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Regulation and Resolution of Systemically Significant Financial Companies Under the Dodd-Frank Act

by Paul L. Lee, Gregory J. Lyons and Christopher J. Ray

The Dodd-Frank Act is a sweeping measure that both expands and reorders the U.S. financial regulatory system. At the core of the Dodd-Frank Act lie various provisions designed to address systemic risk in the U.S. financial system. Among the most important provisions of the Dodd-Frank Act in this respect are those contained in Title I, which creates a new regulatory regime for systemically significant financial companies (which, as described below, will include the largest bank holding companies and could also include the largest insurance companies, private equity firms, hedge funds and other significant nonbank financial firms), and Title II, which creates a new resolution regime for such companies and potentially a broader array of firms. The construct of these two titles reflects the belief that addressing systemic risk requires at a minimum a two-pronged approach: the first prong is heightened regulation of financial firms that present systemic risk; the second prong is a process for the orderly dissolution of firms encountering material distress, the failure of which would have serious adverse effects on U.S. financial stability. Proponents of the Dodd-Frank Act argue that these titles will mitigate the too-big-to-fail problem. Opponents of the Dodd-Frank Act argue that these titles will actually have the perverse effect of reinforcing the too-big-to-fail problem.

This article focuses on the largest bank holding companies and nonbank financial institutions that may be designated as systemically significant companies, discussing in particular how they are designated, regulated, and, if necessary, liquidated. The Dodd-Frank Act appears to contemplate primary use of a formulaic, asset-based test for the designation of bank holding companies as systemically significant. Specifically, it sets a $50 billion consolidated asset floor for a bank holding company to be subject to the heightened oversight and regulation (as of March 31, 2010, there were 36 bank holding companies over this threshold), although the Board of Governors of the Federal Reserve System (the "FRB") can adjust those amounts upward for some of the heightened standards under certain circumstances.

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Dodd-Frank Act

This issue is devoted to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which passed the House of Representatives on June 30, 2010 and the Senate on July 15, 2010, and is expected to be signed into law by the President soon. For a summary of the bill and other analysis, please visit www.debevoise.com/doddfrankact.

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Letter from the Editor

We devote the entire July issue of our *Financial Institutions Report* to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, passed by the House of Representatives on June 30, 2010 and by the Senate on July 15, 2010. The President's signature is expected soon.

The Dodd-Frank Act will bring the greatest change in U.S. regulation of the entire financial sector since the Great Depression and will touch the state-regulated U.S. insurance industry in unprecedented ways.

We are participating in these developments while also monitoring parallel change in financial supervision elsewhere. Banking institutions in the United States, Europe and around the world face the implications of the Basel Committee's proposals. Its Capital Proposal contemplates a new core capital requirement restricted to common equity and retained earnings, limits on recognition of hybrid instruments, a new leverage ratio, counter-cyclical buffers and increased risk coverage for counterparty credit risk exposure. The Liquidity Proposal contemplates global liquidity standards, both short- and long-term. These proposals are likely to change. The Basel Committee's goal is to publish standards by the end of this year for implementation during 2012.

Insurers in Europe are planning for Solvency II, an EU initiative that offers reduced capital requirements as an incentive for better risk management systems and internal controls. The timetable for implementation of Solvency II or its capital requirements may need to be modified to take account of the financial crisis in the Eurozone countries. The effect of Solvency II may change the competitive landscape.

A bank tax now finds widespread support in the EU, as the markets await the outcome of the EU-ordered stress test on all material EU banks and EU Finance ministers discuss the contours of pan-European systematic risk supervision.

The European Community and the UK Financial Services Authority are studying strengthening the relationship between auditors and regulators. There have been calls in Europe for boards of directors to have risk committees. Supervisors are seeking to reduce perceived risks by changing the way banks compensate their employees.

In our interconnected financial system, the G-20 meetings at the end of June underscored how international cooperation among governments and financial supervisors remains an important, if elusive, goal.

In addition to new substantive requirements, regulators are being reorganized. In the UK, the government proposes to phase out the Financial Services Authority, as described in our June 21, 2010 Client Update.

We will continue to follow all of these developments and to report on them in the *Financial Institutions Report*, in Client Updates and at client seminars.

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Editor-in-Chief

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The Dodd-Frank Act's Changes to Regulation of Insured Depository Institutions and Their Holding Companies

by Satish M. Kini, David A. Luigs and Thomas S. Wyler

The Dodd-Frank Act represents a paradigm shift in the U.S. approach to bank regulation. For much of the last four decades, U.S. bank regulatory policy was guided by two tenets: the first being faith in the market and its ability to discipline banking organization risk taking and other potentially problematic activities; the second being a belief that diversification of banking organization activities would lead to a commensurate diversification and reduction of bank risk profiles.

Guided by the experiences of banking organizations, federal regulators, and consumers in the financial crisis, Congress has taken an entirely different approach in the Dodd-Frank Act. Rather than trusting markets to lessen risks, the Dodd-Frank Act revises the federal bank agency structure and empowers federal bank regulators in myriad ways to devise rules to prevent risky activities and to protect consumers. Moreover, rather than fostering product diversification, the Dodd-Frank Act restricts the activities of banking firms, most notably under the so-called "Volcker Rule," in the belief that doing so would lessen conflicts and risks.

In this article, we review some of the principal ways in which the Dodd-Frank Act reforms the bank regulatory structure. We focus first on the changes to the agency framework within which banking firms operate. We then discuss the Volcker Rule and other new rules in the Dodd-Frank Act and their impact on banks and other insured depository institutions and on their holding companies.

Agency Restructuring

Some of the most important changes in the Dodd-Frank Act involve major restructuring of the federal bank regulatory agencies. These changes are of interest not only from an inside-the-Beltway perspective of how power is allocated among regulators, but also from the perspective of the banking organizations that will need to establish and manage new regulatory relationships.

Elimination of the Office of Thrift Supervision

First, the Office of Thrift Supervision (the "OTS"), which came under severe criticism in Congress for its perceived supervisory shortcomings, will be eliminated, and its duties and responsibilities transferred to the other federal banking agencies. This transfer of regulatory authority had long been expected by industry participants and, in later stages of the debate on financial regulatory reform legislation, was not controversial on Capitol Hill.

Thrift holding companies (and their non-depository subsidiaries) will be regulated by the Federal Reserve Board (the "FRB"), federal thrifts will be regulated by the Office of the Comptroller of the Currency (the "OCC") and state-chartered thrifts will be regulated by the Federal Deposit Insurance Corporation (the "FDIC"). The OTS's rulemaking authority relating to thrift holding companies, thrift transactions with affiliates, extensions of credit to insiders and tying arrangements will be transferred to the FRB. The remainder of the OTS's rulemaking authority relating to both state and federal thrifts will be transferred to the OCC. The effective date of the transfers is 1 year after the Dodd-Frank Act's enactment, which may be extended by the Treasury Secretary for up to 6 months.

Although the supervisor will change, the thrift charter will not be eliminated and a separate body of law governing thrifts and thrift holding companies will remain, albeit changed in some respects, particularly with regard to supervision of thrift holding companies. What remains to be seen is whether, notwithstanding the retention of a separate legal regime, the presence of a new supervisor results in a change in the standards under which thrifts and their holding companies operate. In other words: will the OCC and FRB interpret the Home Owners' Loan Act in the same way as the OTS did or, as many expect, will they view their new authority through the prisms of their own experiences and regulatory precedents? To that end, the biggest impact from this change may be with respect to thrift holding companies, which may come under more exacting supervision and requirements under the FRB than they experienced with the OTS. (§312)

Consumer Financial Protection Bureau

More controversially, the Dodd-Frank Act significantly overhauls the regulation of consumer financial activities of depository institutions and other financial firms. It creates a new Bureau of Consumer Financial Protection (the "Bureau"), which will be housed within the Federal Reserve System but which will be independent. The Bureau will be headed by a Director appointed by the President and confirmed by the Senate, and the FRB will generally be prohibited from intervening with respect to Bureau matters, including rulemaking, orders, and personnel. (§§1011-1013)

Authority to implement virtually the entire "alphabet soup" of federal consumer financial protection laws (such as the Truth in Lending Act, Truth in Savings Act and Real Estate Settlement Procedures Act) will be transferred to the Bureau. (§1002(12)) Perhaps most dramatically for depository institutions, the Bureau will receive

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supervisory authority, including the power to conduct examinations and to take enforcement actions, with respect to depository institutions with more than $10 billion in consolidated assets (which may be measured by including affiliates). (§1025) Depository institutions under the $10 billion threshold will continue to be supervised by the banking agencies but will be required to comply with the rules of the new Bureau. (§1026)

In addition to the existing body of federal consumer financial protection laws, the Bureau will have broad new authority, among other things, to declare acts or practices to be "unfair, deceptive, or abusive," to require consumer disclosures, to require that consumers be given access to their information at a financial institution and to restrict the use of mandatory pre-dispute arbitration clauses. (§§1028, 1031-1032) The Dodd-Frank Act also provides for a comprehensive set of new rules regulating residential mortgage underwriting, servicing and related activities and a controversial requirement that interchange transaction fees for electronic debit transactions be "reasonable" and proportional to costs. (§§1075, 1400-1484)

Providers of consumer financial services other than depository institutions will also be subject to the Bureau's new rules. Some such non-depository companies will also fall under the Bureau's supervisory and enforcement authority. These supervised companies will include most residential mortgage firms, certain "larger participants" (to be defined by Bureau regulation) in other consumer financial markets, private student lenders and payday lenders. In addition, certain "service providers" to depository institutions and to other covered non-depository providers of consumer financial products and services will also fall under the Bureau's supervisory authority, based on the parameters of the Bank Service Company Act. (§§ 1002(6), 1024)

Perhaps most dramatically for depository institutions, the Bureau will receive supervisory authority, including the power to conduct examinations and to take enforcement actions, with respect to depository institutions with more than $10 billion in consolidated assets ....

New Powers for the FDIC

As expected, certain provisions of the Dodd-Frank Act directly reflect concerns that arose in the most tense and dramatic days of the financial crisis. As discussed in greater detail in the article on the regulation and resolution of systemically significant financial companies, also in this issue, the Dodd-Frank Act creates an orderly liquidation process that the FDIC can employ for failing financial companies that are not insured depository institutions, including bank and thrift holding companies. Unlike the FDIC's current process for liquidating failing insured depository institutions, the Dodd-Frank Act prescribes a liquidation procedure that must be approved by the Treasury Secretary and FRB based on a finding that the institution's failure would have a significant and negative impact on the stability of the U.S. economy. (§203)

In addition, the Dodd-Frank Act gives the FDIC new authority to create a widely available emergency financial stabilization program to guarantee the obligations of solvent depository institutions, and their holding companies and affiliates, during times of severe economic stress. The FDIC, in consultation with the Treasury Secretary, is to issue regulations on the policies and procedures governing the issuance of guarantees under this authority. The maximum amount of debt that the FDIC can guarantee will be determined by the Treasury Secretary, in consultation with the President and subject to passage of a Congressional joint resolution of approval. This new authority is intended effectively to supersede the FDIC's existing power under Section 13(c)(4)(G)(i) of the Federal Deposit Insurance Act, as the FDIC is prohibited from exercising that existing authority to establish any other such widely available debt guarantee program. (§1105)

Restrictions on Federal Reserve Emergency Powers

For similar reasons, the FRB's authority to act in "unusual and exigent" circumstances under Section 13(3) of the Federal Reserve Act (12 U.S.C. §343), on which the FRB relied to provide significant amounts of emergency credit during the financial crisis, has also come under intense public and congressional scrutiny. As businesses all across the country were failing, major financial institutions were, it appeared to many, being saved by what essentially amounted to unilateral FRB and Reserve Bank actions. Against this backdrop, the Dodd-Frank Act imposes a number of

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> **Under [the] new set of restrictions, it seems clear that it will be more difficult for the FRB to act quickly to aid institutions in a time of crisis and extreme market illiquidity, as it did in 2008.**

new restrictions on the FRB's ability to use its Section 13 powers.

