SENATE PASSES A COMPREHENSIVE FINANCIAL REGULATORY REFORM BILL AND SETS THE STAGE FOR A SENATE-HOUSE CONFERENCE PROCESS

May 24, 2010

To Our Clients and Friends:

On May 20, the Senate passed far-reaching legislation – entitled the Restoring American Financial Stability Act of 2010 ("RAFSA") – designed to alter significantly many aspects of the U.S. financial services regulatory structure. RAFSA passed the Senate by a vote of 59-39 and now must be reconciled with a parallel financial reform measure passed by the U.S. House of Representatives (the "House Bill") in December 2009. The conference process is expected to commence in short order, with a reported aim of producing final legislation for President Obama's signature before the July 4th weekend.

RAFSA and the House Bill are broadly similar in many respects, and both bills generally follow a framework for reform introduced last year by the Obama administration. That said, the two bills also differ in key ways, and how those differences are reconciled in the conference process will be of great importance to many financial institutions. The process for reconciling the differences between the two bills, and some of the key areas of differences between them, are discussed in detail below.

CONFERENCE COMMITTEE PROCESS

As noted above, the next step in the financial reform legislative process is the Senate-House conference. There are virtually no formal rules governing the conference process; conference committees are negotiating forums, and they typically operate without traditional congressional rules on quorums, proxies, amendments and other procedural matters. The proceedings, however, are limited in scope to areas of disagreement between the bills passed by the two chambers; as a general rule, conferees may not change a provision on which both houses agree, nor may they add anything to legislation that is not present in one version or the other. At least parts of the conference process may be public.

When the conferees reach an agreement, a conference report is prepared and submitted to each chamber. Each chamber has rules governing debate on conference reports, but the reports may not be amended. If both houses agree to the report, the compromise bill is then presented to the President for his signature or veto.

In the Senate, conferees are selected through a process worked out by the majority and minority leaders, which ensures that Senators of both parties will be represented in the conference. In the House, the Speaker simply appoints conferees (often including

Representatives of both parties). Both chambers generally refrain from instructing conferees on how to act in conference, but each chamber's rules allow its members to offer such instructive motions, which can be adopted with a simple majority vote. These motions instruct conferees to take a certain position in negotiations, but the motions are not binding and, after a conference report is adopted, no member can object on grounds that the conference result is inconsistent with previously adopted instructions.

With respect to RAFSA, the road to final passage was cleared when the Senate voted 60-40 to invoke cloture, thereby cutting off debate on the bill. In advance of the cloture vote, leaders of both parties reached a compromise that should permit the Senate to move forward with the appointment of conferees on Monday. To reach the compromise, Senator Sam Brownback, R-Kan., agreed to withdraw an amendment to RAFSA that would have excluded auto dealers from the jurisdiction of a proposed consumer protection bureau. Due to certain parliamentary maneuvers, that action also prevented the Senate from voting on a proposed amendment to tighten the restrictions in the so-called "Volcker Rule," which is discussed below.

In return, Senators Brownback and Kay Bailey Hutchison, R-Tex., will be permitted to offer motions on Monday afternoon to instruct the Senate conferees. It is expected that Sen. Brownback's motion will instruct the conferees to include language in the conference report excluding auto dealers from supervision by the consumer bureau and from certain other consumer protection provisions, and that Sen. Hutchison's motion will instruct conferees on some aspect of the proprietary trading ban that is in the Volcker Rule. The precise language of the instructions is not available at this time.

After the two motions are offered, the Senate will take formal steps to begin the conference committee process by appointing its conferees through unanimous consent. It currently appears that seven Democrats and five Republicans will be named as Senate conferees.

As of the time of this publication, the situation in the House is less clear. Reports indicate that House Speaker Nancy Pelosi may wait until after Memorial Day to appoint conferees. There also is no word on how many conferees Speaker Pelosi will appoint; she is not obligated to appoint the same number as the Senate. At this point, there are no indications that the House plans to issue instructions to its conferees.

The length of the conference committee negotiations on RAFSA and the House Bill is unpredictable – particularly if, as has been suggested by members of both parties, the proceedings are televised. As noted above, Democratic leaders announced their desire to get a final bill to President Obama's desk by July 4; to achieve this goal, the conference process will need to be highly active in June.

