or evasion of the Volcker Rule. In addition, because the Volcker Rule is codified as part of the Bank Holding Company Act, the criminal penalties and civil money penalties in Section 8 of that Act (12 U.S.C. § 1847) potentially may be invoked for violations of the Volcker Rule.

Moreover, the federal banking agencies have additional authority under the Federal Deposit Insurance Act (12 U.S.C. § 1818) to bring enforcement actions administratively or in court for violations by a bank or certain of its affiliates for violations of any law, including the Volcker Rule. This enforcement authority provides for very large civil money penalties as well as a broad range of injunctive and equitable relief.

Foreign Banks

A foreign bank is subject to the Volcker Rule if it has a U.S. branch or agency office, a subsidiary U.S. insured bank, Edge Act, or other U.S. commercial lending subsidiary. These are the criteria that subject a foreign bank to the Bank Holding Company Act and Federal Reserve Regulation Y. A foreign bank may have a U.S. representative office, U.S. subsidiary broker-dealer, investment adviser, insurance agency, insurance company, swap dealer, non-depository trust company, or various other types of financial or nonfinancial subsidiaries in the U.S. without becoming subject to the Bank Holding Company Act or the Volcker Rule (unless designated as a SIFI by the FSOC and subjected at the discretion of the Federal Reserve to the Volcker Rule).

For those foreign banks that are subject to the Volcker Rule, provided that the top-tier entity is not a U.S. company, special exemptions and exclusions apply to permit proprietary trading that occurs solely outside the U.S. (the SOTUS exemption), as well as broader private funds activities. The final implementing rules address certain technical issues, including capital calculations for purposes of determining permitted amounts of investments in covered funds.

Notably, the European Union has begun considering adopting its own version of proprietary trading restrictions ("EuroVolcker") for systemically important banks. The interaction between the U.S. Volcker Rule and the final

EuroVolcker rule may create some complicated issues for banks with operations in Europe.

Thrifts, Credit Card Banks, ILCs and Insurance Companies

Although the Volcker Rule is codified in the Bank Holding Company Act, its coverage of "banking entities" is not limited to banks and bank holding companies that are subject to that Act. Any FDIC-insured depository institution is a "banking entity" subject to the Volcker Rule, as are companies that control, are controlled by or are under common control with, the insured institution.

A series of exemptions for U.S. and foreign insurance companies creates some leeway for proprietary trading and covered funds investments and activities for insurance companies that have banking entities as affiliates.

Conclusion

The Volcker Rule is a complex set of statutory and regulatory requirements that contain many uncertain provisions. Between now and July 2015, banking organizations will need to devote significant efforts to establishing a governance and management structure for oversight and conduct of proprietary trading and covered funds activities, bring their activities and investments into conformity with the Volcker Rule, and develop and implement a compliance and control infrastructure that allows the banking organization to operate in conformity with the Volcker Rule. New activities and investments must be carefully screened and documented for conformity with the Rule. Existing activities and investments should be mapped and measured against the requirements of the Volcker Rule and conformed, divested or terminated as soon as reasonably practical, but not later than July 15, 2015.

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OCC Proposes Heightened Supervisory Standards for Large Insured National Banks, Insured Federal Savings Associations and Insured Federal Branches

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On January 27, 2014 the Office of the Comptroller of the Currency (the "OCC") published proposed guidelines in the *Federal Register* ("Proposed Guidelines") that would formalize heightened supervisory expectations for large national banks, federal savings associations and federal branches of foreign banks. The OCC already has been examining some large institutions under these heightened standards since 2012 and meeting with management of these institutions quarterly for progress updates. Through the Proposed Guidelines, the OCC seeks to make these heightened expectations formal, enforceable and potentially applicable to a greater number of institutions.

The Proposed Guidelines would require the development of structural functions, risk assessments, cultural support and oversight in order to meet the OCC's standards. The Proposed Guidelines would apply to any national bank, federal savings association and federal branch of a foreign bank, with average total consolidated assets of US$50 billion or greater (together "Covered Banks" and each a "Covered Bank"), as well as other institutions deemed highly complex or of heightened risk. The OCC is proposing these guidelines through its authority to prescribe safety and soundness standards under section 39 of the Federal Deposit Insurance Act[1] ("FDI Act"). In accordance with this authority, the OCC has the discretion to require the submission of a compliance plan should the agency determine that a Covered Bank failed to meet the standards of the guidelines. The OCC is requesting comments on all aspects of the Proposed Guidelines by **March 28, 2014**.

Scope

The Proposed Guidelines apply to entities that the OCC has determined to be so large and/or complex that they require heightened expectations due to the exposure that they present to capital markets and the economy. These Covered Banks include insured national banks, insured federal savings associations and insured federal branches of foreign banks with average total consolidated assets of US$50 billion or more.[2] Once a Covered Bank crosses

1 12 U.S.C. § 1831p-1.

2 The average total consolidated assets would be calculated from the Covered Bank's call reports for the four most recent consecutive quarters.

the US$50 billion threshold, it would remain subject to the Proposed Guidelines regardless of whether it fell below the threshold at a later date. The OCC would have to make a determination that a Covered Bank was no longer highly complex or of heightened risk in order for that Covered Bank to be relieved of heightened supervisory expectations.

The OCC could also apply the Proposed Guidelines to an entity with less than US$50 billion in average total consolidated assets if the OCC determined that the entity had highly complex operations or otherwise presented a heightened risk. In making that determination, the OCC would consider an entity's complexity of products and services, risk profile and scope of operations. On an informal basis, the OCC has already applied heightened expectations on mid-size banks below the Proposed Guidelines' US$50 billion threshold. Therefore it is likely that the OCC would use its discretion to apply the standards of the Proposed Guidelines to a number of mid-size banks.

The OCC limited the scope of the Proposed Guidelines to insured entities, making the Proposed Guidelines generally inapplicable to non-depository trust banks and other uninsured entities. However, the OCC has indicated that it may apply the Proposed Guidelines to certain uninsured entities at a later date, either informally through the issuance of a policy statement, or through a separate regulation.[3]

The Proposed Guidelines assimilate existing guidelines applicable to federal savings associations with national bank guidelines. Specifically, the *Guidelines Establishing Standards for Safety and Soundness* and the *Guidelines Establishing Information Security Standards* originally issued by the Office of Thrift Supervision would continue to apply to federal savings associations under regulations and guidelines that currently apply to national banks and federal branches of foreign banks. Also, *Guidelines Establishing Standards for Residential Mortgage Lending Practices*, which currently apply only to national banks, federal branches of foreign banks and their operating subsidiaries would, for the first time, also apply to federal savings associations and their operating subsidiaries under the Proposed Guidelines.

3 Since the Proposed Guidelines are authorized and enforced under the FDI Act, they may only apply to insured depository institutions. However, the OCC could seek enforcement of the Proposed Guidelines as applied to uninsured entities under 12 U.S.C. § 1818, which applies to unsafe and unsound practices.

Risk Governance Framework

The Proposed Guidelines require Covered Banks to establish a risk governance framework ("Framework") for the management of risks inherent in their activities, and set forth minimum standards for the permissible design, implementation and oversight of the Framework. The Proposed Guidelines state that Covered Banks should address the following eight risk categories: credit risk, interest rate risk, liquidity risk, price risk, operational risk, compliance risk, strategic risk and reputation risk. The OCC also notes that it expects Covered Banks to address third-party risk as well, even though it is not one of the eight designated risk categories.

The Proposed Guidelines also permit a Covered Bank to satisfy the Framework requirements through the risk governance framework of the Covered Bank's parent company ("Parent Company"). In order for this substitution to occur, a Parent Company must have a risk governance framework that meets the minimum standards of the Proposed Guidelines. Also, the Covered Bank must show through an annual documented assessment that the risk profiles of the Covered Bank and the Parent Company are substantially similar.

Organizational Structure

The Proposed Guidelines require a Framework that engages three separate functions within a Covered Bank: front line units, an independent risk management department and an internal audit department.

Front Line Function

The front line units are the revenue generating business functions of the Covered Bank, as well as the support service departments such as legal, human resources, treasury, operations and information technology. The OCC expects these departments to own the risks of their activities. Under the Framework, these departments are responsible for providing ongoing assessments of the risks of their activities and establishing policies and procedures for managing these risks. These departments must report whether they are compliant with risk limits of the Framework to the Covered Bank's independent risk management department on at least a quarterly basis.

Independent Risk Management Department

Independent risk management (or risk organization or enterprise risk management) is the department within a Covered Bank responsible for monitoring aggregate risk. It creates the written Framework and updates it at least annually. The department also establishes risk management policies and processes for the Covered Bank and conducts ongoing monitoring of material risks.

Independent risk management must be subject to a reporting structure that maintains its independence from business lines and, at times, from the CEO of the Covered Bank. The head of the independent risk management department, the chief risk executive, must be one level below the CEO, and the Board or Board's risk committee approves the hiring, removal and compensation of this officer. The independent risk management department reports material risks of front line business departments to both the CEO and the Board or Board's risk committee. No front line business executive may oversee any independent risk management department. While the CEO may oversee the chief risk officer's day-to-day activities, the independent risk management department must report to the Board or Board's risk committee whenever its assessment of risk differs from the CEO's or when the CEO is not holding front line units accountable to the Framework.

Internal Audit Department

The internal audit department assesses the effectiveness of the Framework. Through an audit plan, this department evaluates whether the front line units and the independent risk management department are compliant with the policies and processes developed through the Framework. The internal audit department must maintain an exhaustive inventory of the Covered Bank's business lines, product lines, services, and functions, then assess the risks of these areas. The OCC has requested comment as to whether, in addition to the internal audit department, the independent risk management department should also be required to maintain a separate additional inventory of a Covered Bank. Through internal audit's inventory of the Covered Bank and corresponding risk assessment, the department should create an audit plan for rating the risks of each front line unit, product offering and service including services outsourced to third parties. The department must update the audit plan at least quarterly. The department should also utilize the audit plan ratings to conduct an independent annual assessment of the Framework culminating in a conclusion as to whether the Covered Bank is compliant with the Framework and whether the Framework is consistent with leading practices in the industry. Internal audit must also notify the Board's audit committee whenever there are significant deviations from the Framework by front line units or the independent risk management department.

The internal audit department must be independent of any front line department and the risk management department. The head of internal audit, the chief audit officer, must be one level below the CEO, and the Board's audit committee is responsible for approving the hiring, removal or compensation of this officer. The CEO or the Board's audit committee may supervise the day-to-day activities of the chief audit officer, but no executive of a front line department may oversee the chief audit officer.

Risk Governance Framework Requirements

In addition to organizational and structural elements, the Proposed Guidelines also require several written components to the Framework including a strategic plan, a risk appetite statement, a risk profile and concentration risk limits.

Strategic Plan

The CEO of the Covered Bank is responsible for developing a written strategic plan covering at least a three-year period. The strategic plan must state the mission of the organization, strategic objectives and the manner in which these objectives will be achieved. The strategic plan must also assess current and future risks of the Covered Bank and explain how the Framework will evolve to address anticipated risks. The strategic plan itself must also evolve should the Covered

Bank's risk profile change. The Board must approve the strategic plan and evaluate its implementation on at least an annual basis.

Risk Appetite Statement

The Covered Bank must develop a comprehensive risk appetite statement articulating the organization's risk tolerance in both qualitative and quantitative manners. Qualitatively, the risk appetite statement should describe the organization's risk culture and leadership's expectations regarding how risks should be treated, especially those risks that are not easily quantifiable. The quantitative component of the risk appetite statement should specify limits related to the earnings, capital and liquidity positions of the Covered Bank. These limits may be in the form of triggers, thresholds or impermissible activity boundary lines and they must be crafted to induce a proactive risk management response. Accordingly, the OCC has discouraged the use of indicators such as delinquencies, problem asset levels and losses as risk appetite limits and encouraged the use of stress testing to set the limits. The risk appetite statement must be approved by the Board or Board's risk committee and explicitly communicated and reiterated throughout the organization.

Risk Profile

The risk profile is an assessment of a Covered Bank's aggregate risks at a single moment-in-time. The independent risk management department is responsible for preparing the risk profile and monitoring the risk profile relative to the risk appetite statement. The independent risk management department must report the risk profile to the Board or Board's risk committee at least quarterly.