Under the revised form of Section 13, the FRB will be able to exercise its emergency lending authority only to participants in programs that have "broad-based" eligibility. Additionally, these programs must receive prior approval from the Treasury Secretary. "Broad-based" is not defined, but any program that is designed or established to remove assets from the balance sheet of, or otherwise to assist, a single and specific company will not be considered "broad-based." In addition, any institution that receives aid will have to provide certain specified collateral for the loans sufficient to protect taxpayers, as opposed to meeting the standard of "secured to the satisfaction of the Federal Reserve bank" that applied to actions during the financial crisis. (§1101)

This provision is intended to prohibit government "bailouts" of failing financial institutions. Under this new set of restrictions, it seems clear that it will be more difficult for the FRB to act quickly to aid institutions in a time of crisis and extreme market illiquidity, as it did in 2008.

The Volcker Rule

Perhaps the most discussed new limitation of the Dodd-Frank Act on the activities of banking organizations is contained in the so-called "Volcker Rule," the new set of restrictions on banking organizations' ability to engage in proprietary trading and sponsorship of or investment in private equity and hedge funds. Although the scope of these new restrictions is significant, the Dodd-Frank Act contains several important exceptions and leaves a number of key questions to be resolved in the future by regulations.

The scope of the Volcker Rule generally covers insured depository institutions, other than certain institutions with limited trust and fiduciary activities, and all of those institutions' affiliates, as well as certain foreign banking organizations with a commercial banking presence in the United States (at least to the extent of their U.S. activities) a ("banking entity"). Proprietary trading, which is generally prohibited under the Volcker Rule, is defined as engaging as a principal for the trading account of the banking entity, with the trading account defined to focus on transactions "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)." (Bank Holding Company Act ("BHCA") §13(h)(4), *as added by* §619) The Volcker Rule also generally prohibits any banking entity from sponsoring or acquiring any ownership interest in a private equity or hedge fund, which are defined as funds that would be investment companies under the Investment Company Act but for the application of the exemptions available in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, and any similar funds as determined by regulation. (BHCA §§13(a)(1)(B), 13(h)(2), *as added by* §619)

The Volcker Rule contains a number of exceptions, which are referred to as "permitted activities." All of the "permitted activities" provided for in the Dodd-Frank Act are, however, subject to a set of overarching limitations that prohibit such activities if they would involve or result in a material conflict of interest, materially expose the banking entity to high-risk assets or trading strategies or pose a threat to the banking entity's safety and soundness or to U.S. financial security.

Transactions are otherwise permitted in the securities of the U.S. government and its agencies, certain government-sponsored enterprises (including Fannie Mae, Freddie Mac and the Federal Home Loan Banks) and states and their political subdivisions, as are investments in small business investment companies under the Small Business Investment Act and investments designed to promote the public welfare under 12 U.S.C. §24. Transactions "on behalf of customers" and in connection with certain underwriting and market making activities, as well as risk-mitigating hedging activities, are granted an exception. Certain foreign banking activities that occur "solely outside of" the United States are also permitted. (BHCA §13(d)(1), *as added by* §619). Certain activities by a regulated insurance company for the general account of the company and by any of its affiliates solely for that general account are also permitted if they are conducted in compliance with the laws of the state or jurisdiction where the insurance company is domiciled and the federal banking agencies have not jointly determined that such applicable state laws are insufficient to protect the banking entity or U.S. financial stability.

The Dodd-Frank Act provides an exception in connection with the banking entity's bona fide trust, fiduciary or investment advisory

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services to permit organizing and offering to its customers a private equity or hedge fund. This exception is also subject to a number of limitations. The banking entity cannot guarantee the obligations of the fund, must disclose to fund investors that the fund's losses are borne solely by its investors, cannot share names with the fund and cannot have more than a *de minimis* interest in the fund, and the banking entity's directors and employees cannot take an interest in the fund unless they are directly engaged in providing services to the fund. (BHCA §13(d)(1), as added by §619)

The Dodd-Frank Act defines certain parameters with respect to a permissible *de minimis* investment in a private equity or hedge fund that the banking entity organizes and offers. Among other things, no later than one year after the date of establishment of the fund, the banking entity's stake must be reduced to no more than 3 percent of the total ownership interests of the fund, and the investment must be "immaterial" to the banking entity. The term "immaterial" is to be defined by regulation, but in no case may the aggregate of all such interests of the banking entity exceed 3 percent of its Tier 1 capital.

In addition to the general prohibition on sponsorship and investment, the Volcker Rule contains a second set of requirements applicable to any private equity or hedge fund that is sponsored by the banking entity or for which it serves as investment manager or investment advisor. Covered transactions (as defined under Section 23A of the Federal Reserve Act) between the banking entity and the fund in these circumstances are prohibited, and transactions between the fund and the banking entity are subjected to the rules under Section 23B of the Federal Reserve Act as if the fund were an affiliate and the banking entity were a member bank. (BHCA §§13(f)(1), 13(f)(2), *as added by* §619)

The various restrictions, exceptions, and interrelationships among the provisions of the Volcker Rule give rise to a number of interpretive questions that will likely have to be answered by regulation. The Volcker Rule will become effective on the earlier of 2 years after enactment or 12 months after the issuance of the regulations that are required to implement the components of the Volcker Rule. After that effective date, banking entities must bring themselves into compliance within 2 years, subject to the ability of the FRB to issue extensions of up to 3 additional years and 5 years with respect to certain illiquid funds. (BHCA §13(c), *as added by* §619)

Other Impacts on Banks and Thrifts

A number of other provisions of the Dodd-Frank Act will have an impact on the businesses and compliance burdens of insured depository institutions. A few of these Dodd-Frank Act provisions will also benefit depository institutions, particularly smaller banks. A discussion of some of the more noteworthy of those provisions follows.

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FDIC Insurance

Many of the Dodd-Frank Act's changes with respect to the FDIC deposit insurance codify temporary changes that had already been implemented. For example, the amount of deposit insurance provided is permanently increased from \$100,000 to \$250,000, effective as of the day after the Dodd-Frank Act's date of enactment. Non-interest-bearing transactional accounts are also covered fully by FDIC insurance beginning December 31, 2010, subject to a two-year sunset. (§§335, 343) In addition, the Dodd-Frank Act shifts the focus of assessments from deposits to assets by providing that the FDIC must amend its regulations under 12 U.S.C. §1817(b)(2) to define the term "assessment base" generally to mean the average total consolidated assets of an insured depository institution minus tangible equity. (§331(b))

FDIC Reserve Ratio Increase

As described in more detail in the article on the regulation and resolution of systemically significant financial companies, also in this issue, an assessment that was to be levied on large financial companies was removed from the Dodd-Frank Act in the final hours of the House-Senate Conferance on H.R. 4173. In its place, a new provision was added to require the FDIC to take steps to raise the deposit insurance fund reserve ratio from 1.15 percent to 1.35 percent. The Dodd-Frank Act states that in setting assessments to meet this new ratio, the FDIC is to "offset" its effect on institutions with less than \$10 billion in consolidated assets. This "offset" requirement is intended to ensure that the burden of the increase of the FDIC

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reserve ratio falls only on banks with assets of $10 billion or more. (§334)

Interest on Demand Deposits

For years, depository institutions have sought a repeal of the prohibition from paying interest on demand deposits. The repeal has frequently been proposed and debated on Capitol Hill, and more than once a repeal has appeared imminent. The Dodd-Frank Act finally implements this repeal. Interest on demand deposits may be paid beginning one year after the Dodd-Frank Act's date of enactment. (§627)

Branching

Another benefit to some banks from the Dodd-Frank Act is a new provision that permits national and insured state banks to engage in *de novo* interstate branching if, under the laws of the state where the new branch is to be established, a state bank chartered in that state would be permitted to establish a branch. This section becomes effective one day after the enactment of the Dodd-Frank Act. (§613)

Lending Limits, Insider Transactions, and Affiliate Transactions

A number of new restrictions are imposed on transactions between banks and thrifts and their affiliates and insiders. These changes incorporate, for example, credit exposures on derivatives into lending limits insider loan limits, and affiliate transactions limits; impose a new set of requirements on insider purchases of assets from an institution; and tighten the "covered transaction" rules under Section 23A. For example, securities lending and borrowing transactions would become covered transactions for the purposes of Section 23A. In addition, the FRB will now be required to act jointly with the other applicable federal banking agency (either the OCC or FDIC) when granting a Section 23A exemption. (§§608-611, 614, 615)

Countercyclical Capital Requirements

One concern arising from the financial crisis is that bank capital requirements should not function in a way that exacerbates a crisis or an economic downturn. To address this concern, the Dodd-Frank Act directs the banking agencies to issue capital requirements for banking institutions that are countercyclical. These will require a higher level of capital to be maintained in times of economic expansion and a lower level of capital during times of economic contraction. Such capital requirements will become effective when the appropriate federal agency has completed rulemaking to determine the appropriate requirement level. (§616)

Bank and Thrift Preemption

The Dodd-Frank Act amends the National Bank Act to address the controversial topic of preemption of state consumer financial laws and applies the same standards to federal thrifts as are currently applied to national banks. (§1046) Preemption of state consumer financial laws is permitted if such laws: (i) discriminate against national banks in favor of state banks; (ii) prevent or significantly interfere with the exercise by the national bank of its powers, in accordance with the preemption standard established in *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner, et al.*,[1] or (iii) are preempted by another provision of federal law. Such a preemption determination is to be made by the OCC on a "case-by-case" basis as applied to an individual state law or other state laws with substantially equivalent terms. (§1044)

The National Bank Act is further amended such that federal preemption of state consumer financial laws will not be applied to subsidiaries and affiliates of national banks that are not themselves national banks, effectively reversing the recent U.S. Supreme Court decision in *Watters v. Wachovia Bank*.[2] (§1045) In addition, the Act's provisions regarding the Bureau authorize state Attorneys General to bring actions against federally chartered insured depository institutions for violations of the Bureau's regulations.

Other Impacts on Bank and Thrift Holding Companies

A new set of special requirements for systemically significant financial institutions will be applied to the largest bank holding companies — generally those with $50 billion in assets or more — and includes a new requirement for publicly traded bank holding companies with $10 billion in consolidated assets to establish a risk committee of its board. This new systemic risk regulation framework is discussed in the article on the regulation and resolution of systemically significant financial companies, also in this issue. All bank and thrift holding companies, including those that will not be deemed systemically significant, will face other new restrictions and limits. We discuss several below.

Capital Requirements

The Dodd-Frank Act requires that bank holding companies must be "well capitalized" and "well managed" in order to engage in the expanded financial activities permissible for financial holding companies under the BHCA. A similar requirement is applied to the comparable authority of thrift holding companies to engage in such activities. The effective date of this provision is one year after the date of enactment of the Dodd-Frank Act. (§606)

Similar to the requirement with respect to insured depository institutions, the Dodd-Frank Act instructs the FRB to seek to make capital requirements applicable to a bank holding company countercyclical, with a higher level required in times of economic

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expansion and a lower level needed in times of economic contraction. The Dodd-Frank Act also provides new explicit authority over the capital levels of thrift holding companies, qualified by a similar direction to make such requirements countercyclical. The effective date of this provision is one year after the date of enactment of the Dodd-Frank Act. (§616)

Another significant change to holding company capital requirements was embodied in the so-called "Collins Amendment." The Collins Amendment was generally designed to require that depository institution holding companies, including thrift holding companies and intermediary U.S. holding companies controlled by a foreign organization, be subject to minimum leverage and risk-based capital requirements that are not less than nor quantitatively lower than those generally applicable to insured depository institutions. (§171) A complex compromise was worked out to provide various exemptions and phased-in effective dates for different institutions and instruments, such as mutual holding companies, small bank holding companies under the FRB's small bank holding company policy statement, holding companies with less than $15 billion in assets, holding companies not previously supervised by the FRB such as thrift holding companies and certain bank holding company subsidiaries of foreign organizations that have relied on the FRB's Supervision and Regulation Letter SR-01-1, as well as for certain instruments issued to the U.S. government in connection with its Troubled Asset Relief Program authority, such as preferred stock under the Capital Purchase Program. The Collins Amendment is also discussed in the article on the implications of the Dodd-Frank Act for insurers, also in this issue.