KEY AREAS FOR RECONCILIATION

Designation and Regulation of Systemically Significant Institutions

RAFSA and the House Bill take broadly similar, but not identical, approaches to the designation and regulation of systemically significant financial institutions. Each, for example, would create a council (the "Council") of regulators (with slightly different memberships) that generally would possess authority to determine that a financial institution is systemically significant and, thus, subject to enhanced regulatory scrutiny. Yet, the two systemic risk regulation regimes differ in some significant respects, including the following:

- Under the House Bill, the Council may determine by a majority vote that a financial company should be deemed systemically significant. In making such a determination, the Council must find that material financial distress at the company could pose a threat to financial stability or that the nature, scope, size, scale, concentration and interconnectedness, or mix of the company's activities could pose such a threat. RAFSA establishes a similar process but requires a two-thirds vote by the Council to designate a non-bank financial company as systemically important. In addition, RAFSA would designate "large, inter-connected bank holding companies" (bank holding companies with more than $50 billion in total consolidated assets) as systemically important and subject to increased regulation and oversight.

- The House Bill allows the Council to designate a company engaged in ***any*** amount of financial activities as systemically important and, thus, potentially subject to increased supervision and regulation. By contrast, RAFSA allows the Council to designate as systemically significant only those firms that are predominantly engaged in financial activities (that is, with financial activities representing at least 85% of a firm's consolidated revenues or assets).

- The House Bill generally would require a systemically significant financial institution engaged in non-financial activities to set up an intermediate holding company (a "Section 6 Holding Company"). With certain exceptions, a Section 6 Holding Company would be required to engage in all of the firm's financial activities, subject to the requirements of the Bank Holding Company Act of 1956. RAFSA contains no such requirement but grants the Federal Reserve discretionary authority to require a systemically significant non-bank financial company to establish an intermediate holding company for its financial activities.

- RAFSA contains what has been dubbed the "Hotel California" provision, under which a bank holding company with total consolidated assets of $50 billion or more, as of

January 1, 2010, and that received financial assistance under the Troubled Asset Relief Program ("TARP") will be treated as systemically significant even if it ceases to be a bank holding company. This treatment is subject to appeal by the company to the Council. The House Bill contains no such provision.

Capital Standards

Both RAFSA and the House Bill generally call on regulators to adopt various higher prudential regulatory standards on systemically significant financial firms and grant the Federal Reserve express authority to impose additional capital requirements on bank holding companies.

RAFSA goes one step further. Per an amendment introduced by Senator Susan Collins, R-Maine, RAFSA requires the federal banking agencies to establish minimum leverage and risk-based capital requirements for insured depository institutions, depository institution holding companies and systemically important non-bank financial companies. The risk-based capital and leverage requirements must be "not less than" the "generally applicable risk-based capital requirements" and the "generally applicable leverage capital requirements" in effect for insured depository institutions as of the date of the statute's enactment.

The current risk-based capital and leverage requirements applicable to insured depository institutions – rather than those currently applicable to bank holding companies – will thus set the new minimum standards for depository holding companies. The result will likely be higher capital requirements for such holding companies. For example, certain trust-preferred and hybrid securities, which the Federal Reserve allows bank holding companies to include in Tier 1 capital, would be includable only in Tier 2 capital. Similarly, this RAFSA provision would appear to require the imposition of capital requirements on thrift holding companies, which the Office of Thrift Supervision had not previously imposed by rule.

Resolution Authority and its Funding

RAFSA and the House Bill both contain a process for the orderly liquidation of systemically important financial firms. In general, both bills vest the Federal Deposit Insurance Corporation ("FDIC") with liquidation authority and grant the agency broad powers fashioned on its current resolution authority for insured depository institutions.

Differences in the bills exist. RAFSA generally requires a federal court review prior to the FDIC being named as receiver to a systemically significant financial firm; the House Bill provides for no such process. The House Bill, but not RAFSA, includes a controversial provision that permits a 10% haircut on certain types of short-term secured claims, secured by collateral other than securities issued by the U.S. Treasury, U.S. agencies or U.S. government-sponsored enterprises. Both bills would allow the FDIC as receiver to treat

similarly situated creditors differently, although RAFSA puts more constraints on the FDIC's use of this power.

There are differences, as well, in the funding of liquidations. The House Bill provides for a $150 billion Systemic Dissolution Fund, to be pre-funded through risk-based assessments imposed by the FDIC on financial institutions with $50 billion or more in total consolidated assets and on hedge fund managers with $10 billion or more in assets under management. These assessments would be based on a risk matrix to be promulgated by the Council that takes into account a number of factors.

RAFSA contains no pre-funding mechanism. Instead, certain financial companies would be subject to risk-based assessments necessary to pay obligations issued by the FDIC in regard to the resolution of a systemically significant financial institution. In general terms, assessments first would be imposed to recover amounts received by any claimant under a resolution to the extent a claimant received additional payments or amounts in excess of what is available from the estate of the liquidated company. To the extent that these "clawback" assessments are insufficient to pay the FDIC's obligations, then assessments would be imposed on systemically significant financial institutions and on other financial companies with $50 billion or more in total consolidated assets.