The OCC expects Covered Banks to have the information technology infrastructure to support the timely determination of the risk profile through risk data aggregation. For Covered Banks that are global systemically important banks, the OCC has stated that it expects these banks to adhere to risk data aggregation and reporting principles issued by the Basel Committee on Banking Supervision ("Basel Committee") for compliance by early 2016.[4] The OCC considers the Basel Committee's principles to be leading practices, and the agency would expect all Covered Banks regardless of their global systemic importance or asset size to align their risk data aggregation practices to these principles where possible.

Concentration Risk Limits

The Framework requires concentration risk limits and, as applicable, front line unit limits. These limits should align with the risk appetite statement. Accompanying these limits should be processes for addressing limit breaches. The processes should determine when breaches are to be reported to management, the Board and the OCC. The processes should also address documentation and resolution of breaches, as well as accountability measures.

Board of Director Oversight

The Proposed Guidelines require the Board to provide active and independent oversight of the Framework. The OCC expects the Board to actively challenge and oppose management when it believes that decisions could cause a Covered Bank's risk profile to exceed the risk appetite. It is likely that OCC examiners will inspect Board minutes for evidence of this active engagement. The Board must conduct an annual self-assessment of its oversight over the Framework. The Board must also consist of at least two members who are independent in that they are not part of the management of either the Covered Bank or Parent Company. These independent directors must receive ongoing formal training to ensure their abilities to provide oversight over the Framework. The OCC has specifically requested comment as to whether the two independent director requirement is appropriate.

Risk Management Culture

The Proposed Guidelines set cultural expectations for Covered Banks as to what the OCC views as elements of a safe and sound risk culture. The stature of the independent risk management and internal audit departments within a Covered Bank is a reflection of this culture according to the OCC. These departments should have all necessary resources, should be included in strategic decisions, and their reports and concerns should be regarded by management and the Board. Also, the risk appetite and limits that result from the Framework should be integrated into other areas of the Covered Bank's operations such as

4 *See* Basel Committee on Banking Supervision, Principles for Effective Risk Data Aggregation and Risk Reporting (Jan. 2013).

capital and liquidity stress testing, new product development, and acquisition/divestiture decisions.

The OCC also believes that a risk management culture is displayed through rigorous staffing and talent management efforts. The Proposed Guidelines require the establishment of processes for talent management that ensures the hiring, retaining, and succession planning of employees with the skills to effectively implement the Framework. Compensation of this talent should be competitive and tailored to incentivize effective risk management. However, the Proposed Guidelines prohibit any incentive-based compensation that could lead to material financial loss or could encourage inappropriate risk-taking.

Enforcement

If the Proposed Guidelines are finalized, then they would establish enforceable standards, subject to the OCC's discretion. If the OCC determines that a Covered Bank has failed to meet the Proposed Guidelines' standards as finalized then it has the option to initiate an enforcement proceeding under the authority of section 39 of the FDI Act. The OCC may request that the Covered Bank submit a compliance plan within 30 days describing the corrective actions to be taken and the timeframe for these actions. If the Covered Bank does not submit a compliance plan that the OCC deems acceptable, or if the OCC determines that the organization failed to comply with the compliance plan, then the OCC may issue a formal and public Order, which is enforceable in federal district court or through civil money penalties.

Conclusion

Through the Proposed Guidelines, the OCC is attempting to formalize and attach additional enforceability to expectations that the agency has been informally implementing since 2012. While many large national banks and federal savings associations may be familiar with these heightened expectations, they should still consider whether these Proposed Guidelines limit any current risk governance practices or organizational structures that may be effective for their organizations. Mid-size and even smaller banks should also consider these Proposed Guidelines because the OCC is reserving the discretion to make these institutions Covered Banks on a case-by-case basis. Given the supervisory trends of the OCC it is possible that some principles from these Proposed Guidelines will still be informally imposed during examinations of institutions, regardless of size.

Arnold & Porter LLP is available to respond to questions raised by the Proposed Guidelines or to provide any assistance in drafting comments in anticipation of the March 28, 2014 submission deadline. For further information, please contact your Arnold & Porter attorney or:

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The U.S. Federal Banking Agencies to Require Large Banks to Maintain a Liquidity Coverage Ratio

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The U.S. federal banking agencies have issued a proposal to require banking firms with at least US$50 billion in total consolidated assets to maintain a 100% liquidity coverage ratio (LCR).[1] The proposed rule is intended to be consistent with the LCR standard that the Basel Committee on Banking Supervision has established for large, global banks as part of the Basel III liquidity framework. But one obvious deviation is that the U.S. proposal would apply a modified LCR requirement to some firms that are not internationally active. Although U.S. bank regulators previously have addressed liquidity in examination ratings and reserve requirements, and as a prudential matter on an *ad hoc* basis, the LCR rule would be the first quantitative liquidity requirement formally included in U.S. banking regulations.

I. Applicability

The standard LCR requirement in the proposed rule is designed to help ensure that banks have sufficient liquidity to survive a 30-calendar-day stress period. It would apply to a depository institution or depository institution holding company with US$250 billion or more in total consolidated assets or US$10 billion or more in total on-balance sheet foreign exposure, as well as a consolidated subsidiary depository institution of such a banking firm that has US$10 billion or more in total consolidated assets. It would also apply to a nonbank financial company that the Financial Stability Oversight Council has designated for supervision by the Federal Reserve Board.

The modified LCR requirement would require sufficient liquidity for a 21-calendar-day stress period – essentially requiring banks in the US$50 to US$250 billion size range to maintain 70% of the full liquidity requirements applicable to the largest banks. It would apply to a depository institution holding company that has US$50 billion or more in total consolidated assets but would not be subject to the standard LCR requirement.

A savings and loan holding company with substantial insurance underwriting or commercial activities would not be subject to the LCR requirement; nor would a bank holding company or nonbank financial company with substantial insurance underwriting activities.

1 Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring; Proposed Rule, 78 Fed. Reg. 71818 (Nov. 29, 2013).

Most banking organizations with less than US$50 billion in consolidated assets are not subject to the proposed LCR requirement.

II. The LCR Requirement

The proposed rule would require a bank to calculate its LCR on each business day, as of the same time, which the bank would need to select before the effective date.[2] The LCR would be calculated as the bank's high-quality liquid asset (HQLA) amount divided by its total net cash outflow amount. The minimum LCR requirement would be 1, which means the bank's HQLA amount must be no less than its total net cash outflow amount. The LCR is designed to help ensure short-term liquidity as its calculation is based on a 30-calendar-day stress period, as discussed below.

III. High-Quality Liquid Assets

The proposed rule identifies three classes of HQLAs and lays out the criteria for each class. It describes the criteria that HQLAs must meet to be included in a bank's HQLA amount, the operating requirements that a bank must meet to include HQLAs in its HQLA amount, and the limits on including level 2 liquid assets in the HQLA amount.

A. Criteria for Each Class of HQLAs

The proposed rule provides for three classes of HQLAs, based on the counterparty or issuer: level 1 liquid assets, level 2A liquid assets, and level 2B liquid assets.

Level 1 liquid assets would generally consist of central bank reserves that the bank may freely use, as well as securities issued or unconditionally guaranteed by the U.S. Treasury. Level 1 liquid assets would also include liquid and readily marketable securities issued or unconditionally guaranteed by foreign sovereign entities or certain multilateral organizations, and assigned a 0% risk weight under the regulatory capital rules (but a 0% risk weight would not be required if the sovereign issued the securities in its own currency, and the bank holds the assets to meet its liquidity needs in that jurisdiction).

Level 2A liquid assets would generally consist of investment-grade debt securities issued or unconditionally guaranteed by a U.S. government-sponsored enterprise; and securities issued or guaranteed by a foreign sovereign entity or multilateral development bank that are assigned to a 20% or lower risk weight under the regulatory capital rules. Level 2A liquid assets would need to be liquid and readily marketable.

Level 2B liquid assets would generally consist of publicly traded corporate debt securities that are liquid, readily marketable, and investment-grade; and publicly traded common equity shares included in the Standard & Poor's 500 Index or a similar index, and issued in the U.S. dollar or a currency in which the bank has liquidity needs.

In addition, level 2A liquid assets (other than GSE debt) and level 2B liquid assets would need to be issued by entities whose obligations have proven to be a reliable source of liquidity in repurchase or sales markets during stressed market conditions, as demonstrated by the market price declining, or the market haircut increasing, by no more than 10% for level 2A assets, 20% for corporate debt securities, and 40% for common equity shares, during a 30-calendar-day stress period.

Further, a security cannot be a level 1, level 2A, or level 2B liquid asset if its issuer is a financial sector entity, i.e., a regulated financial company, non-regulated fund, SEC-registered investment company, SEC-registered investment adviser, or pension fund (or a consolidated subsidiary of any such company). A regulated financial company is defined broadly to include any financial firm supervised by a U.S. federal banking agency, insurance company, SEC-registered broker or dealer, futures commission merchant, swap dealer, or security-based swap dealer (or any similarly regulated foreign financial firm). A non-regulated fund is defined as any hedge fund or private equity fund whose investment adviser is required to file SEC Form PF and any consolidated subsidiary of such a fund, other than a small business investment company (SBICs).

Deposits of SBICs and deposits of private investment funds that are not subject to SEC Form PF filings – such as certain venture capital funds whose advisers are exempt from registration with the SEC under the Investment Advisers Act,

2 We refer to any company subject to the proposed rule as a bank in this Advisory.

some (but not all) real estate funds and mortgage pools, and other investment pools that are not required to be registered with the SEC under the Investment Company Act but do not rely on Sections 3(c)(1) or 3(c)(7) for an exemption from that Act – are treated relatively favorably as deposits of non-financial entities under the proposed LCR rule.

The identity of Form PF filers is not publicly available, making an analysis of deposits of private funds under the proposed rule a challenge. Data in SEC Form ADV can be used to make a reasonable estimate as to whether a private fund is the subject of a Form PF filing, but not with complete certainty. In addition, the terms “hedge fund” and “private equity fund” are not defined, leaving room for further clarification in the final rule.

Generally Applicable Criteria for HQLAs

HQLAs, as described above, would still need to meet the following criteria to be included in a bank’s HQLA amount:

1. The assets are unencumbered (which means that the bank is free to convert them into cash) and not pledged (except that assets may be pledged to a central bank or a U.S. GSE to secure unused borrowing capacity);
2. The assets are not client pool securities or related cash;
3. Assets held in a consolidated subsidiary of the bank could be included in the HQLA amount up to the amount of net cash outflows of the subsidiary plus any additional amount available for transfer to the bank during times of stress without statutory, regulatory, contractual, or supervisory restrictions;
4. Assets that the bank received under a re-hypothecation right could not be included if the beneficial owner has a contractual right to withdraw the assets without remuneration at any time within 30 calendar days following the calculation date; and
5. Assets designated to cover operational costs could not be included.

B. Limits on Including Level 2 Liquid Assets in the HQLA Amount

The proposed rule would allow a bank to include the full fair value of its level 1 liquid assets in the HQLA amount. It would apply a 15% haircut to level 2A liquid assets and a 50% haircut to level 2B liquid assets, which means that a bank could include level 2A liquid assets in its HQLA amount at 85% of fair value (as determined under GAAP) and level 2B liquid assets at 50% of fair value. Further, the proposed rule would cap the amount of level 2 liquid assets (i.e., the sum of level 2A and level 2B liquid assets) at 40%, and level 2B liquid assets at 15%, of a bank’s HQLA amount.

The application of these haircuts and caps would require two calculations. The first calculation would assume that the bank would unwind none of its secured funding transactions, secured lending transactions, asset exchanges, or collateralized derivatives transactions that would mature within 30 calendar days following the calculation day. The second calculation would assume that the bank would unwind all such transactions, which would require the exchange of HQLAs between the bank and its counterparties and thus change the composition of the bank’s HQLAs. The first calculation would yield the bank’s unadjusted excess HQLA amount, and the second calculation would yield the bank’s adjusted excess HQLA amount. The greater of these two amounts would be deducted from the bank’s HQLA amount.

Operational Requirements

To include an HQLA in its HQLA amount, a bank would need to have the operational capability to convert the HQLA into cash, implement policies that require all HQLAs to be under the control of its liquidity management function (which must evidence control over the HQLAs), maintain policies and procedures that determine the composition of the assets in its HQLA amount, and include in its total net cash outflow amount the amount of cash outflows that would result from the termination of any specific hedge against HQLAs included in its HQLA amount.