The Collins Amendment was generally designed to require that depository institution holding companies, including thrift holding companies and intermediary U.S. holding companies controlled by a foreign organization, be subject to minimum leverage and risk-based capital requirements ... not ... lower than those generally applicable to insured depository institutions.

Source of Strength

The Dodd-Frank Act provides that each holding company, including a company that controls one or more insured depository institutions that are exempt from the definition of "bank" under the BHCA, will be required by the appropriate federal banking agency to serve as a "source of strength" for its subsidiary depository institutions. To be a source of strength, the holding company must be able to provide financial assistance to the insured depository institution in cases of financial distress. (§616)

Liability Cap and other Mergers and Acquisitions Rules

Similar to the Riegle-Neal nationwide deposit cap, insured depository institutions and their holding companies, as well as certain foreign banking organizations and nonbank financial companies supervised by the FRB, are generally prohibited from engaging in mergers and acquisitions that would result in the combined company's total consolidated liabilities exceeding 10 percent of the aggregate consolidated liabilities of all financial companies. The FRB is required to issue regulations implementing this prohibition, including any recommendations regarding modifications that result from a Financial Stability Oversight Council study on this prohibition. (§622)

In addition, an acquiring bank holding company must be well capitalized and well managed in order to make an interstate bank acquisition, and the resulting bank in an interstate merger must also be well capitalized and well managed upon consummation of the transaction. (§607) Prior FRB approval is also required for a financial holding company acquisition of certain nonbank financial companies if the assets to be acquired in the transaction exceed $10 billion. (§604)

Examination of Non-depository Subsidiaries

The Dodd-Frank Act repeals prior restrictions on the FRB's authority over "functionally regulated" subsidiaries and provides the FRB broader authority with respect to such entities. (§604) In addition, the Dodd-Frank Act requires the FRB to examine non-depository-institution subsidiaries of a

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depository institution holding company. This requirement applies to such subsidiaries that are not otherwise "functionally regulated" and which are engaged in activities that are permissible for the holding company's depository institution subsidiaries. The FRB is required to examine these activities in the same manner and frequency as would be required if such activities were conducted in the holding company's lead depository institution subsidiary. There are also provisions conferring certain "backup" authority on the federal banking agency that supervises the holding company's lead depository institution subsidiary to recommend such examinations and to take certain actions if the FRB fails to do so. The effective date of this provision is one year after the date of enactment of the Dodd-Frank Act. (§605)

Conclusion

The changes brought by the Dodd-Frank Act for insured depository institutions and their holding companies will be numerous and significant. As the implementation process proceeds, such institutions will want to ensure that they engage in active monitoring, commenting on proposed rulemakings and early planning in order to ensure that they are prepared for the new opportunities and the multitude of new regulatory requirements that will be put into place. ■

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[1] *517 U.S. 25 (1996).*
[2] *550 U.S. 1 (2007).*

Top Implications of the Dodd-Frank Act for U.S. Insurers

by Nicholas F. Potter and John Dembeck

From the date the Treasury Department released its original proposal for federal financial regulatory reform in July 2009, it became readily apparent that the proposal was bank-centric and questions immediately arose about how U.S. insurers, which are state-regulated, were to be treated. Hence, in addition to new substantive rules that apply to U.S. insurers, part of the Dodd-Frank Act story for U.S. insurers is just how some of the key parts of the Dodd-Frank Act relate to them – systemic risk regulation, resolution authority, the Volcker Rule and consumer financial protection.

These implications are in addition to those addressed in other companion articles in this issue, including those addressing (i) the regulation and resolution of systemically significant financial companies, (ii) expanded regulation of insured depository institutions and their holding companies and (iii) new rules regulating derivatives.

Since life insurance producers may also sell variable life insurance policies and variable annuity contracts that are regulated as both insurance and securities, please refer to the companion article addressing the broker-dealer standard of conduct, which discusses the study required under the Dodd-Frank Act to be conducted by the Securities and Exchange Commission with respect thereto. Lastly, please refer to the companion article on significant issues for broker-dealers for a discussion of a provision that clarifies that an equity-indexed annuity that satisfies certain criteria is an exempt security under Section 3(a)(8) of the Securities Act of 1933.

State-Based Insurance Reform

While the Dodd-Frank Act will impose many new burdens on certain U.S. insurers and U.S. insurance holding companies, it also contains at least one important benefit for U.S. insurers, namely state-based insurance reform that preempts certain state insurance regulations relating to reinsurance and non-admitted insurance.

Reinsurance Reform

The date that is 12 months from the date of enactment of the Dodd-Frank Act is an important one for U.S. ceding insurers and U.S. professional reinsurers. On that date, the provisions of the Dodd-Frank Act Title V, Subtitle B, Part II, take effect relating to reinsurance reforms. An extensive description and analysis of these provisions, which preempt certain state laws relating to reinsurance, is set forth in an article entitled "Reinsurance Reform: U.S. Federal Financial Regulatory Reform Bills" in the April 2010 issue of this publication (available at www.debevoise.com). Among other things, from that date forward, if a ceding insurer's domestic state is NAIC-accredited and the state recognizes credit for reinsurance for the ceding insurer's ceded risk, then no other state may deny such credit for reinsurance. Since all states are now NAIC-accredited, if they remain so on that date, all state laws and regulations imposing requirements on non-domestic ceding insurers as a condition of obtaining reinsurance credit in their state will be preempted – so long as reinsurance credit is allowed in the ceding insurer's domestic state. (§§531-533)

Nonadmitted (Excess and Surplus Lines) Insurance Reform

Certain property/casualty insurers are permitted to offer insurance coverage in a

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the state without a license. The date that is 12 months from the date of enactment of the Dodd-Frank Act is also important for nonadmitted insurers (other than risk retention groups) and surplus lines brokers, as the provisions of the Dodd-Frank Act Title V, Subtitle B, Part I, also become effective on this date. Among other things, these provisions: (i) prohibit any state other than the "home State" of an insured from requiring any premium tax payment for nonadmitted insurance, provided that states may enter into a compact or otherwise establish uniform procedures to allocate among the states the premium taxes paid to an insured's home state; (ii) make placement of nonadmitted insurance subject only to the statutory and regulatory requirements of the insured's "home State"; (iii) prohibit a state from imposing eligibility requirements on a U.S. domiciled nonadmitted insurer except in conformity with certain requirements and criteria set forth in the NAIC Non-Admitted Insurance Model Act; and (iv) subject to certain disclosure and written request requirements, state that a surplus lines broker need not satisfy any state requirement to make a due diligence search to determine whether the full amount or type of insurance sought by an "exempt commercial purchaser" can be obtained from admitted insurers. (§§521-527)

Federal Insurance Office

The new Federal Insurance Office ("FIO") will be established as an office of the Department of the Treasury one day after the date of enactment of the Dodd-Frank Act. While it may take some time to get things up and running, the FIO may start doing its work immediately. (31 U.S.C. §313(a), *as added by* §502(a)(3))

Data and Information Requests

The FIO is authorized (subject to a small insurer exception to be determined) to require an insurer or its affiliates to submit data or information. The FIO is required first to obtain any such data and information from each relevant federal agency and state insurance regulator and any publicly available sources. Only if the FIO Director determines that the data or information is not so available may the FIO Director make a request directly to an insurer or its affiliate, and even then, any data or information collection from an insurer or affiliate must comply with the Paperwork Reduction Act. The Dodd-Frank Act includes provisions protecting the confidentiality of insurer-submitted data or information. In addition, the FIO Director has the power to require by subpoena the production of data or information from an insurer and its affiliates on condition that the FIO has first coordinated with state insurance regulators. (31 U.S.C. §313(e), *as added by* §502(a)(3))

Non-Voting Member of Financial Stability Oversight Council

The FIO Director will serve as a non-voting member of the new Financial Stability Oversight Council (the "Council") and must serve in an advisory capacity on the Council. While the FIO expressly has no general supervisory or regulatory authority over the business of insurance, the FIO may provide a federal voice for insurance and insurance regulatory concerns that has been previously lacking. (§111(b)(2); 31 U.S.C. §§313(c)(3) and 313(k), *as added by* §502(a)(3))

FIO Director Study on Modernization of U.S. Insurance Regulation

The FIO Director must conduct a study and submit a report to Congress on how to modernize and improve the system of insurance regulation in the U.S. not later than 18 months after the date of enactment of the Dodd-Frank Act. The study and the report are to be based on and guided by, among other things, the degree of national uniformity of state insurance regulation. Among the factors to be examined by the study and the report are (i) the costs and benefits of potential Federal regulation of insurance across various lines of insurance (except health insurance) and (ii) the feasibility of regulating only certain lines of insurance at the Federal level, while leaving other lines of insurance to be regulated at the State level. (31 U.S.C. §313(p), *as added by* §502(a)(3))

This study, which must examine an optional federal charter (at least for certain insurers), together with a recent statement at a meeting of the National Conference of Insurance Legislators by Rep. Barney Frank (D-Massachusetts), chair of the House Financial Services Committee, that his committee will take up the issue of an optional federal charter for insurers during the next session, may bring life back to this legislative proposal that was introduced in 2001 and that was first formally introduced as federal legislation in 2006.

While the FIO expressly has no general supervisory or regulatory authority over the business of insurance, the FIO may provide a federal voice for insurance and insurance regulatory concerns that has been previously lacking.

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Systemic Risk Regulation; Parity for State Insurance Regulators

The original Treasury Department proposal for financial regulatory reform legislation provided that, when the Council was required to consult with or make recommendations to other regulators, it was only required to consult with or make recommendations to a "primary federal regulatory agency" for a subsidiary. While other U.S. financial institutions, such as banks and broker/dealers, have a primary federal regulator, U.S. insurers have no primary federal regulator as they are regulated by each state in which they are licensed to transact business. The question, then, was whether state insurance regulators would be given the same status as federal regulators under the new systemic risk regulation rules. The Dodd-Frank Act requires consultation with and making recommendations to the "primary financial regulatory agency" for a subsidiary, which includes the domiciliary state insurance regulator of an insurer subsidiary. (*See* §§112(a)(2), 113(g), 120, 153(f), 161, 162(b) and 165(i)).

Orderly Liquidation

Application to Insurers

The new resolution arrangements were designed to replace the existing U.S. bankruptcy rules for systemically significant financial companies with an arrangement that uses the U.S. bank receivership rules as a model. U.S insurers are subject to receivership under their domestic state insurance insolvency laws and are not subject to the U.S. Federal Bankruptcy Code. In addition, under some proposals for financial regulatory reform legislation, the definitions of a financial company that could be subject to resolution under the new resolution arrangements included a stock insurance holding company as well as an insurer parent (*e.g.*, a mutual, fraternal or reciprocal insurer). Furthermore, under some of the proposals, the scope of the new resolution authority included both a parent company and certain of its subsidiaries. Therefore, a question arose as to how to reconcile the scope of the new resolution authority as it might apply to insurers (and their parents and subsidiaries) with existing state insurance insolvency laws, thus preserving in such a proceeding (i) insurance guaranty fund triggering events, (ii) the unique priority of claims distribution for U.S. insurers that benefits claims under insurance policies and (iii) the special status of claims under separate account contracts sold by U.S. life insurers.