RAFSA also provides for recoupment of compensation paid to senior executives and directors of a resolved company who are "substantially responsible for the failed condition" of the resolved company. The FDIC can seek to recoup compensation paid within two years of the agency's appointment as receiver for the company, except in the case of fraud, in which case no time bar exists.

Volcker Rule

Another key element of RAFSA, which does not appear in the House Bill, is the so-called "Volcker Rule." The House Bill was passed prior to the Obama Administration's announcement of its support for the concept of the Volcker Rule.

As embodied in RAFSA, the Volcker Rule generally would require federal banking regulators to issue rules designed to prohibit any insured depository institution, any company that controls an insured depository institution, or any subsidiary or affiliate of an insured depository institution from engaging in "proprietary trading" and from "sponsoring or investing in a hedge fund or private equity fund." The Volcker Rule contains no exceptions for entities such as securities broker-dealers or insurance firms that are affiliated with insured depository institutions.

These Volcker Rule prohibitions are subject to "modifications" suggested by the Council through a study process and must be effected through rulemaking; the regulatory processes (of study and rulemaking) must be completed within 15 months of the enactment of a final

bill, and the prohibitions must take effect two years after the rulemaking is complete, subject to potential case-by-case extensions. Among other things, the Council's study is to consider whether implementation of the Volcker Rule "appropriately accommodates the business of insurance."

"Proprietary trading" is defined under the Volcker Rule to include purchasing or selling stocks, bonds, options, commodities, derivatives or other financial instruments "for the trading book (or such other portfolio as the Federal banking agencies may determine)." If interpreted broadly, this provision might potentially prohibit an insurer that is affiliated with an insured depository institution from investing in corporate bonds, for example. Subject to regulatory guidance, proprietary trading would not include transactions "on behalf of a customer, as part of market making activities, or otherwise in connection with or in facilitation of customer relationships, including risk-mitigation hedging activities related to such [a transaction]." In addition, the Volcker Rule would exclude from its prohibition investments in obligations of the United States (including obligations fully guaranteed by the United States or a U.S. agency); obligations, participations or other instruments of or issued by certain GSEs; and obligations of a state or political subdivision of a state.

As noted, the Volcker Rule's prohibitions would apply to investing in and sponsoring hedge and private equity funds, which are defined as funds exempt from registration under sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 or "similar fund[s]," as regulators may determine. RAFSA defines sponsoring to mean serving as a general partner, managing member or trustee of a fund; selecting or controlling a majority of the directors, trustees or management of the fund; or sharing the same name or a variation of the same name with a fund.

In addition to the above-noted prohibitions, the Volcker Rule would place limits on other relationships between banking organizations and hedge and private equity funds. Specifically, RAFSA would prevent an insured depository institution, any company that controls an insured depository institution and "any subsidiary of such institution or company that serves … as investment manager or investment adviser" to a hedge or private equity fund from entering into "covered transactions" (as defined in Section 23A of the Federal Reserve Act) with such hedge or private equity fund. Covered transactions include, for example, extensions of credit to or purchases of securities from a fund. Other transactions between such entities would need to meet the arm's length requirements of Section 23B of the Federal Reserve Act.

As passed by the Senate, the Volcker Rule's hedge and private equity fund prohibitions would not apply to investments in small business investment companies and certain investments designed to promote the public welfare. In addition, the Volcker Rule would apply only in limited form to foreign banking organizations. Foreign banking organizations

will be able to engage in proprietary trading and investing and sponsoring hedge funds and private equity funds off-shore and "solely outside the United States." RAFSA does not appear to permit U.S. banking organizations to do the same.

As noted above, the House Bill does not contain a direct analog to the Volcker Rule. Instead, the House Bill grants the Federal Reserve discretionary authority to restrict the proprietary trading activities of a systemically significant financial holding company if the agency believes that doing so is necessary to address safety and soundness or financial stability concerns. Presumably, the Federal Reserve would exercise this authority on a case-by-case basis.

Derivatives

Both RAFSA and the House Bill would impose a broad new regulatory structure on the over-the-counter derivatives markets. Both bills would provide the Commodity Futures Trading Commission ("CFTC") with oversight authority over swaps and the Securities and Exchange Commission ("SEC") with authority over security-based swaps, and both generally would require swaps to be cleared through a central clearing agency and traded on a registered exchange or execution facility, subject to exemptions for end-users of swaps to hedge commercial risk. Swap dealers and major swap participants also would be subject to new requirements regarding capital, margin, segregation of related assets such as collateral, registration requirements and new business conduct, reporting and disclosure rules.