IV. Total Net Cash Outflow Amount

Under the standard LCR requirement in the proposed rule, a bank would need to calculate its net cumulative cash outflows (i.e., cumulative cash outflows minus cumulative cash inflows, except that cumulative cash inflows would be capped at 75% of cumulative cash outflows) for each of the 30 calendar days following the calculation date. The largest daily amount over this 30-day period would be the total net cash outflow amount used in the LCR calculation.

A. Cash Outflow Categories

Under the proposed rule, the outflow amount for each category of funding or commitment would be calculated as the outstanding balance multiplied by the applicable outflow rate. The categories and associated outflow rates are summarized below.

1. Unsecured retail funding outflow amount: The outflow rate would be 3% for stable retail deposits or 10% for all other retail deposits. These outflow rates would apply to retail deposits regardless of maturity. A retail deposit would mean a demand or term deposit placed by a retail customer or counterparty and would not include "brokered deposits" as defined for purposes of the Federal Deposit Insurance Act. A stable retail deposit would be a retail deposit that is fully insured and either (a) held in a transactional account or (b) made by a depositor that has another established relationship with the bank, such that withdrawal of the deposit in reaction to liquidity stress would be unlikely.
2. Structured transaction outflow amount: With respect to a structured transaction for which the bank is a sponsor, the outflow amount would be the greater of (a) 100% of the amount of all debt obligations of the issuing entity that mature, and all commitments made by the issuing entity to purchase assets, within 30 calendar days following the calculation date, or (b) the maximum amount of funding the bank may be contractually required to provide to the issuing entity within 30 calendar days following the calculation date.
3. Net derivative cash outflow amount: The net derivative cash outflow amount would equal the sum of the payments and collateral that the bank will make or deliver to each counterparty under derivative transactions within 30 calendar days following the calculation date less, if subject to a valid qualifying master netting agreement, the sum of payments and collateral due from each counterparty during this period.
4. Mortgage commitment outflow amount: A 10% outflow rate would apply to all retail mortgage commitments that can be drawn upon within 30 calendar days following the calculation date.
5. Commitment outflow amount: The proposed rule would apply outflow rates ranging from 0% to 100% to the undrawn portion of committed credit facilities and liquidity facilities provided by the bank to its customers that can be drawn down within 30 calendar days following the calculation date. The outflow rate would depend on the counterparty, with higher rates for facilities committed to financial sector entities (other than an affiliated depository institution) or special purpose entities.
6. Collateral outflow amount: The collateral outflow amount would be the amount of additional collateral that the bank is required to post.

The collateral outflow amount would be calculated as the sum of the following amounts:

a. Changes in financial condition: The bank would need to count as an outflow 100% of all amounts that it is contractually required to post as additional collateral as a result of a change in its financial condition.
b. Potential valuation changes: The proposed rule would apply a 20% outflow rate to the fair value of any collateral posted by the bank that is not level 1 liquid assets to account for the likely devaluation of the collateral, as a result of which the bank would be required to post additional collateral to its counterparties.

c. Excess collateral: The proposed rule would apply a 100% outflow rate to the fair value of any collateral posted by counterparties that exceeds the current collateral requirement.

d. Contractually required collateral: The proposed rule would apply a 100% outflow rate to the fair value of collateral that the bank is contractually required to post but has not yet posted.

e. Collateral substitution: The bank would need to include in the outflow amount the differential in post-haircut fair value between HQLA collateral posted by a counterparty and lower-quality HQLA or non-HQLA that the counterparty may substitute under an applicable contract.

f. Derivative collateral change: The bank would need to include in the outflow amount the absolute value of the largest cumulative net mark-to-market collateral outflow or inflow over 30 consecutive calendar days resulting from derivative transactions realized during the preceding 24 months.

7. Brokered deposit outflow amount for retail customers or counterparties: Different outflow rates would apply to reciprocal brokered deposits, brokered sweep deposits, and other brokered deposits.

Outflow Rates Applicable to Different Types of Retail Brokered Deposits

a. Reciprocal brokered deposits: The proposed rule would apply a 10% outflow rate to all reciprocal brokered deposits that are fully insured, and a 25% rate to those not fully insured. These outflow rates would apply to reciprocal brokered deposits that have no contractual maturity date. For those that have a contractual maturity date, the actual cash outflows due to maturity during the 30-calendar-day stress period would be included in the outflow amount.

b. Brokered sweep deposits: The proposed rule would assign outflow rates to brokered sweep deposits based on whether the deposits are fully insured and whether the broker sweeping the deposits is an affiliate of the bank. It would apply a 10% outflow rate to deposits that are fully insured and swept by an affiliated broker, a 25% rate to deposits that are fully insured but swept by an unaffiliated broker, and a 40% rate to deposits that are not fully insured. These outflow rates would apply to brokered sweep deposits that have no contractual maturity date. For those that have a contractual maturity date, the actual cash outflows due to maturity during the 30-calendar-day stress period would be included in the outflow amount.

c. All other brokered deposits: For retail brokered deposits that are neither reciprocal brokered deposits nor brokered sweep deposits, the proposed rule would apply a 10% outflow rate if they mature later than 30 calendar days from the calculation date, or otherwise a 100% rate.

8. Unsecured wholesale funding outflow amount: The outflow rates assigned to unsecured wholesale funding would generally be based on the purpose of the funding, deposit insurance coverage, and the counterparty. These outflow rates would apply where there is no contractual maturity date. For funding that has a contractual maturity date, the actual outflows due to maturity during the 30-calendar-day stress period would be included in the outflow amount.

Outflow Rates Applicable to Unsecured Wholesale Funding

a. Unsecured wholesale funding that is an operational deposit: Lower outflow rates would apply to operational deposits, which are deposits that the bank's customers maintain as a condition to using the bank's operational services, such as clearing, custody, and cash management services. Deposits of an SEC-registered investment company or investment adviser, or a non-regulated fund, would not qualify as operating deposits; nor would certain overnight deposits owned by another depository institution for which the bank serves as a correspondent bank. The outflow rate would be 5% for operational deposits (excluding escrow accounts) that are fully covered by deposit insurance, or 25% for those not fully insured.

b. Unsecured wholesale funding that is not an operational deposit: The proposed rule would apply a 100% outflow rate to unsecured wholesale funding that is not an operational deposit, if it is provided by a financial sector entity. For such funding provided by a non-financial sector entity, the proposed rule would apply a 20% rate if the entire amount is covered by deposit insurance and not a brokered deposit, or otherwise a 40% rate.

9. Debt security outflow amount: Where a bank is the primary market maker for its own debt securities, the proposed rule would apply a 3% outflow rate to those debt securities that are not structured securities and a 5% rate to those that are. These outflow rates would apply to securities that mature outside the 30-calendar-day stress period. For securities that mature within the 30-day period, the bank would include the actual cash outflows due to the maturity of the securities.

10. Secured funding and asset exchange outflow amount: The secured funding outflow rates would range from 0% to 100% to account for the risk that the bank could be required to provide additional collateral or higher-quality collateral to support a given level of secured debt. The asset exchange outflow rates would range from 0% to 100% to account for the risk that the bank would be contractually obligated to provide higher-quality assets in return for less liquid, lower-quality assets.

11. Foreign central bank borrowings: For borrowings from a foreign central bank, the outflow rate would be the rate established by the foreign jurisdiction for central bank borrowings under its minimum liquidity standard. If the foreign jurisdiction has not established such an outflow rate, the bank would apply the outflow rates for secured funding under the U.S. rule.

12. Other contractual outflow amounts: The proposed rule would generally apply a 100% outflow rate to amounts payable within 30 days of the calculation date under applicable contracts.

B. Total Cash Inflow Amount

The proposed rule would exclude from the total cash inflow amount a bank's operational deposits held at other regulated financial companies, credit or liquidity facilities extended to the bank, assets included in the bank's HQLA amount and any amount payable to the bank with respect to such assets, assets that are nonperforming as of the calculation date or reasonably expected to become nonperforming within 30 calendar days following the calculation date, and payments from forward sales of mortgage loans or derivatives that are mortgage commitments. Payments with no contractual maturity date or payable to the bank more than 30 calendar days following the calculation date also could not be included in the total cash inflow amount.

The proposed rule would include the following amounts payable to the bank within 30 calendar days after the calculation date in the total cash inflow amount:

1. Net derivative cash inflow amount, which would equal the sum of payments and collateral that the bank will receive from each counterparty under derivative transactions, less the sum of payments and collateral that it will make or deliver to each counterparty (if subject to a qualifying master netting arrangement).

2. Retail cash inflow amount, which would equal 50% of all payments contractually payable to the bank from retail customers.

3. Unsecured wholesale cash inflow amount, which would equal 100% of all payments payable by financial sector entities or central banks, plus 50% of all payments contractually payable by wholesale customers that are not financial sector entities.

4. Securities cash inflow amount, which would include 100% of all contractual payments due to the bank on securities it owns that are not HQLAs.
5. Secured lending cash inflow amount, which would range from 0% to 100% of contractual payments due to the bank pursuant to secured lending transactions to recognize the bank's contractual right to require additional or higher-quality collateral from borrowers to support a given level of secured debt.
6. Asset exchange cash inflow amount, which would range from 0% to 100% of the fair value of HQLAs that the bank will receive from a counterparty pursuant to asset exchanges to recognize the bank's contractual right to deliver less liquid, lower-quality assets to the counterparty in return for higher-quality assets.

V. LCR Shortfall

If a bank's LCR falls below the required level, it would be required to notify its primary federal regulator. If its LCR remains below the required level for three consecutive business days, or if the supervisor otherwise determines the bank to be materially noncompliant with the LCR requirement, the bank would be required to submit a plan for achieving compliance.

VI. Transitions

The LCR requirement would become effective on January 1, 2015. The required LCR would be 0.8 in 2015, 0.9 in 2016, and 1.0 beginning on January 1, 2017.

VII. Modified LCR

The modified LCR requirement would be based on a 21-calendar-day stress scenario. A bank subject to the modified LCR requirement would calculate its LCR generally in the same manner as under the standard LCR requirement, with several differences. First, the bank would use a 21-calendar-day period (as opposed to a 30-calendar-day period) in calculating its HQLA amount. Second, the bank would use 70% of each outflow and inflow rate for outflows and inflows without a contractual maturity date, and would include outflows and inflows occurring within 21 calendar days (as opposed to 30 calendar days) following the calculation date for those with a contractual maturity date. Third, under the modified LCR requirement, the bank's total net cash outflow amount would be the difference between its total outflow amounts and total inflow amounts during a 21-calendar-day stress period, as opposed to the largest daily net cumulative outflow amount during a 30-calendar-day stress period.

Banks may face significant operational challenges in implementing the LCR requirement. Banks with US$250 billion or more in consolidated assets will face the most significant challenges, while banks in the US$50 to US$250 billion size range will need to address its requirements to a slightly lesser degree. To comport with the final rule, affected banks will need to model the impact of the LCR rule, re-assess their funding sources and asset mix, and restructure their balance sheets. Coordination among bank staff from different functions will be necessary. It is not too early to start planning even though the final rule may still be months away.

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Volcker Rule Action Plan and Model Board Documents: *The Conformance and Compliance Effort Begins*

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The recently issued final rules implementing section 619 of the Dodd-Frank Act (the "Volcker Rule") start the clock on banking entities' efforts to comply with the Volcker Rule's prohibition on short-term proprietary trading in securities or derivatives and limitation on relationships with "covered funds."[1] Both prohibitions are subject to detailed and highly technical exceptions spelled out in the Volcker Rule and the final implementing rules. Banking entities should now turn their attention to the process of conforming investments and activities to the basic prohibitions and limitations of the Volcker Rule and establishing required governance structures and compliance programs.

The final implementing rules become effective on April 1, 2014. The Federal Reserve Board has extended the period for banking entities to conform their investments and activities until July 21, 2015. New activities and investments should be conformed from the present, and proprietary trading activities should be promptly brought into conformity with the final implementing rules, well ahead of the 2015 conformity date. Certain banking entities with substantial trading assets and liabilities will be required to report quantitative measurements for trading activities beginning on June 30, 2014.

Attached is a Volcker Rule Action Plan and a series of model corporate documents for use in planning Volcker Rule conformance efforts. Like the Volcker Rule obligations themselves, the Action Plan and model corporate documents should be adapted based on a banking entity's size and the scope and nature of its activities.