The Dodd-Frank Act requires that resolution of a U.S. insurer be conducted as provided under state insurance insolvency laws. However, this exception does not apply to an insurer's non-insurance company subsidiaries. If the domestic state insurance regulator has not filed the appropriate judicial action in the appropriate state court to place an insurer into orderly liquidation under relevant state law within 60 days of the systemic risk determination, the Federal Deposit Insurance Corporation ("FDIC") is authorized to stand in the place of the domestic state insurance regulator and file such action. (§203(e)) It remains to be seen whether this FDIC authority is constitutional. While federal law may preempt state law, federal law cannot generally dictate what a state must do, and this authority seems to dictate that a state court must accept the standing of the FDIC in commencing a state insurance receivership proceeding under a state law that otherwise grants standing only to the domestic state insurance regulator.

FDIC Jurisdiction Over Insolvent Subsidiaries of Insurers

Since the FDIC would still have jurisdiction over certain insolvent non-insurance company subsidiaries of an insurer, in the House-Senate Conference on H.R. 4173 (the "Conference Committee"), the House conferees offered an amendment to assure that the value of any solvent subsidiary of an insurer must be used for the protection of policyholders and not creditors of the insurer's parent. While this amendment was rejected by the Senate conferees, Senator Dodd stated the following at the June 17, 2010 meeting of the Conference Committee:

> … the House offer seeks to keep the FDIC away from the assets of subsidiaries of insurance companies that failed and to restrict the FDIC's use of those assets. However, the additional language offered by the House is not necessary and, therefore, we respectfully cannot accept it. The conference base text already states that an insurance company would be resolved as provided under state law. Furthermore, the assets of a solvent or insolvent subsidiary of an insurance company, as with other corporations – other corporations, are always used to first pay the debt to the

The Dodd-Frank Act requires that resolution of a U.S. insurer be conducted as provided under state insurance insolvency laws. However, this exception does not apply to an insurer's non-insurance company subsidiaries.

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subsidiary and second the debts of its parent, in this case the insurance company. This is true even if the insurance company is part of a financial company placed into FDIC receivership under Title II. There is no alternative under corporate law. The FDIC concurs with our view that this language is not necessary.

Mutual Insurance Holding Companies

The typical mutual insurance holding company statute (included in state insurance laws) provides that, if a subsidiary stock insurer is placed into receivership under its domestic state insurance insolvency law, (i) the mutual insurance holding company automatically becomes a party to the proceeding, (ii) the assets of the mutual insurance holding company, including its interest in the intermediate stock holding company, are deemed assets of the estate of the stock insurer to the extent needed to satisfy policy claims of the stock insurer and (iii) the assets and liabilities of the mutual insurance holding company are subject to inclusion in the estate of the stock insurer. The articles of incorporation of the mutual insurance holding company typically give effect to these provisions. Furthermore, in order to assure this outcome, the mutual insurance holding company in some cases has granted the stock insurer a security interest in its assets, including the shares of the intermediate stock holding company. Since the mutual insurance holding company is automatically subject to the stock insurer proceeding and the assets of the mutual insurance holding company, including the shares of the intermediate stock holding company held by it, are by law available to pay policy claims of the stock insurer, the resolution of the stock insurer and its mutual insurance holding company are so interconnected that it would make little sense to make the mutual insurance holding company subject to resolution under Title II of the Dodd-Frank Act.

However, there may be some question as to whether a mutual insurance holding company is an "insurance company" under Title II and would thus enjoy the exception for insurers described above. Without the exception, the mutual insurance holding company may be eligible for an orderly liquidation under Title II. This is because an "insurance company" is defined to mean an entity that, among other things, is "engaged in the business of insurance" and the typical mutual insurance holding company law expressly prohibits a mutual insurance holding company from transacting insurance. (§201(a)(13))

[T]he resolution of the stock insurer and its mutual insurance holding company are so interconnected that it would make little sense to make the mutual insurance holding company subject to resolution under Title II of the Dodd-Frank Act.

The Senate Banking Committee Report on the Dodd-Frank Act[1] (the "Senate Banking Committee Report") includes the following Committee statement relating to whether a mutual insurance holding company is an "insurance company" as defined in Title II of the Act: "A mutual insurance holding company organized and operating under State insurance laws may be considered an insurance company for the purpose of this title." This statement may be helpful in avoiding a case in which an insurance company owned by a mutual insurance holding company is placed in an insurance insolvency proceeding under state law but its parent mutual insurance holding company is subject to an orderly liquidation under Dodd-Frank Act Title II.

FIO Director Role in Orderly Liquidation Recommendation

The FDIC and the Federal Reserve Board ("FRB") may make a recommendation to the Treasury Secretary to appoint the FDIC as receiver for a financial company upon a two-thirds vote of their respective boards, and shall consider whether to make such a recommendation on their own initiative or at the request of the Treasury Secretary. (§203(a)(1)(A)) Where the financial company or its largest U.S. subsidiary (as measured by total assets as of the end of the previous calendar quarter) is an insurance company, the recommendation must be made by the FRB by vote of not fewer than two-thirds of its board and by the FIO Director and in consultation with the FDIC. (§203(a)(1)(C)). While the other roles of the FIO Director are largely consultative and information gathering, this role has some significance in that it appears that the FIO Director must consent to the recommendation to appoint the FDIC as receiver for such a financial company.

Orderly Liquidation Fund Assessments

Insurers have observed that, even if U.S. insurers are not to be resolved under the Dodd-Frank Act, they continue to be "financial companies" as defined in Section 201(a)(5), and thus subject to potential

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assessments to support the Orderly Liquidation Fund. Thus, even if an insurer (and its creditors) cannot benefit from being resolved under the Dodd-Frank Act, the insurer may still be subject to assessments to support the resolution of other financial companies. Congress did not entertain efforts by the insurance industry to remove insurance company assets or liabilities from being included in the assessment base. What remains in the Dodd-Frank Act are the following provisions, which have some potential to soften the effect of Orderly Liquidation Fund risk-based assessments on insurers and insurance holding companies:

1. In imposing assessments, the FDIC must take into account any assessment imposed on a financial company or its affiliate that is an insurance company 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. (§210(o)(4))
2. The FDIC's assessment regulations must take into account the differences in risks posed to the financial stability of the U.S. by financial companies, the differences in the liability structures of financial companies and the different bases for other assessments that such financial companies may be required to pay, in order to ensure that assessed financial companies are treated equitably and that assessments reflect such differences. (§210(n)(6))

The Senate Banking Committee Report suggests that insurers should be treated differently than other financial companies and that fraternals be given special consideration because of their not-for-profit status:

> It is intended that the risk-based assessments may vary among different types or classes of financial companies in accordance with the risks posed to the financial stability of the United States. For instance, certain types of financial companies such as insurance companies and other financial companies that may present lower risk to U.S. financial stability (as indicated, for example, by higher capital, lower leverage, or similar measures of risk as appropriate depending on the nature of the business of the financial companies) relative to other types of financial companies should be assessed at a lower rate. Furthermore, the FDIC should consider the impact of potential assessment on the ability of certain tax-exempt entities to carry out their legally required charitable and educational missions, such as the ability of not-for-profit fraternal benefit societies to carry out their state and federally required missions to serve their members and communities.

Since the FDIC is required, in consultation with the Treasury Secretary, to prescribe regulations to carry out the Orderly Liquidation Fund risk-based assessment requirements, insurers may want to monitor such regulations to (i) be sure that they are treated fairly and equitably; and (ii) determine how insurance guaranty fund assessments are taken into account.

Savings and Loan Holding Companies That Include Insurers

Given that some of the companies most affected by the financial crisis were savings and loan holding companies, it is no surprise that the federal financial reform legislation places additional regulatory burdens on savings and loan holding companies, including capital and source of strength requirements, oversight of certain subsidiaries and the Volcker Rule. This affects an insurance holding company that is a savings and loan holding company.

Preservation of Bank Holding Company Exception

The original Treasury Department proposal released in July 2009 would have removed the Bank Holding Company Act ("BHCA") exemption for savings and loan holding companies, thus making all savings and loan holding companies bank holding companies subject to regulation under the BHCA. This would have been a fairly straight-forward approach to enhancing the regulation of savings and loan holding companies, but it drew strong objection from such companies. The House version of the financial regulatory reform bill made some exceptions to this, most importantly for a fraternal benefit society and for a company that is, together with all of its affiliates on a consolidated basis, predominantly engaged in the business of insurance. This approach is not the one taken in the Dodd-Frank Act. Instead, the Dodd-Frank Act puts this question off by requiring that the Comptroller General conduct a study within 18 months of enactment to determine whether it is necessary to eliminate exceptions under Section 2 of the BHCA for industrial banks, credit card banks, trust companies and savings institutions. (§603(b)) Insurance groups that own savings institutions will want to monitor this study and its recommendations as to how they address savings and loan holding companies.

New Capital and Leverage Requirements (SAP vs. GAAP)

The Dodd-Frank Act clarifies the authority of the FRB (i) to impose capital requirements on savings and loan holding companies and (ii) to require a savings and loan holding company to serve as a source of financial strength for any savings and loan that is an FDIC insured depository institution. In addition, regulations regarding savings and loan holding company capital levels are to

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be made countercyclical, such that the amount of capital required to be retained increases in times of economic expansion and decreases in times of economic contraction. (§§616(a) and 616(d)) Furthermore, the Dodd-Frank Act requires the FRB to establish minimum leverage capital and risk-based capital requirements on a consolidated basis on a savings and loan holding company that are not less than, nor quantitatively lower than, those generally applicable to FDIC insured depository institutions as in effect on the date of enactment of the Act (the so-called "Collins Amendment"). (§171)

Each of these three requirements raises a question as to how these rules might be applied to mutual insurers and fraternals that only report their financial condition using statutory accounting principles. In the case of the first two, the Senate Banking Committee Report includes the following Committee statements of intent:

1. For the general capital requirement authority, the FRB "should take into account the regulatory accounting practices and procedures applicable to, and capital structure of, holding companies that are insurance companies (including mutuals and fraternals), or have subsidiaries that are insurance companies."
2. For the new source of strength requirement authority, the FRB should permit insurers to use "the accounting method they currently employ in reporting their financial information" and the provision is not "intended to mandate that insurance companies otherwise subject to alternative regulatory accounting practices and procedures use GAAP."

Because Section 171 of the Dodd-Frank Act was added during the full Senate debate and after Senate Banking Committee approval of the bill, no such similar statement of Congressional intent exists for the Collins Amendment.

[I]f a company is a savings and loan holding company, the company and all its subsidiaries (including insurer subsidiaries) will be subject to the prohibitions of the Volcker Rule.

Apart from a general interest in seeing how these financial condition rules may be implemented by the FRB, savings and loan holding companies that are also insurers may be keenly interested in monitoring whether the stated Senate Banking Committee intent is followed in fashioning any general capital and source of strength requirements and whether a similar approach may be taken, absent any specifically stated Senate Banking Committee intent, with respect to the minimum leverage capital and risk-based capital requirements under Section 171 of the Dodd-Frank Act.

Volcker Rule

The Volcker Rule was the second to last major piece of the Dodd-Frank Act to be addressed by the House-Senate Conference in part since it was included in the legislation approved by the Senate but was not included in the legislation approved by the House. The Volcker Rule prohibits proprietary trading and certain relationships with hedge funds and private equity funds. It applies to every affiliate of an FDIC insured depository institution. Therefore, if a company is a savings and loan holding company, the company and all its subsidiaries (including insurer subsidiaries) will be subject to the prohibitions of the Volcker Rule. From the beginning of the Senate discussion of the proposed Volcker Rule, the insurance industry expressed concern that this prohibition might bar ordinary investment activity of insurers that are regulated under state insurance investment laws. In response, the Conference Committee approved a version of the Volcker Rule that includes an insurance company exception. (BHCA §13(d)(1)(F), *as added by* §619) The ultimate scope of the Volcker Rule will be set following recommendations by the Council and the issuance of implementing regulations by the applicable federal regulatory agencies. U.S. insurers that are affiliated with FDIC-insured depository institutions will be keenly interested in following how these recommendations and regulations implement the insurance company exception.