A major difference between the two bills is that RAFSA contains a prohibition on the provision of certain assistance from the Federal Reserve (such as discount window loans) or the FDIC (such as deposit insurance) to a swaps entity engaged in such swaps operations. This provision appears to have the practical effect of prohibiting banking institutions (and possibly their affiliates) from engaging in such swaps operations, requiring them to divest their swaps businesses. This "push-out" requirement is one of the most controversial provisions remaining in either bill; it had been expected to be removed or modified in the final Senate process, but no such change has been agreed to yet.

In addition, RAFSA has a narrower exemption for commercial end-users engaged in hedging operations, which would appear to subject a broader range of swaps, especially those engaged in by financial entities, to the new requirements. RAFSA would also impose a fiduciary duty on swap dealers in their swap dealings with municipalities (as well as pension plans, endowments and retirement plans).

Consumer Financial Protection Agency

Both RAFSA and the House Bill would create a new consumer financial protection regulator with broad rulemaking, examination and enforcement authority to protect consumers from unfair, deceptive and abusive practices in connection with financial products and services

(other than insurance and securities/commodities). The new agency would succeed to the consumer protection authorities currently exercised by the federal banking agencies, including enforcement and examination of insured depository institutions with total assets of at least $10 billion and their affiliates. This new regulator would be focused solely on consumer protection issues, without the banking agencies' focus on safety and soundness.

A principal difference between the House Bill and RAFSA is in the structure of the new agency. The House Bill would create a new independent, stand-alone agency headed by a Director for roughly two years, and then by a five-person Commission. RAFSA, by contrast, would create a new Bureau within the Federal Reserve, but subject to protections from intervention by the Federal Reserve in its operations.

Fiduciary Standards for Brokers and Advisers

Both RAFSA and the House Bill address the differential between the duties that investment advisers owe to their clients as compared to the duties that broker-dealers owe to their customers. The House Bill directs the SEC to establish a single fiduciary duty standard for investment advisers and broker-dealers when providing personalized investment advice to retail customers. In contrast, RAFSA requires the SEC to study the effectiveness and the gaps and overlap of the current legal and regulatory system for broker-dealers and investment advisers with regard to the provision of personalized advice to retail customers and address any gaps through its existing rulemaking authority.

Investment Adviser Registration/Private Offering Standards

Both the House Bill and RAFSA would eliminate the existing exemption from registration under the Investment Advisers Act of 1940 (the "Advisers Act") generally used by private fund managers and would require those managers to register. Both bills would provide a new exemption from registration for advisers to "venture capital" funds (to be defined by the SEC), although the House Bill imposes additional recordkeeping and reporting requirements on these advisers. Both bills also would provide an exemption from registration for foreign private fund advisers – generally, advisers that have no place of business in the United States, have fewer than 15 clients and less than $25 million in assets under management attributable to U.S. clients and investors, and do not hold themselves out to the public in the United States as investment advisers.

There are other significant differences with regard to the Advisers Act exemptions. RAFSA provides an exemption for advisers to "private equity" funds (to be defined by the SEC). The House Bill, however, does not provide such an exemption but does provide an exemption to small private fund advisers whose only clients are private funds and who have less than $150 million in assets under management. In both cases, the advisers to "private equity" funds under RAFSA and the small private fund advisers under the House Bill would be subject to certain recordkeeping and reporting requirements. In addition, RAFSA creates

an exclusion from the definition of "investment adviser" for "family offices" (to be defined by the SEC).

In addition to the current registration requirements under the Advisers Act, the registered private fund advisers would be subject to additional recordkeeping and reporting requirements with regard to the private funds, largely to be fleshed out through rulemaking by the SEC. The types of information that the bills envision will be provided include: assets under management, use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies and practices, types of assets held, trading practices and any other information the SEC deems is necessary and appropriate in the public interest, for the protection of investors or for the assessment of systemic risk.

RAFSA also changes the minimum threshold of the assets that an investment adviser would have to manage to register with the SEC from $25 million to $100 million. Investment advisers that manage less than $100 million would be required to register with a state.

RAFSA also requires that the SEC amend the definition of "accredited investor" to adjust the current income and net-worth thresholds for inflation and to readjust those thresholds every five years. While the House Bill does not contain such a provision, it would require the SEC to adjust for inflation the thresholds used in the rule permitting advisers to charge performance fees.

Please feel free to contact us with any questions.

Kenneth J. Berman
+1 202 383 8050
kjberman@debevoise.com

Satish M. Kini
+1 202 383 8190
smkini@debevoise.com

David A. Luigs
+1 202 383 8145
daluigs@debevoise.com

Gregory T. Larkin
+1 202 383 8064
gtlarkin@debevoise.com

Christopher J. Ray
+1 212 909 6206
cjray@debevoise.com

Thomas S. Wyler[1]
+1 202 383 8052
tswyler@debevoise.com

[1] *Admitted in New York only.*