The Volcker Rule Requires Tailored Compliance Programs

In addition to the basic prohibitions and limitation requirements, the final implementing rules impose a series of corporate governance, compliance and control programs, recordkeeping, regulatory reporting, training, and audit requirements on almost all banking

1 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule, 79 Fed. Reg. 5536 & 5808 (Jan. 31, 2014). The substantive requirements of the Volcker Rule are discussed in Arnold & Porter's advisory titled *Volcker Rule - Final Implementing Rules*, http://www.arnoldporter.com/publications.cfm?action=advisory&u=VolckerRuleFinalImplementingRules&id=1110.

entities. These requirements become more stringent and detailed for larger banking organizations, and as the scope and complexity of a banking organization's covered activities increases, as follows:

- *Tier 1: No Compliance Program.* If a banking entity has no investments in covered funds, and does not engage in proprietary trading (other than in domestic government obligations), it is not required to have a Volcker Rule compliance program. It would only be required to implement such a program before it engages in any covered activities. As a matter of best practices, however, even the smallest banking entity should implement some sort of control infrastructure to prevent it from wandering into restricted territory.
- *Tier 2: Limited Compliance Program.* The new regulations provide that banking entities with total consolidated assets of US$10 billion or less may satisfy the compliance program requirements by including in their existing compliance and control policies and procedures appropriate provisions referencing the Volcker Rule and its final implementing rules. Even smaller institutions with significant covered fund or proprietary trading activities may want to implement more robust Volcker Rule compliance and control programs.
- *Tier 3: General Compliance Program.* Banking entities with more than US$10 billion in consolidated assets will be required to implement a separate Volcker Rule compliance and control program to ensure and monitor compliance. The regulations require that programs must, at a minimum, include written policies and procedures, internal controls to monitor activities and prevent violations, a framework to delineate management responsibility and accountability, independent testing and audit of the compliance program, training, and recordkeeping.
- *Tier 4: Enhanced Compliance Program.* Where a banking entity has total consolidated assets of US$50 billion or more, or is subject to the reporting obligations for significant trading discussed below, or is directed by regulators, it will be subject to the most detailed and stringent compliance program requirements. In general, these requirements expand upon those specified for the general program (e.g., internal controls, training, management frameworks, etc.). For example, the CEO of a banking entity that falls under this program requirement will have to attest annually in writing to regulators as to the maintenance of an appropriate compliance program.

During the regulatory conformance period, the Volcker Rule essentially requires banking entities, as part of the process of conforming existing activities and investments and building a compliance program, to map out existing trading and covered funds activities and investments, the trading desks, business units and legal entities in which they are conducted, and the personnel responsible for them. These activities and investments must be compared to the requirements of the Volcker Rule, a gap analysis performed to determine whether the existing activities and investments meet the Volcker Rule's requirements and what aspects are in non-conformity, and a plan developed to conform, terminate or divest them within the conformance period.

The Volcker Rule requires board oversight of the rule's compliance effort. Generally, this includes assignment to a board committee of oversight responsibility, designation of specific management officials by the board to conduct those trading and covered fund activities subject to the restrictions of the Volcker Rule, designation of a compliance officer for Volcker Rule activities, and a reporting line for management and reporting personnel to periodically provide updates to the board or a board committee regarding the compliance effort. For the largest banking organizations (those with US$50 billion or more in consolidated assets) and others notified by regulators, the Volcker Rule also requires CEO attestation of the existence and effectiveness of compliance and control programs.

The attached documents include:

- *The Volcker Rule Action Plan:* This summary document contains simple checklists for board and management actions, measuring and mapping proprietary trading activities and covered fund relationships, conforming activities and investments, and developing and implementing a compliance and control program.

- *Model Board Policy for Compliance with the Volcker Rule:* The model board policy sets out appropriate governance structures; directs senior management to, among other things, develop risk management requirements, internal controls, and documentation for proprietary trading activities and investments in covered funds; provides standards for the remediation of violations, independent testing, training, and recordkeeping; and directs senior management to develop a conformance plan and report on its progress against the plan. A separate management-level set of written compliance procedures will also be required.
- *Model Board Resolutions Implementing the Volcker Rule Compliance Program:* The model board resolutions establish a Volcker Rule Committee of the board, adopt a committee charter, and designate managers and compliance officers responsible for conducting and revising the banking entity's Volcker Rule-related activities.
- *Model Volcker Rule Committee Charter:* The model committee charter creates a committee of the board to assist in fulfilling the board's oversight and monitoring obligations under the Volcker Rule.

Each banking entity should conduct a comprehensive and tailored review its investments or activities and determine the scope of the appropriate compliance program.

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

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Volcker Rule Action Plan

Timing:
Effective date of implementing rules: April 1, 2014.
Compliance program in place in part by April 1, 2014;
Reporting on proprietary trading phased in by size from June 30, 2014 through Dec. 31, 2016;
Compliance/conformity date for investments and activities: July 21, 2015.

Board actions:
Adopt board-level policies.
Designate oversight board committee.
Designate compliance officer.
Assign responsibility to specific senior management/reporting lines.
Require periodic reporting to committee.
Adopt timeline for implementation.

Management actions:
Prepare proposal for board consideration.
Assign staff and specific responsibilities.
Develop implementation plan and timeline.
Determine which level of compliance program required and timeline required by rule.
Measure & map, conform activities, develop and implement compliance & control program.
Report periodically to board committee on progress.
CEO attestation on compliance program.

Proprietary trading module:

Measure and Map

Map out where proprietary trading occurs within organization, by whom, what instruments, how frequently, in what amounts, in what accounts, for what purposes.

Compare activity to exclusions and exemptions:

- Buy and hold/not short-term trading or arbitrage;
- Exempted instruments (govis, munis, FX, etc.);
- Assets and instruments that are not "securities," swaps, options or other derivatives (such as bank deposits, non-variable insurance contracts that are not derivatives, physical precious metals and currencies, loans, real estate);
- Issuance and repurchase by banking entity of its own securities;
- Cash management;
- Bona fide risk-mitigating hedging;
- Dealing and underwriting book at regulated dealer entities within defined limits to meet customer needs;
- Insurance company accounts;
- Offshore trading (foreign organizations only);
- Customer accounts (fiduciary, custody, advisory, etc.);
- Pension plans of banking entity and its clients.

Volcker Rule Action Plan

Report to board on current status and what needs to be changed on what timeline.

Conform

Develop plan to conform, terminate or divest trading activities.

- Compare map of all business units and activities that are engaged in short-term trading or arbitrage to exemptions and identify what needs to change.
- Demarcate and separate permitted cash management activities, define permitted cash investments, maturities, portfolio duration, risk and strategy (keeping also in mind 12 CFR Part 1, and LCR rule requirements) and conduct through separate accounts.
- Demarcate and separate permitted U.S. government and agency securities and municipal government securities investment and trading activities from other trading and investment activities. Define permitted investments, maturities, portfolio duration, risk and strategy and conduct through separate accounts.
- Define permitted risk-reducing hedging activities, set strategy, permitted instruments, metrics, tracking to hedged asset, controls, business units and assets hedged (note that diversification is not considered "hedging" for this purpose).
- Define permitted dealing and underwriting activities and positions in regulated dealer units, define and conform book size, holding periods and position limits, compensation program for traders.
- Review, define and conform permitted FX, interest rate swaps, contracts and trading.
- Review loan portfolio for anything that might be a "security" and conform as necessary.
- Review, define and conform "buy and hold" investment positions, separate from trading accounts and arbitrage activities. Establish system to monitor and detect any short-term trading.
- Figure out what is left, and determine whether and how to conform or terminate it.

Implement controls and measurements.

Assign timelines, specific responsibilities, internal reporting for conforming activities.

Report to board on progress and status of conforming activities.

Develop and Implement Compliance and Control Program

Development and implementation of compliance program for proprietary trading:

- Determine what level and type of compliance program required by rules based on size of organization and nature and extent of proprietary trading;
- Develop timelines, assign specific responsibilities, internal reporting for developing and implementing compliance program;
- Develop written compliance program;
- Written description of management responsibilities and management systems;
- Develop record-keeping system;
- Develop management information system;

- Develop system for internal compliance reporting;
- Develop system for regulatory compliance reporting;
- Develop quantitative risk measurement systems–
  - Risk and position limits and usage
  - Risk factor sensitivities
  - Value-at-Risk and Stress VaR
  - Comprehensive profit and loss attribution
  - Inventory turnover
  - Inventory aging
  - Customer-Facing Trade Ratio;
- If applicable, develop "Appendix B" programs–
  - Trading desk policies and procedures
  - Description of risks and risk-management procedures
  - Limits and internal controls on risks, instruments and products
  - Hedging policies and procedures
  - Enhanced analysis and quantitative measurements
  - Other compliance requirements;
- Develop system of internal controls;
- Assign internal audit team/retain external testing group to test compliance;
- Develop internal audit program;
- Develop risk management policies, procedures and controls, position limits, etc.;
- Develop conflicts of interest policies, procedures and controls;
- Develop compliance training program;
- Develop formal compliance and approval process for approving new investment and trading activities and changes to activities; and
- CEO attestation as to compliance program.

Implement compliance and control programs.

Report to board on progress in developing and implementing compliance and control program.

Periodic independent testing of compliance program.

Periodically review and update compliance and control programs.

Covered funds module:

Measure and Map

Look carefully at:

- Private investment funds sponsored or advised by banking entity or provided to clients;
- Securitization vehicles in which banking entity invests as principal;
- Securitization vehicles sponsored, used or serviced by banking entity;

- All principal investments in BOLI, CRA/SBIC, leveraged leasing structures, loan and other asset participations, interests in lease and loan pools, CLOs, CDOs, TruPs, tax-credit partnerships, two-tiered real estate structures, private REITs, private equity, venture capital, hedge funds and other investment funds or privately-placed structured investments or pools;
- Anything that has a private placement memorandum, or that is offered in a private placement, 144A transaction, is restricted as to transfer, is limited to 100 or fewer beneficial owners, or that mentions Sections 3(c)(1) or 3(c)(7) of Investment Company Act, “qualified purchasers” or “qualified institutional buyers”; and
- What business units involved in investing in, sponsoring or servicing private investment funds.

Develop list of covered funds–

- In which the banking entity is an investor as principal (along with measure against 3%/3% test);
- For which the banking entity is a “sponsor”;
- To which the banking entity provides advisory or other services;
- With which the banking entity does business as a principal; or
- That are “controlled” by the banking entity (as defined in BHC Act).

Document exclusions from being a “covered fund” and exemptions for sponsorship of, servicing or investment in covered funds.

Determine options for:

- Disposing of or decreasing investments as principal;
- Eliminating sponsorship (e.g., change fund name, restructure so not a trustee, general partner, managing member and not in control of board, no guarantee of fund);
- Eliminating “control” of covered fund by banking entity.

Consider options for restructuring covered funds into something else (e.g., registration under Investment Company Act, business development company, common trust fund, conforming asset securitization, etc.).

Consider options for fitting fund relationships within an exemption for “sponsorship” or investment (fiduciary fund exemption, SBIC/CRA fund exemption, securitization exemption, hedging, BOLI insurance exemption) and map requirements of exemption against current structure.

What changes would be required to conform the fund? What approvals needed from other investors and service providers? What are steps/timeframe to accomplish changes?

Evaluate accounting treatment of principal positions that cannot be conformed (available for sale?).

Analyze servicing relationships for conformity to affiliate transaction restrictions of Volcker Rule–

- No guarantees;
- No direct or indirect extensions of credit or other 23A “covered transactions” with covered funds;
- 23B conformity/not less favorable to banking entity than arms’ length terms;
- No investment as principal (except within narrow limits permitted by rules);
- No purchases of assets.

Analyze risk exposures and conflicts of interests involving covered funds and banking entity.

Calculate and model projected capital haircuts for retained investments in covered funds.

Report to board on current status and what needs to be changed on what timeline.

Conform

Change name of covered funds to eliminate any similarity to name of banking entity or use of word “bank”.

Restructure and conform covered fund structures and relationships to permitted relationships.

Divest or redeem principal investments in covered funds to permitted limits.

If cannot be divested or conformed, consider seeking time extension from Federal Reserve.

Implement steps to reduce or eliminate risk exposures and conflicts of interest.

Update disclosure documents of covered funds (and/or send supplemental disclosures to existing investors) to include Volcker Rule items.

Update Form PF, Form D, Form 99, Form ADV Schedule D and Part 2, and other filings of funds to conform to name and other changes to covered funds.

Report to board on progress and status of conforming activities.