One interesting aspect of the insurance exception to the Volcker Rule is that the exception can be nullified if the appropriate federal banking agencies, after consultation with the Council and the relevant state insurance regulators, jointly determine that a particular law, regulation, or written guidance with which an insurer must comply in engaging in a permitted activity under the insurance exception is insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States. This indicates some reservation on the part of the federal government about the effectiveness of state insurance regulation of investments by insurers. By comparison, under Title X of the Dodd-Frank Act relating to consumer protection discussed below,

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there is deference to state insurance regulation of insurance products without any possible federal regulatory override.

Consumer Financial Protection

Since 2001, many U.S. insurance trade associations have been urging Congress to enact a federal law allowing for the optional federal chartering of insurers. Proponents have argued that, since banks can elect to be either federally chartered or state chartered, insurers, which can presently only be state chartered, should be allowed to elect to become federally chartered. One main justification for this approach was that, under state law, insurance products must be approved by the states prior to sale and the multitude of state product regulation rules and administrative determinations (i) caused substantial delay in introducing a new insurance product and (ii) caused a nationwide insurance product to have a multitude of state variations as conditions of approvals by various state regulators. By becoming a federally chartered insurer, an insurer would have to meet one federal standard for insurance product regulation and not a multitude of state variations as all state insurance product regulation rules would be preempted.

Since the beginning of the U.S. financial crisis in 2008, the effort to obtain optional federal charter legislation has taken a back seat to U.S. federal financial regulatory reform. The release of the original Treasury Department proposal for U.S. federal financial regulatory reform included the concept of a consumer financial protection agency – an umbrella agency under which much federal consumer financial protection regulatory authority would be lodged. The thought was that the federal financial regulators gave primary attention to financial regulation and only secondary attention to consumer protection. The new agency would have as its primary purpose consumer protection. The Dodd-Frank Act includes a Bureau of Consumer Financial Protection (the "Bureau") in Title X. However, while the original Treasury Department proposal included exceptions for persons regulated by such federal financial regulators as the SEC and the CFTC, there was no exemption for persons regulated by state insurance regulators. Without such an exemption, insurers ran the risk that their insurance products could be subject to dual regulation – by the states and by the new federal consumer financial regulator. Unlike the optional federal charter proposal, which would have reduced the number of insurance regulators from 51 to 1 for a federally chartered insurer, such an approach would have increased the number of insurance regulators from 51 to 52, the last with nationwide jurisdiction. However, the insurance industry prevailed in convincing Congress to exempt insurance from the jurisdiction of the new Bureau. This exemption has three components.

First, the business of insurance (specially defined in Section 1002(3)) is excluded from the defined term "financial product or service." (§1002(15)(C)) This is important because the Bureau's mission is to implement and, where applicable, enforce federal consumer financial law consistently for the purpose of ensuring that markets for consumer financial products and services are fair, transparent, and competitive. The term "consumer financial product or service" is defined to mean any "financial product or service" that is described in one or more categories under (i) the definition of "financial product or service" and is offered or provided for use by consumers primarily for personal, family, or household purposes; or (ii) clauses (i), (iii), (ix), or (x) of the definition of "financial service or product" and is delivered, offered, or provided in connection with a consumer financial product or service referred to in item (i). (§1002(5))

Second, there is an exclusion from the Bureau's jurisdiction for persons regulated by a state insurance regulator. (§1027(f)) The term "person regulated by a state insurance regulator" is defined to mean any person that is engaged in the business of insurance and subject to regulation by any state insurance regulator, but only to the extent that such person acts in such capacity.

Third, the Bureau may not define as a financial product or service, by regulation or otherwise, engaging in the business of insurance. (§1027(m)) This is important because the Bureau has the authority to define certain other financial products or services as a "financial product or service" under Title X. (§1002(5)(A)(xi))

Conclusion

Given the bank-centric nature of the original proposal for federal financial regulatory reform in July 2009, insurers have come a long way towards being sure they are appropriately addressed under the Dodd-Frank Act in important areas like the Orderly Liquidation Authority and the Bureau. One big win in the Dodd-Frank Act for insurers is the reinsurance reform measures that preempt extraterritorial reinsurance credit rules. However, one area in which insurers could not avoid being lumped in with other financial companies was regulation of bank and savings and loan holding companies, and this will pose additional regulatory costs and burdens on many of them. ■

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[1] *S.Rep. No 176, 111th cong., 2nd Sess. 57.*

Derivatives Regulations: Central Clearing and Transparency

by Byungkwon Lim and Emilie T. Hsu

Title VII of the Dodd-Frank Act, the "Wall Street Transparency and Accountability Act" ("Title VII"), intends to lay the foundation of a new regulatory system for the U.S. market for swaps and other over-the-counter derivatives. Prior to the enactment of the Dodd-Frank Act, the focus of U.S. derivatives regulation had been mostly on the prevention of fraudulent and manipulative practices in futures and securities markets and on the preservation of the financial soundness of regulated financial institutions such as banks and broker-dealers. Under the new regime, all derivatives transactions and all entities that enter into them could be subject to potential regulations, and the goal of the regulatory framework is to promote the stability of the entire financial system and further transparency and competition in the derivatives market.

Title VII intends to achieve these objectives by introducing a regulatory system that includes the following features:

- Subject to certain exceptions, all swaps will need to be centrally cleared through clearinghouses, and all such cleared swaps will need to be centrally executed to the extent central trading markets are available for trading. End-users will generally not be required to enter into centrally cleared swaps, but may elect to do so. Swaps will generally be subject to margin requirements under the rules of the Commodity Futures Trading Commission (the "CFTC") or the Securities and Exchange Commission (the "SEC," together with the CFTC, the "Commissions" and each, a "Commission").
- Information on economic terms and certain other terms of all derivatives will need to be reported to data repositories (or, if depositories are not available, to the CFTC or the SEC) and such information will generally be made available to the public.

[T]he goal of the regulatory framework is to promote the stability of the entire financial system and further transparency and competition in the derivatives market.

- Swap and security-based swap dealers and major swap and security-based swap participants will become subject to registration requirements and a set of new regulations (including capital, margin, trade reporting, recordkeeping and other conduct rules) to be promulgated by the CFTC and the SEC.
- Except for certain matters involving banks and other insured depository institutions, the CFTC and the SEC will have regulatory authority over swaps.

The full implementation of Title VII will require comprehensive new regulations to be promulgated by the CFTC and the SEC, so the effect of the new system is difficult to predict at the present time. The Commissions are required to issue the majority of the regulations within a year from the enactment of the Dodd-Frank Act. In addition, the Commissions are also required to conduct a number of studies to gauge the effects of certain regulations and how to improve regulatory harmonization of worldwide derivatives markets.

Swaps, Security-Based Swaps and Mixed Swaps

Under the Title VII regime, all derivatives are essentially divided into "swaps," "security-based swaps" and "mixed swaps" for the purpose of dividing regulatory jurisdiction between the CFTC and the SEC. Swaps are regulated by the CFTC, security-based swaps are regulated by the SEC and mixed swaps are regulated by both Commissions. In addition, Title VII also explicitly prohibits states from treating swaps as insurance and from regulating swaps as insurance contracts. (§712)

The term "swap" essentially captures all derivatives (including those on interest rates, currencies, commodities and credit) except security-based swaps. However, a number of contracts and other instruments are excluded from the definition of "swap," such as futures contracts, forward contracts intended to be physically-settled, options on securities or broad-based securities indices and certain other contracts that are subject to federal securities laws. (The remainder of this article will use the term "swap" to indicate

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any or all of a swap, security-based swap and mixed swap unless otherwise specified. (§721(a)(21))

A "security-based swap" is a swap on a single security or loan, narrow-based securities index or a credit or other event of a single issuer of a security or the issuers in a narrow-based securities index (such as a "single name" credit default swap). A "mixed swap" is a contract that meets the definitions of swap and security-based swap. (§761(a)(6))

The rulemaking process should provide more clarity as to the specific jurisdiction of each Commission with respect to certain derivatives instruments, such as equity swaps with more than one security as underlying assets or certain credit default swaps that reference both credit names and securities. Title VII leaves the status of certain contracts as "swaps" open pending future regulatory action. Foreign exchange swaps and forwards are regulated as swaps under Title VII unless the Treasury Secretary determines otherwise in the future, while stable value contracts are not regulated and are not deemed to be "swaps" unless the SEC and the CFTC determine otherwise in the future.

The Regulators

The CFTC and the SEC have primary jurisdiction over swaps and security-based swaps, respectively, and have joint jurisdiction over mixed swaps. (§712) However, they will be required to consult the FRB in issuing regulations on a joint basis and in determining the definitions of the fundamental concepts of Title VII. In addition, the FRB is also given the authority to regulate, together with the CFTC or the SEC, affiliates of any insured depository institution that are swap entities. (§721(a)(17))

Title VII gives the new Financial Stability Oversight Council the authority to resolve rulemaking disputes between the CFTC and the SEC and to prohibit the provision of federal assistance to any particular swap entity. The U.S. Court of Appeals for the District of Columbia Circuit has the authority to resolve any dispute between the CFTC and the SEC with respect to either Commission's jurisdiction to issue regulations or orders. (§712(c))

[C]entral clearing is intended to minimize systemic risk to the U.S. financial markets arising from the credit risk of one or more market participants, which so far has been left to private agreements between derivatives counterparties.

Central Clearing and Trading

Under the Title VII regime, all swaps must be cleared through clearinghouses unless exceptions apply. Together with the implementation of mandatory margin requirements, central clearing is intended to minimize systemic risk to the U.S. financial markets arising from the credit risk of one or more market participants, which so far has been left to private agreements between derivatives counterparties. (§§723(a), 763(a))

The CFTC and the SEC have the mandate to determine the universe of swaps required to be cleared through clearinghouses. Swaps that are required to be cleared and that are accepted for clearing will have to be executed on a designated contract market, regulated exchange or swap execution facility. To ensure that margin posted by derivatives counterparties is subject to supervision by a regulatory authority, margin posted with respect to cleared swaps must be held by a registered futures commission merchant and margin with respect to cleared security-based swaps must be held by a registered broker-dealer or security-based swap dealer. Margin may not be commingled with assets of the entity holding it and must be invested only in U.S Treasury securities or certain other assets prescribed by the Commissions. (§§723, 724, 763(d))

If, however, a swap is entered into by an end-user that is not a "financial entity" and that uses the swap to hedge or mitigate its commercial risk, then the end-user can elect not to clear the swap if it notifies the CFTC or the SEC, as applicable, as to how it generally meets its financial obligations associated with uncleared swaps. The exact scope of this end-user exemption from mandatory clearing will mainly depend on how the Commissions define the meaning of the phrase "to hedge or mitigate commercial risk." At the moment, it is not clear whether the Commissions will interpret "hedging or mitigating commercial risk" in the same manner as the CFTC has interpreted "*bona fide* hedging" in the

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The exact scope of this end-user exemption from mandatory clearing will mainly depend on how the Commissions define the meaning of the phrase "to hedge or mitigate commercial risk.

past in the context of applying its rules for setting position limits and margin requirements in the futures market. For example, it is not clear if balance sheet hedging, hedging in excess of the amount of the underlying risk or certain "long term" hedging for a future risk will meet the definition of "hedging or mitigating commercial risk." (§§723(a), 763(a))

Parties that are "financial entities" cannot benefit from the end-user exemption even if they are hedging or mitigating their commercial risk. A "financial entity" is defined to include a swap dealer; a security-based swap dealer; a major swap participant; a major security-based swap participant; a commodity pool; a private fund as defined in the Investment Advisers Act (e.g., a hedge fund or a private equity fund); an employee benefit plan as defined in the Employee Retirement Income Security Act ("ERISA"); or any person predominantly engaged in activities that are within the definition of the "business of banking" or that are "financial in nature" as defined in the Bank Holding Company Act (which includes insurance companies). (§§723(a)(2), 763)

Uncleared swaps will nevertheless be subject to margin requirements to be determined by the CFTC and the SEC, respectively. Based on the Dodd-Frank Act's legislative history, it appears that the mandatory margin requirement for uncleared swaps is not intended to apply to end-users who are otherwise exempt from the mandatory clearing requirement, but this is not clear based on a literal reading of Title VII and the industry awaits further clarification during the rulemaking process.