Develop and Implement Compliance and Control Program

Development and implementation of compliance program for covered funds activities:

- Determine what level and type of compliance program required by rules based on size of organization and nature and extent of covered funds activities;
- Develop timelines, assign specific responsibilities, internal reporting for developing and implementing compliance program;
- Implement process for identifying and documenting covered funds and exemptions, business units involved in covered funds activities and their permitted activities;
- Develop written compliance program;
- Description of compliance program meeting “Appendix B” requirements;

- Valuation/pricing program and requirements;
- Written description of management responsibilities and management systems;
- Program for monitoring/limiting investments as principal in covered funds;
- Program for monitoring/limiting aggregate investments in SBICs, CRA, historic tax credit funds;
- Program for disclosures to investors in covered funds;
- Program for monitoring/compliance with covered transaction restrictions;
- Develop record-keeping system;
- Develop management information system;
- Develop system for internal compliance reporting;
- Develop system for regulatory compliance reporting;
- Develop system of internal controls;
- Assign internal audit team/retain external testing group to test compliance;
- Develop internal audit program;
- Develop risk identification and management policies, procedures and controls;
- Develop conflicts of interest policies, procedures and controls;
- Develop compliance training program;
- Develop formal compliance and approval process for approving new fund relationships, modification of existing fund relationships; and
- CEO attestation as to compliance program.

Implement compliance and control programs.

Report to board on progress in developing and implementing compliance and control program.

Periodic independent testing of compliance program.

Periodically review and update compliance and control programs.

[FORM OF BOARD POLICY FOR COMPLIANCE WITH THE VOLCKER RULE]

The board of directors ("Board") is responsible for oversight of the Bank's establishment, maintenance, and enforcement of a compliance and control program for ensuring and monitoring compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments set forth in section 13 of the Bank Holding Company Act (together with the implementing regulations, the "Volcker Rule").

The implementing regulations become effective on April 1, 2014. The Federal Reserve Board has extended the conformance period until July 21, 2015, but the Bank will be required to report quantitative measurements for its trading activities beginning on June 30, 2014.

The Board adopts this policy to ensure that the Bank complies with the Volcker Rule. Management of the Bank shall prepare and implement a detailed program of control and compliance regarding "proprietary trading" and "covered funds" activities consistent with the requirements of the Volcker Rule and principles of safe and sound banking.

I. General Governance Matters

A. Establishment of and Delegation to the Board's Volcker Rule Committee

The Board has established a Volcker Rule Committee and delegated the responsibility for overseeing the Bank's compliance with the Volcker Rule to its Volcker Rule Committee. The Volcker Rule Committee must review and approve the Bank's Volcker Rule compliance program prepared by senior management and any update to it. The Volcker Rule Committee shall receive and review reports from senior management relating to the compliance program and take necessary action.

B. Compliance Program

The Board directs senior management of the Bank to establish a compliance and control program for ensuring and monitoring compliance with the Volcker Rule before [December 31, 2014], except that senior management must ensure that the Bank will be able to report quantitative measurements for its trading activities beginning on June 30, 2014. The compliance program shall be designed to meet the requirements of the Volcker Rule, including the requirements of Subpart D of the implementing regulations and the enhanced standards in Appendix B to the implementing regulations. A summary of these requirements, which represents the Board's expectation for the minimum breadth of the compliance program, is set forth below as part of this policy.

Senior management shall review and update the compliance program as necessary, but at least annually. If the business activities of the Bank that are subject to the Volcker Rule change materially, the compliance program must be updated accordingly.

Senior management shall report to the Volcker Rule Committee on the implementation of the compliance program at least monthly through July, 2015, and thereafter quarterly or more frequently if required by the compliance program (for example, in connection with remediation of violations).

C. Assignment of Responsibility

Senior management is responsible for implementing the compliance and control program. Under the implementing regulations, the Chief Executive Officer of the Bank is required to attest in writing to the [Agency], annually, that the Bank has in place processes to establish, maintain, enforce, review, test, and modify the compliance program in a manner reasonably designed to achieve compliance with the Volcker Rule.

For each trading desk and each organizational unit engaged in covered fund activities and investments, senior management shall appoint a manager who is responsible for implementing the compliance program with respect to the trading desk or organizational unit.

Senior management shall maintain a schedule that sets out, by name and title, (a) each senior executive officer who is responsible for the enterprise-wide implementation of the compliance program, (b) each manager who is responsible for the implementation of the compliance program at each trading desk or organizational unit engaged in covered fund activities and investments, and (c) a clear reporting line showing a chain of responsibility.

The Volcker Rule Committee shall designate senior executive officers to be responsible for the enterprise-wide implementation of the compliance program. The performance review and compensation of any such senior executive officer shall take into account the officer's effectiveness in implementing the compliance program and ensuring compliance with the Volcker Rule.

Senior management shall establish a compensation structure that provides appropriate incentives for implementing the compliance program. The performance review and compensation of each manager responsible for implementing the compliance program at each trading desk and each organizational unit engaged in covered fund activities and investments shall take into account the manager's effectiveness in implementing the compliance program and ensuring compliance with the Volcker Rule. Compensation arrangements for traders engaged in underwriting or market making-related activities or risk-mitigating hedging activities shall not reward or incentivize prohibited proprietary trading, or encourage excessive or imprudent risk-taking and shall instead conform to the requirements of the implementing rules.

II. Proprietary Trading Module of the Compliance Program

A. Risk Management Processes

The risk management processes shall include the following elements:

1. The reporting line for managing the risks of trading activity, including processes for initial and senior-level review of new products and new strategies;

2. The process for using models in managing the risks of trading activity and related positions, including periodic independent testing of the reliability and accuracy of the models;
3. The process for establishing and reviewing limits for each trading desk;
4. The management review process, including escalation procedures, for approving any temporary exceptions or permanent adjustments to limits for each trading desk; and
5. The process for the audit, compliance, and risk management functions to conduct independent testing of trading and hedging activities, techniques, and strategies.

B. Policies and Procedures for Each Trading Desk

Written policies and procedures governing each trading desk shall include:

1. The process for identifying, authorizing, and documenting financial instruments the trading desk may trade, with separate documentation for market making-related activities and for risk-mitigating hedging activities;
2. Mapping the trading desk to the division, business line, or other organizational structure that is responsible for managing and overseeing the trading desk's activities;
3. The type of trading activity (e.g., market making or trading in sovereign debt) and strategy of the trading desk;
4. The activities that the trading desk is authorized to conduct, including (i) authorized instruments and products, and (ii) authorized hedging strategies, techniques, and instruments;
5. Limits on the types and amount of risks the trading desk may incur;
6. Description of how the risks will be measured;
7. Discussion on why the permitted levels of risks are appropriate to the activities authorized for the trading desk;
8. Limits on the holding period of, and the risk associated with, financial instruments under the responsibility of the trading desk;
9. The process for setting new or revised limits, as well as escalation procedures for granting exceptions to any limits or to any policies or procedures governing the desk, the required analysis to support revising limits or granting exceptions, and the process for independently reviewing and documenting those exceptions and the underlying analysis;
10. The process for introducing new products, trading strategies, and hedging strategies;
11. The type of clients, customers, and counterparties with whom the trading desk may trade; and
12. The compensation arrangements, including incentive compensation, which shall be designed not to reward or incentivize prohibited proprietary trading or excessive or imprudent risk-taking.

C. Hedging Policies and Procedures

Written policies and procedures for the use of risk-mitigating hedging instruments and strategies shall describe:

1. The positions, techniques, and strategies that each trading desk may use to hedge the risk of its positions;

2. How the Bank will identify risks and determine that those risks have been properly and effectively hedged;
3. The level of the organization at which hedging activity and management will occur;
4. Who will monitor hedging strategies and how;
5. The risk management processes for controlling unhedged or residual risks; and
6. How each trading desk and the Bank as a whole engages in hedging in reliance on the exemption for risk-mitigating hedging activities.

D. Internal Controls for Authorized Risks, Instruments, and Products

Internal controls shall monitor and enforce limits on:
1. The financial instruments (by type and exposure) that each trading desk may trade;
2. The types and levels of risks that each trading desk may take; and
3. The types of hedging instruments used, hedging strategies employed, and the amount of risk effectively hedged.

E. Analysis and Quantitative Measurements

Analysis and quantitative measurements shall be tailored to the particular risks, activities, and strategies of each trading desk. They shall include:
1. Quantitative measurements for each trading desk, including:
   a. Risk and position limits and usage;
   b. Risk factor sensitivities;
   c. Value-at-Risk and Stress VaR;
   d. Comprehensive Profit and Loss Attribution;
   e. Inventory Turnover;
   f. Inventory Aging; and
   g. Customer-Facing Trade Ratio; and
2. Internal controls and written policies and procedures reasonably designed to ensure the accuracy and integrity of quantitative measurements;
3. Ongoing, timely monitoring and review of calculated quantitative measurements;
4. Numerical thresholds for each trading desk and heightened review of trading activity not consistent with the thresholds, including related analysis, escalation procedures, and documentation; and
5. Immediate review and investigation of the trading desk's activities, escalation to senior management with oversight responsibilities for the trading desk, timely notification to the regulator, appropriate remedial action, and documentation of the investigation findings and remedial action taken, in the event of a finding of a reasonable likelihood that the trading desk violated the Volcker Rule.

F. Liquidity Management Plan

To distinguish between trading for liquidity management purposes and prohibited proprietary trading, the Bank shall maintain a written liquidity management plan that:

1. Sets out the securities authorized for liquidity management, limits on the amount, types, and risks of those securities, and the liquidity circumstances in which the securities may or must be traded;
2. Requires trading in securities under the plan be principally for the purpose of liquidity management;
3. Requires that the securities traded be highly liquid and their market, credit, and other risks not give rise to appreciable profits or losses as a result of short-term price movements;
4. Limits trading for liquidity management purposes to an amount that is consistent with the Bank's near-term funding needs; and
5. Includes written policies and procedures, internal controls, analysis, and independent testing.

G. Overall Compliance Requirements

The compliance program shall:
1. Identify activities of each trading desk that will be conducted in reliance on exemptions from the prohibitions on proprietary trading, including an explanation of:
    a. How and where in the Bank the activity occurs, and
    b. Which exemption is being relied on and how the activity meets the specific requirements for reliance on the exemption.
2. Establish policies for monitoring and preventing material conflicts of interest between the Bank and its clients, customers, or counterparties.
3. Describe how the Bank monitors for and prohibits material exposure to high-risk assets or high-risk trading strategies presented by each trading desk that relies on an exemption from the prohibitions on proprietary trading.

III. Covered Fund Activities or Investments Module of the Compliance Program

A. Identification of Covered Funds

The compliance program shall include a process for identifying and documenting covered funds that each organizational unit invests in, sponsors, or organizes and offers. The documentation shall identify the exemption or exclusion under which the Bank is permitted to invest in or sponsor each covered fund under the Volcker Rule.

B. Identification of Covered Fund Activities and Investments

The compliance program shall identify each organizational unit that is permitted to invest in or sponsor any covered fund and map each such unit to the division, business line, or other organizational structure that is responsible for managing and overseeing that unit's activities and investments.

C. Documentation of Covered Fund Activities and Investments

For each organizational unit engaged in covered fund activities and investments, the compliance program shall document:

1. The covered fund activities and investments that the unit is authorized to conduct;
2. The Bank's plan for actively seeking unaffiliated investors to ensure that any investment by the Bank conforms to the investment limits or that the fund becomes registered under the securities laws and thereby exempt from the limits within the required period; and
3. How the unit complies with the requirements of the Volcker Rule.

D. Overall Compliance Requirements

The compliance program shall include processes and safeguards with respect to the Bank's covered fund activities and investments to prevent:

1. Material conflicts of interest between the Bank and its clients, customers, or counterparties;
2. Any threat to the safety and soundness of the Bank; and
3. Material exposure to high-risk assets or high-risk trading strategies.

E. Internal Controls

The Bank shall establish internal controls that:

1. Monitor and limit the Bank's individual and aggregate investments in covered funds;
2. Monitor the amount and timing of seed capital investments, and the effectiveness of efforts to seek unaffiliated investors;
3. Monitor required disclosures to prospective and actual investors in any covered fund sponsored by the Bank;
4. Monitor for and prevent any relationship or transaction between the Bank and a covered fund that is prohibited under the Volcker Rule; and
5. Require appropriate management review and supervision on an enterprise-wide basis to ensure that services and products provided by all affiliated entities comply with the limitations of the Volcker Rule.

IV. Remediation of Violations

The compliance program shall provide for remediation of violations. The program shall:

1. Effectively monitor and identify for further analysis any trading activity, or covered fund activity or investment, that may indicate potential violations;
2. Establish procedures for identifying and remedying violations, including a requirement to promptly document and remedy any violation and document all proposed and actual remediation efforts;
3. Include specific written policies and procedures reasonably designed to assess the extent to which any activity or investment indicates that modification to the Bank's

compliance program is warranted and to ensure that appropriate modifications are implemented; and

4. Provide for prompt notification to appropriate management, including senior management and the Board's Volcker Rule Committee, any material weakness or significant deficiencies in the design or implementation of the compliance program.

V. Independent Testing

The compliance program shall provide for independent testing at least annually. The independent testing shall be conducted by either the internal audit department or outside auditors. It shall include an evaluation of:

1. The overall adequacy and effectiveness of the Bank's compliance program;
2. The effectiveness of the Bank's internal controls; and
3. The effectiveness of the Bank's management processes.

VI. Training

The compliance program shall include an appropriate training program.

VII. Recordkeeping

The compliance program shall include appropriate recordkeeping requirements and procedures, consistent with the requirements of the implementing regulations and Appendix A to the implementing regulations.

VIII. Conforming Existing Activities and Investments

Senior management shall proceed to promptly identify, map and document existing trading and covered funds activities; develop and present to the Volcker Rule Committee a plan to conform or terminate those existing trading and covered funds activities on or before July 21, 2015 consistent with the requirements of the Volcker Rule; and periodically report to the Volcker Rule Committee on progress in implementing that plan. The conformance plan shall include a process for demarcating and carrying on permitted trading activities (such as cash management, government securities and municipal securities trading) separately from buy-and-hold investment activities through different accounts. To the extent any activities or investments are determined not to be able to be conformed or divested on or before July 21, 2015, senior management shall promptly report to the Volcker Rule Committee. If an application for an extension is necessary, it should be submitted to the Federal Reserve no later than January 20, 2015 and *must* be submitted no later than April 21, 2015.

[FORM OF BOARD OF DIRECTORS RESOLUTIONS TO IMPLEMENT VOLCKER RULE GOVERNANCE PROGRAM]

The members of the Board of Directors (the "Board") of **_______________** (the "Bank"), present in person or by telephone at a meeting of the Board held on **_______**, 2014, at which a quorum was present and acting throughout, hereby adopt the following Resolutions:

WHEREAS, on December 10, 2013 the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Securities and Exchange Commission adopted final rules (the "Final Rules") implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Section 619," and, together with the Final Rules, as they may be amended from time to time, the "Volcker Rule"); and

WHEREAS, the Final Rules become effective on April 1, 2014 and require that banking entities, including the Bank, develop and implement a compliance program reasonably designed to ensure and monitor compliance with the prohibitions on proprietary trading and covered fund activities and investments set forth in the Volcker Rule; and

WHEREAS, the Bank is required to conform all activities and investments to the requirements of the Volcker Rule by July 21, 2015 (the "Conformance Date") and to commence reporting on its covered trading activities beginning on [Date] (the "Initial Reporting Date"); and

WHEREAS, the Board has determined that it is in the best interests of the Bank to establish a comprehensive program for compliance with the Volcker Rule, commensurate with the type, size and scope of the Bank's activities, including, without limitation, ongoing Board oversight, the adoption of appropriate policies and procedures and the implementation of those policies and procedures by Bank Management (the "Volcker Rule Compliance Program"); and

WHEREAS, the Board, in furtherance of these objectives, has reviewed the Volcker Rule Committee Charter attached to these Resolutions as Annex A and the Board Policy for Compliance with the Volcker Rule (the "Board Policy") attached to these Resolutions as Annex B; and

NOW, THEREFORE, BE IT RESOLVED, that the Board hereby establishes a Board "Volcker Rule Committee," to be initially composed of __________, ________, and ________, and thereafter of at least three members of the Board chosen by the full Board from time to time, to serve at the discretion of the full Board and until such time as their successors shall be appointed; provided, that, in order for a director to be eligible to serve on the Committee, he or she must be "independent" as that term is defined in the Volcker Rule Committee Charter; and

BE IT FURTHER RESOLVED, that the Volcker Rule Committee shall have the primary responsibility, subject to review and ratification or adjustment by the full Board, for oversight of the Bank's compliance activities, in accordance with the terms of the Volcker Rule Committee Charter; and

BE IT FURTHER RESOLVED, that the Volcker Rule Committee Charter is hereby approved and adopted in the form attached to these Resolutions; and

BE IT FURTHER RESOLVED, that the Board hereby establishes the position of Chief Volcker Rule Compliance Officer (the "Chief Compliance Officer"), who shall supervise Bank officers and employees tasked with maintaining Bank Compliance with the Volcker Rule and hereby appoints __________ as the Chief Compliance Officer; and

BE IT FURTHER RESOLVED, that the Chief Compliance Officer shall serve at the pleasure of the Board and until a successor is appointed by the Board and shall report directly to the Volcker Rule Committee and be available to report to the full Board when and as required; and

BE IT FURTHER RESOLVED, that __________, or such other officer of the Bank as the Board shall appoint from time to time, shall be designated as the "Proprietary Trading Officer," and shall oversee the operations of the Bank's proprietary trading activities; and

BE IT FURTHER RESOLVED, that __________, or such other officer of the Bank as the Board shall appoint from time to time, shall be designated as the "Covered Funds Officer," and shall oversee the operations of the Bank's covered funds activities; and

BE IT FURTHER RESOLVED, that the Proprietary Trading Officer and the Covered Funds Officer shall each report directly to the Bank's Chief Executive Officer with respect to the operations under his or her supervision and shall consult from time to time with the Chief Compliance Officer as appropriate with regards to the implementation and effectiveness of the Volcker Rule Compliance Program as it relates to such operations; and

BE IT FURTHER RESOLVED, that ___________, or such other officer of the Bank as the Board shall appoint from time to time, shall be designated as the "Volcker Rule Audit Officer," and shall oversee any internal audit and testing activities undertaking to assess the Bank's ongoing compliance with the Volcker Rule Compliance Program; and

BE IT FURTHER RESOLVED, that the Volcker Rule Audit Officer shall report directly to [insert whichever officer has oversight responsibility for the internal audit function] and shall consult from time to time with the Chief Compliance Officer as appropriate with regards to the implementation and effectiveness of the Volcker Rule Compliance Program as assessed through and internal audit or testing; and

BE IT FURTHER RESOLVED, that the Board Policy is hereby approved and adopted in the form attached to these Resolutions; and

BE IT FURTHER RESOLVED, that the Chief Compliance Officer is hereby authorized and directed to work with Bank Management, Bank employees and third parties, including outside counsel and consultants, to develop the Volcker Rule Compliance Program in accordance with the Board Policy and satisfying the applicable requirements of the Volcker Rule, as summarized in the Board Policy; and

BE IT FURTHER RESOLVED, that without limiting in any way its scope, the Volcker Rule Compliance Program shall address:

- The preparation of appropriate written policies and procedures;

- Internal controls for monitoring compliance and preventing prohibited activities and investments;

- A management framework that clearly delineates responsibility and accountability for compliance;

- Independent testing and audit of effectiveness of the compliance program;

- Training personnel as necessary or appropriate to assure effective implementation and enforcement of the compliance program; and

- Record keeping sufficient to demonstrate compliance; and

BE IT FURTHER RESOLVED, that the Chief Compliance Officer shall report to the Volcker Rule Committee or a designee thereof on the progress of implementation of the Volcker Rule Compliance Program not less frequently than monthly through the Conformance Date, and thereafter not less frequently than quarterly (and more often as the Volcker Rule Committee shall deem necessary or appropriate), with copies of any materials relating to such implementation to be promptly provided to the full Board; and

BE IT FURTHER RESOLVED, that the Chief Compliance Officer shall be available to respond to questions from members of the Volcker Rule Committee or the full Board in a timely manner; and

BE IT FURTHER RESOLVED, that not later than _____________, 2014, the Chief Compliance Officer shall deliver to the Volcker Rule Committee a detailed schedule of timing and responsibility for full implementation of the Volcker Rule Compliance Program, including, without limitation, (1) the preparation of all written policies and procedures, and all other documentation necessary or appropriate for the Program; (2) full implementation of the conformance of all activities and investments to the requirements of the Volcker Rule by the Conformance Date; (3) full implementation of all required reporting of covered trading activities by the Initial Reporting Date; and (4) full compliance with any other requirements of the Volcker Rule that may become effective prior to the Conformance Date on or before such earlier date; and

BE IT FURTHER RESOLVED, that the Bank, the Board, the Volcker Rule Committee and the Chief Compliance Officer shall take all necessary and appropriate actions to ensure full and timely implementation of the Volcker Rule Compliance Program; and

BE IT FURTHER RESOLVED, that that the proper officers of the Bank are authorized in the name and on behalf of the Bank, to take or cause to be taken all such further actions and to execute and deliver or cause to be executed and delivered all such further agreements, documents, certificates, applications, filings and undertakings and to incur all such fees and expenses as in their judgment shall be necessary, appropriate or convenient to carry into effect the purpose and intent of any and all of the foregoing resolutions; and

BE IT FURTHER RESOLVED, that the proper officers of the Bank for purposes of the foregoing resolutions are, and shall be, ______________________.

[FORM OF VOLCKER RULE COMMITTEE CHARTER]

_____________ BANK
Volcker Rule Committee Charter
As of ________, 2014

Purpose

The Volcker Rule Committee (the "Committee") of the Board of Directors ("Board") of ___________Bank (the "Bank"), is established to assist the Board in fulfilling its oversight responsibilities regarding compliance with Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Section 619") and the final rules adopted by the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Securities and Exchange Commission to implement Section 619 (the "Final Rules") (the Final Rules, as they may be amended from time to time, together with Section 619, constituting the "Volcker Rule").

Membership

The Committee shall be comprised of at least [three] directors, all of whom shall be "independent" directors (as defined herein), who will serve as "Committee Members" (see Appendix A). Committee Members shall be appointed by the Board. The Bank's [_______________] shall serve as the Committee Secretary. The Board shall determine each Committee Member's independence at least annually.

To be considered independent, a director must be free of any relationship that would render the director beholden to the Bank, its affiliates or their management. Generally, a director will not be considered independent if such director:

- Is, or has been within the preceding three years, an officer, employee or consultant of the Bank or an affiliate.

- Is, or has been within the preceding three years, a member of the immediate family of a current officer or employee of the Bank or an affiliate.

- Is an executive officer, partner or affiliate, or directly or indirectly owns or controls (or has directly or indirectly owned or controlled within the preceding three years) assets representing 10 percent or more of any outstanding class of voting securities, of an institution that has a significant commercial, legal, consulting, advisory or charitable relationship with the Bank or an affiliate.

- Has a material relationship which, in the opinion of the Board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a committee member.

Meetings

The Committee shall meet at not less frequently than monthly through July 21, 2015(the date by which the Bank is required to conform all activities and investments to the requirements of the Volcker Rule), and thereafter not less frequently than quarterly, and more frequently as the Committee shall deem necessary or appropriate. The Committee shall meet at a time and place determined by the Committee Chair, with further meetings to occur, or actions to be taken by unanimous written consent, when deemed necessary or desirable by the Committee or its Chair. Members of the Committee may participate in a meeting of the Committee by means of conference call or a similar communication method by means of which all persons participating in the meeting can hear each other.

A majority of the members of the Committee shall constitute a quorum. All matters to be determined by the Committee shall be determined by a majority vote of the members present at a meeting at which a quorum is present. In the event of a tie vote on any matter, the Chair's vote shall determine the matter. The Committee Chair shall be a member that is nominated by the Chief Executive Officer ("CEO") of the Bank and approved by the Committee.

The Committee shall meet periodically with the Chief Volcker Rule Compliance Officer (the "Chief Compliance Officer") and the CEO and such other members of Bank Management as it deems appropriate, in combined or separate sessions, and have such other direct and independent interaction with such persons from time to time, as the members of the Committee deem appropriate.

Resources and Cooperation

The Committee shall have the authority to meet with and seek any information it requires from employees, officers or directors of the Bank or any of its affiliates and may also retain legal counsel or other independent consultants, as it deems appropriate, to facilitate the discharge of the Committee's responsibilities. The Committee is empowered to conduct its own investigations into issues related to its responsibilities.

The Bank shall provide for appropriate funding, as determined by the Committee, for payment of compensation to any consultants or advisors retained by the Committee and for administrative expenses of the Committee.