However, if an end-user were to post collateral (either based on private agreement with its counterparty or by regulation) with respect to uncleared swaps, it would have the right to demand that its swap dealer or major swap participant counterparty hold the initial (but not variation) margin in a segregated account at a third party custodian. If the end-user does not exercise this right for segregation, the counterparty who has custody of the margin may still be subject to certain obligations to be further clarified and determined by the Commissions, such as the provision of quarterly reports showing that the back office procedures of the counterparty are in compliance with the agreement between the parties. (§§724, 763(d))

Swap and Security-Based Swap Data Repositories

Under Title VII, all swaps and security-based swaps, whether cleared or uncleared, must be reported to the appropriate data repository registered with the CFTC or the SEC. A swap data repository must generally accept and maintain data collected from counterparties for the purpose of establishing a centralized recordkeeping facility for swaps and making such data available to regulators. If the data with respect to a swap are not accepted by a swap data repository, such data must be reported to the appropriate Commission. The CFTC and the SEC must also require real-time public disclosure of swaps and security-based swaps to enhance price discovery. Real-time reporting is required for any swap that is subject to the mandatory clearing requirement (even if such swap is exempted from clearing) or is actually cleared at a clearinghouse. Uncleared swaps that are reported to a data repository are also subject to real-time public reporting, but in a manner that does not disclose the positions of any particular counterparty. The CFTC and the SEC must use such data to publish periodic reports on the trading and clearing of swaps and security-based swaps. (*see* §§727-730, 763)

Grandfather Provisions for Reporting and Clearing

Swaps entered into before the enactment of Title VII and still outstanding at that time must be reported to a registered data repository or the appropriate Commission no later than 30 days after the enactment or within any other period to be determined by the Commissions during the rulemaking process. Swaps entered into before the enactment of the Title VII are exempt from the mandatory clearing requirement if they are reported to a registered data repository or the appropriate Commission. There is no similar grandfather provision with respect

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to the margin requirement. Therefore, all swaps entered into prior to the enactment of Title VII (presumably other than those entered into by exempted end-users) will be subject to the mandatory margin requirement. (§§723(a), 763(a))

Registration of Swap Dealers and Major Swap Participants

Under Title VII, a person will have to register with the CFTC or the SEC as a swap dealer or a security-based swap dealer, as applicable, if such person (i) holds itself out as a dealer in swaps or security-based swaps, (ii) makes a market in swaps or security-based swaps, (iii) regularly enters into swaps or security-based swaps with counterparties in the ordinary course of business for its own account or (iv) engages in any activity causing such person to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps. Excluded from the definition of "swap dealers" are insured depository institutions that enter into swaps with customers in connection with loans that such institutions have extended to their customers, so the mere provision of interest rate hedges in connection with a loan by a financial institution that is also a lender will not make such an institution a swap dealer. (§§731, 764 (a))

A person will have to register with the CFTC or the SEC as a major swap participant or a major security-based swap participant, as applicable, if such person is not a swap or security-based swap dealer, but (i) maintains a substantial position in swaps or security-based swaps, excluding (a) positions held for hedging or mitigating commercial risk and (b) swaps (but not security-based swaps) maintained by any employee benefit plan as defined in ERISA for the primary purpose of hedging or mitigating any risk associated with the operation of the plan, (ii) whose outstanding swaps or security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets or (iii) (a) is a financial entity that is highly leveraged relative to the amount of capital it holds and is not subject to capital requirements established by appropriate federal banking agency and (b) maintains a substantial position in outstanding swaps or security-based swaps. The second and third types of major swap participant do not contain an explicit hedging related exclusion in determining "substantial counterparty exposure" or "substantial position," and the implementing rules may take into account the uncollateralized exposure arising from swaps and related positions in determining who should be included in the category of major swap participant. We note that a major swap participant does not include a captive finance company that is engaged in providing financing for the purchase of the merchandise or manufactured products of the related end-user under certain circumstances. (§§731, 764(a))

The term "substantial position" is to be defined by the Commissions at a threshold that each Commission determines to be prudent for the effective monitoring, management and oversight of entities that are systemically important or can significantly impact the financial system of the U.S. In determining "substantial position," a

[A]ll swaps entered into prior to the enactment of Title VII (presumably other than those entered into by exempted end-users) will be subject to the mandatory margin requirement.

Commission is required to consider a person's relative position in uncleared as opposed to cleared swaps or security-based swaps and the value and quality of collateral held to mitigate counterparty credit exposure. Again, the phrase "hedging or mitigating commercial risk" needs to be defined and interpreted by the Commissions. (§§721(a)(16), 761(a)(6))

The registration requirement for major swap participants is a novel and unusual rule that will result in the registration of hedge funds and certain currently unregulated entities with large swap portfolios (including public companies). In the current regulatory system, there is no equivalent requirement for the registration of a person with a federal agency simply because it holds a substantial amount of assets for its own account.

Swap dealers and major swap participants will be subject to capital, margin and various recordkeeping and

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data reporting requirements and other conduct requirements to be determined by the CFTC and the SEC.

Swap dealers and major swap participants that provide advice regarding, or enter into, swaps with any (i) federal, state, city, or municipality or any political subdivision thereof, (ii) endowment plan or (iii) employee benefit plan or governmental plan subject to ERISA are subject to a higher level of responsibilities and duties with respect to these special entities. For example, swap dealers and major swap participants serving as advisors to such special entities must comply with anti-fraud rules and conduct due diligence on such entities. This higher level of duty will not apply, however, to a transaction that is traded on an exchange or a swap execution facility if the identity of the counterparty to a swap is not known to the swap dealer or the major swap participant. (§§731, 764(a))

Clearing organizations, swap and security-based swap execution facilities and swap and security-based swap data repositories all have to register with the CFTC and the SEC, respectively, under Title VII.

Position Limits

Title VII requires the CFTC to establish monthly position limits (or grant exemptions from such limits) on the aggregate number or amount of contracts based on any underlying commodity that may be held by any one person by holding (i) futures traded on designated contract markets, (ii) certain contracts linked to futures or traded outside the United States or (iii) swaps that perform a significant price discovery function. These aggregate limits may be imposed with respect to any person, including a group or class of persons (which may include a group of unrelated traders). In addition, the CFTC must establish for any person position limits on futures or options on futures with respect to certain commodities that are held by such person and that are not for hedging purposes. Last, the CTFC must establish position limits on the amount of positions, other than for hedging purposes, in swaps that are economically equivalent to futures or options on futures. The SEC may impose similar requirements for security-based swaps, and these limits may include positions in related securities on an aggregate basis. Large-volume traders of swaps that perform a significant price discovery function must report data pertaining to such swaps and keep books and records subject to the inspection of the CFTC or otherwise be subject to daily position limits set by the CFTC for such swaps. (§§737, 763(h))

Foreign Entities

The CFTC or the SEC, in consultation with the Treasury Secretary, may prohibit a foreign entity from participating in the U.S. in any swap or security-based swap activity, if the relevant Commission determines that the regulation of swaps or security-based swaps markets in the foreign country undermines the stability of the U.S. financial system. (§715)

Section 716 or the "Swap Push Out" Provision

The controversial "swap push-out" provision remains in Title VII but was ultimately modified to permit an insured depository institution to establish an affiliate to transact in derivatives. In addition, an insured depository institution will not be required to divest derivatives held for hedging and risk mitigation directly related to such institution's activities, and it will be able to keep derivatives involving rates and certain reference assets in which a national bank is permitted to invest (except for credit default swaps that are not cleared by a derivatives clearing organization). Insured depository institutions have also been granted a 24-month period (extendable for an additional year) to divest or cease the types of derivatives transactions that would prohibit them from receiving federal assistance. (§716)

Conclusion

Title VII, for the first time in the history of the U.S. financial system, will provide a basic framework for comprehensive regulation of the swaps market and industry. Whether this regulation will achieve its intended objectives without adversely affecting U.S. competitiveness in the global markets will largely depend on the rules to be promulgated by the CFTC and the SEC and how effective the U.S. government will be in promoting harmonization of regulatory systems in overseas markets. Due to the international nature of the financial markets and the relative ease with which parties have been able to enter into derivatives transactions in all major financial markets worldwide, the effectiveness of the new regulatory system in ensuring the overall stability of the financial markets in the United States will ultimately require both regulatory and diplomatic efforts on the part of the U.S. government. ■

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The Battle Over Corporate Governance: Round One to Investors

by Lawrence K. Cagney and Alan H. Paley

Though the Dodd-Frank Act is focused primarily on reforming the U.S. financial system, it touches upon a pot pourri of executive compensation and corporate governance issues that have been hotly debated in recent years. These include "say-on-pay" shareholder votes, proxy access, independence of compensation committee members and compensation clawbacks, among others. In the Dodd-Frank Act, Congress has largely sided against the preferences of the corporate world on these issues and has affirmed the position of the Securities and Exchange Commission (the "SEC") in regulating these areas of corporate governance.

Say on Pay and Golden Parachutes

The Dodd-Frank Act adds a new Section 14A to the Securities Exchange Act of 1934, as amended (the "Exchange Act"), that includes provisions allowing shareholders a more formal voice in the compensation practices of public companies by mandating certain non-binding shareholder votes on compensation-related matters. (§951) Allowing shareholders to voice their approval or disapproval of compensation practices generally has been championed by many shareholder activists.

Under Section 14A, commencing with the first meeting of shareholders occurring more than six months after the enactment of the Dodd-Frank Act, all public companies must provide for a separate, non-binding shareholder vote to approve the compensation of certain executive officers ("Say-on-Pay"). In addition, at the same meeting, each public company must seek shareholder direction as to whether to have such a Say-on-Pay vote annually, biennially or triennially. Thereafter, the Say-on-Pay vote must be held at least once every three years and the vote regarding the frequency of the Say-on-Pay vote must be held at least once every six years. In addition, commencing with any meeting in which shareholders are asked to approve an acquisition, merger, or other extraordinary transaction that occurs more than six months after enactment of the Dodd-Frank Act, Section 14A requires disclosure of any compensation payments triggered by such a transaction ("Golden Parachute Payments") in the proxy materials related to the meeting and requires that these Golden Parachute Payments be put to a separate, non-binding shareholder vote, to the extent that the arrangements have not been subject to a prior Say-on-Pay vote.

The obvious intent of these non-binding resolutions is to make compensation committees even more acutely aware that their decisions will be reviewed and scrutinized by shareholders. Beyond this, however, the likely efficacy of these resolutions is not yet clear. Several companies that were required, or that voluntarily elected, to implement Say-on-Pay for the 2010 proxy season have gotten negative votes. But with such resolutions focused on the entire compensation program, and the vote being purely an "up or down" vote, it is not possible to determine which aspects (if any) of the compensation program the majority of shareholders found objectionable, or what actions would need to be taken to correct the perceived deficiencies. However, it is safe to assume that companies that receive a negative vote will adjust their compensation programs to reduce compensation, increase contingencies or otherwise make the compensation more difficult to earn.

Proxy Access

One of the more contentious corporate governance issues during the past decade has been whether, and under what circumstances, shareholders of a company should be able to nominate candidates for directors by using the company's own proxy statement. Recently, the SEC proposed to adopt a rule enabling shareholders who own specified amounts of an issuer's stock for a specified period to nominate a director in this way. Business groups objected vehemently to the SEC's proposal, due to their concern that certain institutional and activist investors would use proxy access to further parochial political or social agendas at odds with the interests of other shareholders. The U.S. Chamber of Commerce threatened to bring a judicial challenge should the SEC adopt a proxy access rule, on the grounds that the SEC lacked the authority to adopt such a rule.

Although the SEC has stated on numerous occasions that it believes it has sufficient authority to adopt its proposed proxy access rules, Section 971 of the Dodd-Frank Act confirms the SEC's authority to adopt such rules so that its proxy access rules would not be subject to judicial attack on that ground. The statute amends Section 14(a) of Exchange Act to authorize expressly the SEC to adopt rules requiring an issuer subject to the proxy rules that solicits proxies to include candidates for election as directors nominated by shareholders in the issuer's proxy solicitation materials, subject to such terms and conditions as the SEC determines as are in the interests of shareholders and for the protection of investors. At its discretion, the SEC may exempt an issuer or class of issuers from the proxy access requirements. (§971)

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During the final negotiations, the House-Senate Conference on H.R. 4173 (the "Conference Committee") considered modifying this provision to limit the SEC's authority to grant proxy access. Senator Chris Dodd (D-Connecticut) proposed an eligibility requirement under which proxy access would extend only to those shareholders who own a minimum of 5 percent of an issuer's outstanding stock and have held the shares for at least 2 years. Large institutional investors and activist investors objected to this ownership threshold on the grounds that no investor would qualify to nominate a director for some of America's largest publicly traded companies. Senator Charles Schumer (D-New York) offered an alternative 3 percent interest requirement, a 3-year holding period and a 2-year tail provision that would have compelled nominators of victorious board candidates to continue holding their shares for another two years following the board election. Conference Committee members protested on both administrative and constitutional grounds and ultimately rejected imposing an eligibility requirement altogether.

The SEC's previously proposed rule would require issuers to include shareholder nominees if the nominating shareholder owns at least a certain percentage of the issuer's voting shares, ranging from 1 to 5 percent depending on the size of the issuer.

As a result, the final bill reverts back to permitting the SEC to determine these thresholds. The SEC's previously proposed rule would require issuers to include shareholder nominees if the nominating shareholder owns at least a certain percentage of the issuer's voting shares, ranging from 1 to 5 percent depending on the size of the issuer. The SEC rule would authorize shareholders to aggregate their shares in order to satisfy these thresholds, whereas the rejected statutory thresholds did not explicitly permit aggregation. The SEC rule would also require the shareholder to have owned the shares for at least 1 year and represent that it intends to continue owning the shares through the date of the next annual meeting. (§971)

Compensation Committee Independence

While many public companies already comply with independence standards for the members of their compensation committees, and such committees have the authority to hire and fire their own advisors, the Dodd-Frank Act adds new legal requirements regarding compensation committee member independence and the right of a compensation committee to hire its own advisors. Through mandatory listing standards, the Dodd-Frank Act mandates that the compensation committee of each listed company consist entirely of independent directors. Independence is to be determined by considering relevant factors, including the source of all compensation paid to a director and any affiliation the director may have with the issuer. In addition, the Dodd-Frank Act requires each public company's compensation committee to have the authority to hire independent advisors and that such company make available the funds to do so.

While many public companies already comply with independence standards for the members of their compensation committees, and such committees have the authority to hire and fire their own advisors, the Dodd-Frank Act adds new legal requirements regarding compensation committee member independence and the right of a compensation committee to hire its own advisors.

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The Dodd-Frank Act also requires the compensation committee of a public company to "consider" the independence of any outside advisor, applying independence factors to be identified by the SEC which must be competitively neutral among categories of advisors. While it is likely that many committees have already considered this issue in order to address requirements currently applicable to the disclosure in the Compensation Discussion and Analysis mandated under Item 402 of Regulation S-K, it is likely that the new requirement will place even more emphasis on outside advisor independence. Moreover, the Dodd-Frank Act requires a company's proxy statement to include disclosure of whether the compensation committee has retained a compensation consultant, as well as a discussion of any conflict of interest raised by the consultant's work.

In addition, under the Dodd-Frank Act the SEC is required to report to Congress within 2 years of enactment on the use of independent compensation consultants and the effects thereof. Thus, it is conceivable that the actions implemented regarding such compensation consultants in the Dodd-Frank Act are just the first step in regulating the conduct of such advisors. (§952)

Broker Voting

The Dodd-Frank Act prohibits brokers from voting in a shareholder vote with respect to election of directors, executive compensation, or any other "significant matter" (as determined by the SEC), unless they receive specific voting instructions from the beneficial owners of the securities to be voted. This extends a recent New York Stock Exchange rule change prohibiting broker voting without instructions for election of directors to the area of executive compensation and potentially beyond. This change is likely to make it more difficult for management to obtain majority approval in Say-on-Pay and other shareholder votes on compensation issues, particularly where Risk Metrics has recommended a "no" vote. (§957)

Corporate Leadership Structure Disclosure

Section 972 of the Dodd-Frank Act adds to the newly adopted Section 14B of the Exchange Act. Section 14B(b) requires the SEC, within 180 days after enactment, to issue rules requiring an issuer to disclose in its annual proxy statement the reasons why the issuer has chosen to combine or separate the positions of chairman of the board of directors and chief executive officer. (§972)

This provision is of little consequence, as the SEC already amended its rules effective February 2010 to require this disclosure in proxy statements. Item 407(h) of Regulation S-K requires an issuer to disclose whether the roles of chairman and principal executive officer are combined or separated and why the issuer determined that the structure is appropriate in light of the issuer's specific characteristics or circumstances. In addition, if an issuer has combined the roles of chairman and principle executive officer, Item 407(h) requires the issuer to disclose whether it has a lead independent director, as well as the role of any lead independent director in the leadership of the board.

Clawback on Erroneous Compensation

Under Section 954 of the Dodd-Frank Act, listed companies must develop and implement policies providing for both (i) disclosure of the issuer's policy on incentive compensation based on reported financial information and (ii) recovery (or "clawback") from current or former executive officers of "erroneously awarded" incentive compensation in the event of an accounting restatement required due to material noncompliance with financial reporting requirements under the securities laws. For purposes of a clawback, "erroneous compensation" would consist of the incentive compensation paid to an executive officer of the issuer during the 3 years preceding the restatement, to the extent that such compensation is in excess of what would have been paid to the executive under the accounting restatement.

[I]t is conceivable that the actions implemented regarding such compensation consultants in the Dodd-Frank Act are just the first step in regulating the conduct of such advisors.

Unlike the existing clawback provision of the Sarbanes-Oxley Act of 2002 ("SOX"), the new provision will apply to all executive officers, whether or not the officers engaged in misconduct, and will go back three years instead of 12 months. Like the SOX requirements, however, the new broader clawback is triggered only by a financial restatement, and therefore may have limited practical effect. Moreover, in response to the inclusion of a reporting company's clawback policy as a discussion item in the Compensation Discussion and Analysis section required to be included in proxy statements and other filings, many companies have already adopted clawback

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policies similar to what will be mandated by the Dodd-Frank Act. (§954)

Executive Compensation Proxy/Filing Disclosures

Three additional elements of executive compensation disclosure are required by the Dodd-Frank Act. Proxy materials in which compensation disclosures are required will need to include a clear description of compensation, including information showing the relationship between executive compensation actually paid and the financial performance of the employer. Pursuant to Section 958 of the Dodd-Frank Act, all issuers must also include hedging policy disclosure in annual meeting proxy or consent solicitation material indicating whether employees or directors are permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities of the issuer held by or granted to an employee or director. Additionally, under Section 954(b) of the Dodd-Frank Act the, SEC is directed to require disclosure of (i) median employee compensation, excluding the compensation of the issuer's CEO (or equivalent executive), (ii) CEO compensation and (iii) the ratio of median employee compensation to CEO compensation. (§954(b))

Small Issuer Exemption from Sarbanes-Oxley Act Section 404(b)

Section 404(a) of SOX requires the SEC to adopt rules requiring an issuer's annual report filed under Sections 13(a) or 15(d) of the Exchange Act to contain a report of management on the issuer's internal controls over financial reporting, including an assessment of the issuer's internal control structure and procedures for financial reporting. The SEC phased in these rules over several years, applying first to larger issuers and thereafter to all issuers.

While the momentum has swung in favor of shareholder interests, the ultimate victor will emerge only as the SEC promulgates the rules required to bring these statutory mandates into full effect.

Section 404(b) of SOX requires the independent public accountant auditing an issuer's financial statements to attest to management's assessment regarding the effectiveness of the issuer's internal controls. As with the requirement of Section 404(a), the SEC phased in this requirement over several years. However, because of the expense of such an attestation, the SEC has continued to delay the applicability of this requirement to small issuers.

Section 989G(a) of the Dodd-Frank Act codifies this exemption by adding a new Section 404(c) to SOX. Under Section 404(c) issuers that are not "large accelerated filers" or "accelerated filers" will be exempt from the requirement to provide an attestation report by their independent public accountant on management's assessment of the effectiveness of internal control over financial reporting. Any issuer with a market capitalization of less than $75 million or that has not been a reporting company for 12 months would fall within this exemption. Furthermore, the SEC is required to conduct a study on reducing the burden of complying with this requirement for companies with a market capitalization of between $75 million and $250 million. (§989G)

The Devil is in the Details – Round Two at the SEC?

Implementation of some of the corporate governance changes in the Dodd-Frank Act will rest with the SEC and its rulemaking process. While the momentum has swung in favor of shareholder interests, the ultimate victor will emerge only as the SEC promulgates the rules required to bring these statutory mandates into full effect. ■

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The Dodd-Frank Act's Impact on Private Fund Managers

by Kenneth J. Berman and Gregory T. Larkin

The Dodd-Frank Act amends the Investment Advisers Act of 1940 (the "Advisers Act") in several respects, but the major thrust of the amendments (contained in Title IV, the "Private Fund Investment Advisers Registration Act of 2010") is centered on the managers of hedge funds, private equity funds and other types of private funds. For a more detailed summary of the Dodd-Frank Act, including other provisions with effects on investment advisers, please see the *Summary of Key Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, available at www.debevoise.com/doddfrankact, in particular Title IV and Title IX. This issue also contains articles going into more detail on significant issues of the Dodd-Act for broker-dealers and on the broker-dealer standard of conduct.

With the limited exceptions discussed below, private fund advisers will be required to register with the Securities and Exchange Commission (the "SEC") under the Advisers Act (each such registered investment adviser, an "RIA"). In addition, the Dodd-Frank Act authorizes the SEC to impose additional reporting and recordkeeping requirements on advisers to private funds. The extent of the increased burdens on private fund advisers will largely depend on future SEC rulemaking, most of which should occur within the next year.

The extent of the increased burdens on private fund advisers will largely depend on future SEC rulemaking, most of which should occur within the next year.

Registration of Advisers to Private Funds

Many private fund managers are exempt from Advisers Act registration under Section 203(b)(3), which provides an exemption from registration for an investment adviser that has fewer than 15 clients during the preceding 12 months and does not hold itself out to the public as an investment adviser. This exemption will be eliminated on the date one year after the date of enactment of the Dodd-Frank Act (the "Effective Date"). In addition, the Dodd-Frank Act will prohibit advisers to private funds from relying on the exemption that is available to "intrastate" advisers (Section 203(b)(1)). (§403)

The Dodd-Frank Act defines a "private fund" as an investment vehicle that is exempted from registration and regulation under the Investment Company Act of 1940 (the "Investment Company Act") by Section 3(c)(1) (privately-offered funds with fewer than 100 investors or "Section 3(c)(1) Funds") or Section 3(c)(7) (privately-offered funds for which all of the investors are qualified purchasers or "Section 3(c)(7) Funds"). It should be noted that a variety of entities other than hedge funds, private equity funds and venture capital funds often rely on these exemptions as well and would be considered "private funds" under the Dodd-Frank Act. Other "private" investment vehicles, such as certain types of real estate funds, do not necessarily rely on Section 3(c)(1) and 3(c)(7) and would not be "private funds." (§402)

New Exemptions for Certain Private Fund Advisers and New Limitations on Others

The Dodd-Frank Act provides several new exemptions from Advisers Act registration, which may allow certain advisers to private funds to continue to avoid registration. However, in several cases these private fund managers will not be entirely free from SEC oversight.