Responsibilities and Duties

The Committee shall assist the Board in fulfilling oversight responsibilities with respect to corporate-wide satisfaction of Volcker Rule compliance requirements. In particular, the Committee shall:

1. Oversee and monitor the Bank's and affiliates' Volcker Rule Compliance Program (the "Compliance Program") and maintenance of required policies and procedures, which shall include:

    - The systems, controls, policies, procedures and processes designed to ensure that the Bank complies with the requirements of the Volcker Rule and prevent the occurrence of prohibited activities or investments.

    - A system of internal controls reasonably designed to monitor compliance with the Volcker Rule.

    - A management framework that clearly delineates responsibility and accountability for Volcker Rule compliance that includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified as requiring attention.

    - Independent testing and audit of the effectiveness of the compliance program, conducted periodically.

    - Appropriate training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program.

    - Appropriate record-keeping and periodic reporting requirements consistent with the standards laid out in the Final Rules.

    - Regular reporting by the Bank's management, including the Chief Compliance Officer, to the Committee, and, as appropriate, the Board, regarding the status of the Bank's compliance efforts.

2. Recommend to the Board the appointment of the Chief Compliance Officer.

3. Oversee the activities of the Chief Compliance Officer, who shall have a reporting line to the Committee.

4. Assess with Management, the Chief Compliance Officer, and with legal or other advisors, the Bank's compliance with the Volcker Rule, and any significant legal and regulatory exposures or concerns identified with respect to Volcker Rule compliance.

5. Regularly report to the Board regarding the Committee's activities, including its assessment of the adequacy of the Bank's Volcker Rule compliance, including applicable policies and procedures and Management's effectiveness in the execution thereof.

6. Oversee and monitor the ongoing effectiveness of communications with Federal agencies engaged in any Volcker Rule compliance review or examination of the Bank. The Committee shall receive regular reporting by Management and the Chief Compliance Officer regarding communications with such government agencies, including providing to the Committee copies of all written communications to and from such agencies.

7. Oversee and monitor Management's compliance with the Volcker Rule, including any terms and conditions required from time to time by any action, formal or informal, of any federal regulatory agency, and oversee Management's timely responses to any inquiries from any such agency, ensuring that the appropriate corrective and preventive actions have been implemented by Management.

8. Review and reassess the adequacy of this Charter at least annually and recommend any changes to the Board for approval.

9. Evaluate the Committee's performance on an annual basis and establish criteria for such evaluation. The results of the annual evaluation will be discussed with the Board.

10. Oversee and monitor Management's program and process for identifying, documenting and conforming, divesting or terminating existing proprietary trading and covered funds activities and investments as required by July 21, 2015.

Charter Revision History		
Date	**Comment**	**Approved by/Reported**

Appendix A

COMMITTEE COMPOSITION

ARNOLD & PORTER LLP

ADVISORY February 2014

Federal Reserve Adopts Final Rule Implementing Enhanced Prudential Standards for Certain Domestic Bank Holding Companies and Foreign Banking Organizations

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On February 18, 2014, the Board of Governors of the Federal Reserve System (the Board) approved its final rule implementing enhanced prudential standards for certain domestic bank holding companies and foreign banking organizations (the Final Rule). While the Final Rule does not implement every provision of the December 2011 and December 2012 proposed rules,[1] the Final Rule still requires enhanced standards of liquidity, risk management, and capital for covered institutions. Compliance with certain of the provisions of the Final Rule begins January 1, 2015.

I. Scope of the Final Rule

Generally, sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)[2] require the Board to establish enhanced prudential standards for bank holding companies and foreign banking organizations with a banking presence in the United States with consolidated assets of US$50 billion or more, and nonbank financial companies the Financial Stability Oversight Council (the FSOC) designates as systemically important financial institutions (SIFIs) and subject to supervision by the Board.[3] Although the Final Rule applies to bank holding companies and foreign banking organizations, it does not set out specific regulations for SIFIs subject to the Board's supervision. Rather, the Final Rule states that the Board will assess the business model, capital structure, and risk profile of SIFIs on a case-by-case basis to determine how to apply the enhanced prudential standards and whether a tailored approach would be more appropriate. The fewer the differences between a SIFI and a bank holding company, the more likely the enhanced prudential standards will apply as written.

1 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (proposed Jan. 5, 2012) (to be codified at 12 C.F.R. § 252); Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76628 (proposed Dec. 28, 2012) (to be codified at 12 C.F.R. § 252).

2 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 *See* 12 U.S.C. § 5365.

II. Provisions of the Final Rule

A. Enhanced Prudential Standards for Certain Bank Holding Companies

1. Capital Planning and Stress-testing Requirements

The Final Rule incorporates the capital planning and stress-testing requirements adopted previously by the Board. These requirements require a bank holding company with consolidated assets of US$50 billion or more (covered bank holding companies) to submit annually a plan to the Board demonstrating the company's ability to maintain capital above minimum risk-based capital ratios during stressed conditions, and to test the plan during supervisory and company-run stress tests.[4] The minimum risk-based capital ratios are those set forth in the revised capital framework: a minimum common equity tier 1 capital ratio of 4.5%; a minimum tier 1 ratio of 6%; and a leverage ratio of 4%.[5]

2. Risk Management and Risk Committee Requirements

Publicly traded bank holding companies with consolidated assets of US$10 billion or more must establish risk committees that will oversee, approve, and periodically review risk management policies and frameworks. For covered bank holding companies, the risk committee must be a separate committee of its board of directors, and report at least quarterly directly to its board of directors. The risk management policies and framework must establish procedures for risk-management governance, practices, control mechanisms, and monitoring infrastructure in a manner that reflects a company's structure, risk profile, complexity, activities, and size.

The risk committee must be chaired by an independent director who (i) is not currently, or within the previous three years, an officer or employee of the bank holding company; "(ii) is not a member of the immediate family … of a person who is, or has been within the last three years, an executive officer of the bank holding company … ; and (iii)(A) is an independent director under [17 C.F.R. § 229.407(a)], if the bank holding company has an outstanding class of securities traded on an exchange registered with the [SEC] as a national securities exchange under [15 U.S.C. § 78f]; or (B) would qualify as an independent director under the listing standards of a national securities exchange … if the bank holding company does not have an outstanding class of securities traded on a national securities exchange."[6]

Additionally, the risk committee must have at least one member with risk-management expertise in a financial firm commensurate with the characteristics of the company, and at least one member with experience in identifying, assessing, and managing risk exposures of large, complex firms. For bank holding companies with assets equal to or greater than US$10 billion and less than US$50 billion, experience in a nonfinancial field is sufficient to meet the requirement. Covered bank holding companies must also appoint a chief risk officer to implement risk management policies and practices. The chief risk officer will report both to the chief executive officer and the risk committee.

On January 10, 2014, the Office of the Comptroller of the Currency (OCC) published proposed guidelines that would formalize heightened supervisory expectations for national banks, federal savings associations,[7] and federal branches of foreign banks each with total consolidated assets of US$50 billion or more.[8] The heightened

4 12 C.F.R. §§ 225.8, 252.

5 *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62018 (Oct. 11, 2013) (codified at 12 C.F.R. § 217).

6 12 C.F.R. § 252.22(d)(2).

7 The Final Rule applies the previously adopted company-run stress test requirements to domestic and foreign savings and loan holding companies (SLHCs) with consolidated assets of US$10 billion or more. Other than the company-run stress test, the Final Rule does not apply enhanced prudential standards to SLHCs. The Board, however, stated that it may apply enhanced prudential standards to SLHCs in the future if it determines that doing so is consistent with the safety and soundness of such companies.

8 OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches, 79 Fed. Reg. 4282 (Jan. 27, 2014).

expectations include detailed requirements for covered institutions to establish a risk governance framework that applies to all facets of the institution from support services to the board of directors. The OCC's proposed guidelines go beyond the requirements of the Final Rule and include additional requirements such as establishing an independent risk management department, a strategic risk plan, and an internal audit plan. Also, the OCC proposed guidelines permit a covered institution to use its parent company's risk framework if the parent company's framework meets the OCC's proposed guidelines, and the covered institution can show that its risk profile is substantially similar to the risk profile of its parent holding company.[9]

3. Liquidity Requirements

Under the Final Rule, the board of directors of covered bank holding companies must implement liquidity risk management processes; review and approve liquidity risk management strategies, policies, and procedures; and set risk tolerances annually. The board of directors is also responsible for reviewing and approving contingency liquidity funding plans, a task formerly assigned to the risk committee under the proposed rules. The contingency plan consists of policies and procedures for managing a liquidity crisis, such as alternate sources of funding, and must be tested during liquidity stress tests.

The Final Rule does not set a particular limit for liquidity risk, although it specifies that companies must consider their size, complexity, capital structure, risk profile, and activities when setting their liquidity risk limit.[10] Covered bank holding companies must establish an independent review process to evaluate at least annually the adequacy and effectiveness of its liquidity risk management program.

Senior management is responsible for reviewing and approving new products and business lines and their effect on liquidity risk. After implementation, senior management must annually review the liquidity risk of new products and business lines that may have a significant effect on the company's liquidity risk profile.

The Final Rule requires covered bank holding companies to maintain highly liquid assets as a buffer to protect against a liquidity crisis. The buffer must be sizable enough to meet the company's cash outflows for 30 days under a range of liquidity stress scenarios. Covered bank holding companies must conduct monthly liquidity stress tests on their cash-flow projections[11] under three scenarios tailored to the companies' specific vulnerabilities over several time horizons. Companies must use the results of the tests to set and adjust their liquidity buffer.

4. Debt-to-Equity Limitation

If the FSOC determines that a bank holding company is a "grave threat" to the financial stability of the Unites States, the Final Rule requires that the bank holding company maintain a debt-to-equity ratio of 15-to-1. Under the Final Rule, "debt" and "equity" have the same meaning as "total liabilities" and "total equity capital" in a company's reports of financial condition.

B. Enhanced Prudential Standards for Foreign Banking Organizations

1. Intermediate Holding Company Requirement

Under the Final Rule, foreign banking organizations with total assets of US$50 billion or more and U.S. non-branch assets of US$50 billion or more (covered foreign banking organizations) must form or designate a U.S. intermediate

9 For additional discussion on the OCC's proposed guidelines, *see* Arnold & Porter, Advisory: OCC Proposes Heightened Supervisory Standards for Large Insured National Banks, Insured Federal Savings Associations and Insured Federal Branches (Feb. 6, 2014) *available at* http://www.arnoldporter.com/publications.cfm?action=advisory&u=OCCProposesHeightenedSupervisoryStandardsforLargeInsuredNationalBanksInsuredFederalSavingsAssociationsandInsuredFederalBranches&id=1112.

10 The Board has, however, issued a proposed rule that implements a liquidity requirement affecting bank holding companies with assets of US$50 billion or more that is consistent with the liquidity coverage ratio standard established by the Basel Committee. *See* Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 Fed. Reg. 71818 (proposed Nov. 29, 2013).

11 The Final Rule also requires bank holding companies to develop comprehensive cash-flow projections.

holding company, and transfer all ownership interests in any U.S. subsidiary to the intermediate holding company. The Final Rule defines "subsidiary" as any company directly or indirectly controlled by another company,[12] and "control" is defined under the Bank Holding Company Act.[13] Upon petition, the Board will authorize covered foreign banking organizations at its discretion to use alternate structures or multiple intermediate holding companies.

Covered foreign banking organizations may still hold subsidiaries under section 2(h)(2) of the Bank Holding Company Act and DPC branch subsidiaries outside the intermediate holding company. Additionally, the Final Rule does not require covered foreign banking organizations to transfer assets held through a U.S. branch or agency to the intermediate holding company. Foreign banking organizations that meet or exceed the US$50 billion non-branch asset threshold as of July 1, 2015 have until the following year, July 1, 2016, to reorganize its subsidiaries under an intermediate holding company. Those organizations that meet or exceed the threshold after July 1, 2015 must come into compliance by the first day of the ninth quarter after reaching the asset threshold.

Intermediate holding companies will be subject to the same risk-based and leverage capital requirements as bank holding companies, as well as the capital planning rule. They will not, however, be subject to the advanced approaches risk-based capital rules. The Final Rule mandates compliance with the capital requirements by January 1, 2018. Similar to the enhanced prudential standards described above for bank holding companies, intermediate holding companies must form a risk committee for risk management, appoint a U.S.-based chief risk officer, implement a liquidity risk management framework, conduct liquidity stress tests, and maintain a thirty-day liquidity buffer to cover cash-flows under stressed conditions. U.S. branches and agencies, however, need only hold a liquidity buffer sufficient to cover the first fourteen days of a thirty-day liquidity stress horizon. Intermediate holding companies must also conduct stress tests in accordance with existing regulations, but compliance is not mandated until October 1, 2017.[14] Lastly, the Final Rule subjects intermediate holding companies to a debt-to-equity ratio of 15-to-1.

III. Significant Changes from the Proposed Rules

The Final Rule made several significant changes to the 2012 proposed rules. Included among those significant changes are the following:

- Nonbank financial companies are not automatically subject to the enhanced prudential standards of the Final Rule. However, upon the FSOC's designation as a SIFI to be supervised by the Board, the Board will assess the business model, capital structure, and risk profile of SIFIs on a case-by-case basis to determine how to apply the enhanced prudential standards and whether a tailored approach would be more appropriate.
- The Final Rule delays implementing the proposed single counterparty credit limits and early remediation requirements.
- Under the Final Rule, the U.S. asset threshold for forming an intermediate holding company is US$50 billion instead of US$10 billion as originally proposed.
- The deadline for forming intermediate holding companies was extended by one year to July 1, 2016.
- Intermediate holding companies are not subject to the leverage capital requirements until January 1, 2018.
- The foreign parents of U.S. branches and agencies are no longer required to hold remaining portions of the liquidity buffer.

Conclusion

The Final Rule implements a number of complex requirements that apply to both domestic and foreign banking institutions, and seems to focus predominantly

12 12 C.F.R. § 252.2(s).

13 12 U.S.C. § 1841(a)(2).

14 *See* 12 C.F.R. § 252, Subparts F through H.

on implementing controls to detect and manage liquidity and other potentially systemic risks. Covered bank holding companies and covered foreign banking organizations must carefully determine what and when requirements apply to them, and anticipate how these structural and capital changes will impact lending and other activities.

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

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ARNOLD & PORTER LLP

ADVISORY March 2014

Federal Regulators Issue Joint Guidance on Company-Run Stress Tests for Mid-sized Banks

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On March 20, 2014, the Board of Governors of the Federal Reserve System (Federal Reserve) announced the results of the annual company-run stress tests for the 30 largest banking institutions, concluding that the institutions have improved their capital positions and are now better positioned to endure conditions of extremely severe stress than they were five years ago.[1] For Mid-sized Banks,[2] this announcement offers a glimpse into the implementation of the stress-test public disclosure requirements, which such institutions are required to meet in 2015.

This Advisory summarizes the long-awaited final supervisory guidance on Mid-size Bank company-run stress tests (the Guidance), which was recently issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively the Federal Regulators).[3] The Guidance sets general supervisory expectations for how to conduct company-run stress tests, and provides examples of practices that supervisors would consider consistent with those expectations.

I. Background

Section 165(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires financial companies with more than US$10 billion in total consolidated assets to conduct stress tests. Bank holding companies with at least US$50 billion in total consolidated assets and systemically important nonbank financial companies are subject to annual supervisory stress tests and must also conduct semi-annual company-run stress tests. Mid-sized Banks must conduct annual company-run stress tests.

In May 2012, after publishing a proposed regulation to implement the Dodd-Frank Act stress test requirements, the Federal Regulators issued initial supervisory guidance applicable to

1 Board of Governors of the Federal Reserve System, Press Release (Mar. 20, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20140320a.htm.

2 Mid-sized Banks are banks, savings associations, bank holding companies, and savings and loan holding companies with total consolidated assets of more than US$10 billion, but less than US$50 billion.

3 Supervisory Guidance on Implementing Dodd-frank Act Company-Run Stress Tests for Banking Organizations with Total Consolidated Assets of More Than $10 Billion but Less Than $50 Billion, 79 Fed. Reg. 14153 (Mar. 13, 2014).

banking organizations subject to these requirements.[4] The May 2012 guidance set forth five principles for creating satisfactory stress testing frameworks. Under the principles, stress tests should:

- Include activities and exercises tailored to the institution's exposures, activities, and risks;
- Employ multiple stress testing activities and approaches;
- Be forward-looking and flexible;
- Be clear, actionable, well supported, and inform decision-making; and
- Include strong governance and effective internal controls.

In October 2012, the Federal Regulators finalized the stress test rules implementing the Dodd-Frank Act requirements.[5] Recognizing that Mid-sized Banks are less complex than Large Banks and that size and complexity should be taken into account in implementing the stress test rules, the Federal Regulators simultaneously indicated that they would publish supplemental guidance specifically for Mid-sized Banks to assist in the development of stress test programs. Accordingly, the Federal Regulators issued the current Guidance to supplement the May 2012 guidance, which continues to apply to both Mid-sized Banks and Large Banks. The Guidance is intended to clarify supervisory expectations with respect to each requirement of the stress test rules.

II. Supervisory Expectations for Stress Test Practices

A. Stress Test Timing and Scope

Mid-sized Banks must conduct annual company-run stress tests using three macroeconomic scenarios (baseline, adverse, and severely adverse) provided no later than November 15 by their primary federal regulator. The stress test projections are based on exposures as of September 30 and must cover a nine-quarter planning horizon that begins with the quarter ending on December 31 of the current year, and ends with the quarter ending on December 31 two years later. Mid-sized Banks must project losses, pre-provision net revenues (PPNR), the balance sheet, risk-weighted assets, and capital for each quarter. Additionally, Mid-sized Banks must estimate adequate levels of allowance for loan and lease losses (ALLL) to cover credit risk that remains at the end of each quarter.

The stress test should cover all business lines and risk areas in order to assess the effect of each scenario on the entire enterprise. Since Mid-sized Banks vary in activities, they need not use those variables defined by the regulators that are not relevant to the company's business. Likewise, Mid-sized Banks may incorporate additional variables in order to administer the stress tests more accurately. Mid-sized Banks may use additional variables supplied by third-party vendors, but they should meet supervisory expectations for using third-party vendors. Stress tests should evolve to match a Mid-sized Bank's growing size, complexity, and sophistication.

B. Core Principles

Generally, stress test policies and practices should be transparent and critical, consist of well-documented methods and assumptions, and be based on models that are commensurate with the size, complexity, and sophistication of the institution. Mid-sized Banks are not required to use any one method in particular to estimate and project the effects of the variables, but the choice of method(s) should accurately represent a Mid-sized Bank's products and business lines, and be appropriately sensitive to the scenarios. The methodologies chosen must be consistent, repeatable, transparent, and well documented. Additionally, estimates and projections should be consistent with each other across the stress test so that one element accurately responds to the

4 *See* Supervisory Guidance on Stress Testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets, 77 Fed. Reg. 29458 (May 17, 2012).

5 *See* Annual Stress Test, 77 Fed. Reg. 61238 (Oct. 9, 2012) (12 C.F.R. § 46); Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. 62378 (Oct. 12, 2012) (12 C.F.R. § 252); Annual Company-Run Stress Test Requirements for Banking Organizations With Total Consolidated Assets Over $10 Billion Other Than Covered Companies, 77 Fed. Reg. 62396 (Oct. 12, 2012) (12 C.F.R. § 252); Annual Stress Test, 77 Fed. Reg. 62417 (Oct. 15, 2012) (12 C.F.R. § 325).

behavior of corresponding elements. Lastly, appropriately competent staff and senior management must oversee the stress test process.

C. Areas of Focus

The Guidance specifically identifies and elaborates on nine areas of focus: data sources, data segmentation, model risk management, loss estimation, PPNR, balance sheet and risk-weighted asset projections, immaterial portfolios, quarterly provisions for loan and lease losses (PLLL) and quarter-end ALLL, and quarterly net income. In each of these nine areas, the Guidance emphasizes the core principles that apply across the stress test.

1. Data Sources

Mid-sized Banks must have appropriate management information systems and data processes to collect data for stress tests. Data on which projections are based must be reliable and generally consistent across time. If a Mid-sized Bank lacks historical internal data or data with sufficient granularity, it may use data from similar organizations, but it must also develop mechanisms to gather requisite data for future use. Mid-sized Banks should apply conservative assumptions to bridge gaps in relevant data.

2. Data Segmentation

Mid-sized Banks should segment data on their portfolios and business activities into categories based upon common risk characteristics. The goal is to separate exposures with varying degrees of sensitivity to the stress test scenarios.

3. Model Risk Management

Model risk management involves developing practices for validating a Mid-sized Bank's models. Mid-sized Banks should subject models to appropriate standards for development, implementation, use, and governance. They should document each model's assumptions, limitations, and uncertainties, and have in place a process by which to challenge methodologies and results.

4. Loss Estimation

Loss estimation practices must capture risks associated with portfolios, business lines, and activities. The Federal Regulators expect loss estimation methods for credit risk to be more sophisticated than those for other types of risks because credit risk typically presents the largest risk to capital for Mid-sized Banks. Additionally, a bank may use a different method of estimation for each scenario. Mid-sized Banks must estimate credit losses from loan portfolios and securities holdings directly and separately, while incorporating other losses into PPNR. Mid-sized Banks may estimate loan losses at an aggregate level, loan-segment level, or loan-by-loan level using appropriate techniques such as net charge-off models, roll-rate models, and transition matrices.

5. Pre-Provision Net Revenues

The Federal Regulators caution Mid-sized Banks not to assume revenue streams will remain constant or come from the same sources across all stress scenarios. PPNR estimates should consider the effects of higher nonaccruals, increased collection costs, and changes in funding sources, and be consistent with loss projections, the balance sheet, and risk-weighted assets. Mid-sized Banks may estimate PPNR on an aggregate level for the entire company or by business line. They may base their PPNR estimates on internal or industry historical experience or use a model-based approach. Operating losses and losses other than credit losses associated with loan portfolios and securities holdings should be included in projecting PPNR.

6. Balance Sheet and Risk-weighted Assets

Balance sheet and risk-weighted asset projections should take into consideration a Mid-sized Bank's business decisions and actions during past stressful periods. For example, when making balance sheet and risk-weighted asset projections, Mid-sized Banks should consider whether they reduced their activities and the overall size of the balance sheet during past stressful periods. Mid-sized Banks must justify major changes to the composition of their risk-weighted assets in stress scenarios, such as material purchase or sale of assets. They must also consider the effect of changes in balance sheet and risk-weighted asset projections on PPNR. Any assumptions about reductions in risk-weighted assets and thus capital requirements should be well supported.

7. Estimates for Immaterial Portfolios

Mid-sized Banks need not apply the same rigor and analysis to lower-risk and immaterial portfolios. Immaterial portfolios are those that would not have a consequential effect on capital adequacy under the stress test scenarios.

8. Quarterly Provisions and Ending Allowance for Loan and Lease Losses

Estimated PLLL should incorporate a Mid-sized Bank's need for higher reserve levels under stressed conditions due to poor loan performance. Mid-sized Banks should ensure that ALLL covers remaining losses at the end of each quarter, and that ALLL at the end of the last quarter of the stress test horizon covers losses projected beyond the planning horizon.

9. Quarterly Net Income

Mid-sized Banks should base projected net income on its loss, revenue, and expense projections. Tax estimates should reflect relevant assumptions made in other projections.

D. Additional Areas of Guidance

As part of the stress test, Mid-sized Banks are required to estimate the impact of each scenario on the bank's capital levels and ratios. The Office of the Comptroller of the Currency expects that under the various scenarios, a bank's capital levels and ratios would decrease as the severity of the scenario increases. Any case in which the resulting capital levels and ratios increase should be well supported and documented. Unlike holding companies, which are required to make specific assumptions about capital actions (such as dividend payments), banks need only use ones that are consistent with their internal practices.

The guidance also elaborates on the supervisory expectations for controls, oversight, and documentation; regulatory reporting; and public disclosures.

III. Conclusion

The Guidance emphasizes that a Mid-sized Bank should develop sophisticated, well-documented methodologies for its stress tests to accurately represent the effect each scenario will have on the institution. At the same time, the Guidance allows for flexibility in developing and implementing methodologies appropriate to each bank's unique circumstances.

Stress tests have significant regulatory and reputational implications for banks. In addition to ensuring satisfactory stress test methodologies and practices, a Mid-sized Bank may consider stress testing an important component of its risk management program. In implementing such a program, the bank may decide to adjust its balance sheet to increase capital, improve liquidity, decrease leverage, enhance interest rate risk management, and/or reduce dependence on short-term funding. Such adjustments may help the bank become more resilient and meet regulatory expectations.

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