Advisers to Venture Capital Funds

The new venture capital fund adviser exemption is available to an investment adviser that acts as an investment adviser solely to venture capital funds. The term "venture capital fund" must be defined by the SEC by the Effective Date. The Dodd-Frank Act authorizes the SEC to subject these advisers to certain recordkeeping and reporting requirements. (§407) In addition, there is a new exemption available to an adviser that provides advice only to small business investment companies that are licensees (or certain applicants for licenses) under the Small Business Investment Act of 1958. (§403)

Foreign Private Advisers

The new foreign private adviser exemption will be available to an investment adviser that (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients in the United States and investors in the United States in private funds that it advises; and (iii) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds that it advises of less than $25 million (or such higher amount as the SEC determines). The exemption is not available to an investment adviser who (i) holds itself out generally to the public in the United States as an investment adviser;

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(ii) acts as an investment adviser to an investment company registered under the Investment Company Act; or (iii) acts as a company that has elected to be a business development company (a "BDC") under the Investment Company Act. (Note that it is likely that the clause (iii) is intended to cover advisers to BDCs and not advisers that are themselves BDCs.) (§402)

This new "exemption" could have a substantial impact on foreign financial institutions that do not manage private funds but provide investment advisory services to a limited number of U.S. accounts. Previously, Section 203(b)(3) did not impose an assets under management limitation on such advisers. Under the Dodd-Frank Act, such an institution will not be able to rely on the exemption if it manages $25 million or more of U.S. client assets.

While the prospect of registration may not be welcome, an institution that will be required to registar may take comfort in the fact that, under traditional SEC staff positions, certain of the burdens of Advisers Act registration are not applicable to RIAs that have their principal place of business outside of the United States. For example, the SEC staff has traditionally taken the position that certain of the substantive provisions applicable to an RIA discussed below (such as the custody requirement) do not apply to a foreign RIA in connection with its dealings with non-U.S. clients.

Certain "Small" Advisers

The Dodd-Frank Act requires the SEC to promulgate rules providing an exemption for certain small private fund advisers – that is, an investment adviser that (i) acts as investment adviser solely to private funds and (ii) has less than $150 million in "assets under management in the United States." As in the case of exempt venture capital fund advisers, these advisers may also be subject to recordkeeping and reporting requirements. The required SEC rulemaking will likely clarify whether the phrase "assets under management in the United States" is intended to address the location of the investment adviser, the location of the investors in the private funds or the location of the portfolio investments of the private funds. The Dodd-Frank Act does not impose a deadline for the SEC to adopt rules relating to this exemption. (§408)

CFTC-Registered Advisers

The Dodd-Frank Act limits the current exemption for an investment adviser registered with the Commodity Futures Trading Commission (the "CFTC") whose business does not consist primarily of acting as an investment adviser. In the case of a private fund manager, the exemption will not be available if the business of the adviser becomes predominantly the provision of securities-related advice. (§403)

Required SEC rulemaking will likely clarify whether the phrase "assets under management in the United States" is intended to address the location of the investment adviser, the location of the investors in the private funds or the location of the portfolio investments of the private funds.

Family Offices

The Dodd-Frank Act creates a new exclusion from the definition of "investment adviser" for "family offices." The SEC is required to adopt a definition of "family office" that is consistent with its previous exemptive policy and that "recognizes the range of organizational, management, and employment structures and arrangements employed by family offices." Family offices typically provide investment management and other services to members of a single family (as well as to certain employees of the family office). Prior exemptive orders have allowed family offices to sponsor private funds that serve as investment vehicles for family members and their charitable foundations. Presumably, the definition of "family office" will permit these activities to continue without requiring the office to register under the Advisers Act. The definition of family office will include existing family offices that, prior to January 1, 2010, provided, and continue to provide, investment advice to (i) certain employees with existing investments in the family offices; (ii) certain family-controlled companies; and (iii) certain RIAs who co-invest with the family office. However, these family offices will be subject to the Advisers Act's general anti-fraud provisions. The Dodd-Frank Act does not impose a deadline for the SEC to adopt rules relating to the "family office" definition. (§409)

What Awaits Newly Registered Advisers?

The Advisers Act imposes significant substantive requirements on an RIA and the conduct of its business. The SEC actively monitors compliance with the Advisers Act through its inspection program and conducts both routine and "for cause" inspections,

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each of which generally involves an SEC visit to an adviser's offices, as well as periodic "sweep" exams that typically involve document requests relating to a specific issue or practice. Violations of the Advisers Act may result in the imposition of civil or administrative sanctions by the SEC, as well as substantial monetary penalties and criminal liability.

A complete discussion of the requirements of the Advisers Act is beyond the scope of this article. However, advisers that will be required to register should begin to focus on several issues.

Form ADV

In order to register under the Advisers Act, an adviser must electronically file a Form ADV with the SEC. Part 1A of the Form ADV requires general identification and financial information about the adviser and its business, including information regarding the disciplinary history of the adviser and its employees. Part II requires more detailed information about the adviser's business, including disclosures concerning potential conflicts of interest. The adviser's Form ADV must be updated at least annually and certain disclosures must be updated more frequently. An RIA must deliver Part II to prospective clients (which, for this purpose, do not include private fund investors) prior to entering into an advisory contract with the client and must deliver, or offer to deliver, an updated Part II to current clients on an annual basis. The SEC has proposed amendments to Part II of Form ADV, which it may adopt in the near future.

Compliance Policies and a Chief Compliance Officer

An RIA must adopt, implement and enforce written policies and procedures reasonably designed to prevent the violation of the Advisers Act by the adviser or any of its supervised persons. The compliance policies

The Dodd-Frank Act appears to contemplate that the SEC will devote substantial resources to the examination of private fund managers.

must include (i) a code of ethics that (a) sets forth a standard of conduct that must reflect the fiduciary obligations of the firm and its supervised persons, (b) requires compliance with federal securities laws and (c) requires, among other things, that certain personnel provide the adviser with information concerning personal securities transactions; (ii) written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the RIA or any person associated with the RIA; and (iii) proxy voting policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of clients. An RIA must designate a chief compliance officer to administer its compliance policies and procedures.

A key component of the compliance policies relates to policies designed to assure that the RIA does not violate the general anti-fraud provisions of the Advisers Act. These provisions, which also apply to unregistered investment advisers, have been interpreted to impose on the adviser an affirmative duty of utmost good faith to act solely in the best interests of its clients and to make full and fair disclosure of all material facts, particularly where the adviser's interests conflict with those of its clients.

SEC Examinations

The books and records of an RIA are subject to SEC examination. The Dodd-Frank Act appears to contemplate that the SEC will devote substantial resources to the examination of private fund managers. (§404)

The Dodd-Frank Act contemplates certain changes to the SEC's examination program that could have an impact on registered investment advisers generally. For example, the Dodd-Frank Act requires the SEC, with limited exceptions, to provide registrants with its findings from an on-site compliance examination within 180 days after completion of the on-site examination. (§929U) In addition, the organization of the SEC's examination program may change. The Division of Investment Management (as well as the Division of Trading and Markets) will now have its own staff of examiners to perform compliance examinations. (§965)

Custody

RIAs that are deemed to have custody of client assets or funds are subject to detailed safe-keeping requirements. As a general matter, the general partner of a private fund is deemed to have custody of the assets of the fund. In most cases, the general partner or manager of a private fund will be able to avoid the most burdensome requirements imposed by the rule if the private fund (i) is subject to an annual audit by an independent public accountant that is registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board and (ii) distributes its audited financial statements to all limited partners within 120 days of the end of the fund's fiscal year (or 180 days, in the case of a fund of funds).

Performance Fees and Advisory Contracts

RIAs may only charge performance fees (*e.g.*, a carried interest) in limited circumstances. In most cases, private fund managers will be

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in a position to rely on one of the exceptions contained in Section 205 of the Advisers Act (*e.g.*, clients that are Section 3(c)(7) Funds or non-U.S. residents). Rule 205-3 provides an exemption with respect to fees charged to "qualified clients" – persons who (i) have $750,000 under management with the RIA; (ii) have a net worth of more than $1.5 million; (iii) are the type of investors that can invest in Section 3(c)(7) Funds; or (iv) are "knowledgeable employees" of the RIA. The Dodd-Frank Act also provides that the dollar amount tests in the definition of "qualified client" will be inflation-adjusted not later than the Effective Date and every five years thereafter. (§418)

One of the transition issues that the SEC will hopefully address is whether existing fee arrangements between newly-registered investment advisers and non-qualified clients (e.g., Section 3(c)(1) Funds that may include investors who are not qualified clients) will be grandfathered.

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Section 205 of the Advisers Act also requires that an advisory contract contain a provision requiring client consent to its "assignment." For this purpose, an assignment includes transactions that involve the transfer of a "controlling block" in the RIA.

Pay-to-Play

On June 30, 2010, the SEC approved a new anti-pay-to-play rule applicable to investment advisers. The rule restricts (i) the ability of an investment adviser to be compensated for managing the money of a state or municipal government if the investment adviser or certain of its employees have made political contributions to certain officials of that government and (ii) the use of solicitors or placement agents who are not registered investment advisers or registered broker-dealers. This rule is also applicable to investment advisers currently exempt from registration under Section 203(b)(3). These advisers will have to comply with the rule before they register under the Advisers Act.

Private Fund Recordkeeping, Reporting and Examination

The Advisers Act imposes extensive books and records requirements on all RIAs. Currently, the Advisers Act requires an adviser to retain, among other items, (i) communications with clients and (ii) documents that are necessary to calculate performance information used in communications that are distributed to 10 or more people. While not explicitly addressed by SEC rules, e-mails may constitute

Under the Dodd-Frank Act, private fund managers that are RIAs will face significant new recordkeeping and reporting requirements and potentially increased examinations with regard to the private funds.

required records (for example, client correspondence). The retention of required e-mails can pose a major challenge for an RIA, both in terms of cost and in terms of assuring the accessibility of the e-mails that are required records.

Under the Dodd-Frank Act, private fund managers that are RIAs will face significant new recordkeeping and reporting requirements and potentially increased examinations with regard to the private funds. Managers exempt from registration may also face recordkeeping and reporting requirements. (§§404, 407, 408)

Advisers Act recordkeeping and reporting requirements have historically been designed to address the protection of investors. In the case of books and records with respect to private funds, the Dodd-Frank Act also requires the SEC to consider "the assessment of systemic risk." This provision will allow the SEC to consider the

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concerns of Financial Stability Oversight Council (the "Council") in adopting recordkeeping and reporting requirements. (§404)

The required private fund records and reports will contain a variety of information regarding systemic risk and/or investor protection including: (i) the amount of assets under management and use of leverage, including off-balance-sheet leverage; (ii) counterparty credit risk exposure; (iii) trading and investment positions; (iv) valuation policies and practices; (v) the types of assets held; (vi) side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors; (vii) trading practices; and (viii) any other information the SEC determines is necessary and appropriate. The Dodd-Frank Act contemplates that this information will be shared with the Council for the purpose of assessing systemic risk. In addition, the Dodd-Frank Act provides that the information will be provided to other Federal regulators and self-regulatory organizations upon request, subject to certain conditions to protect its confidentiality. (§404)

Other Provisions Affecting Private Funds

There are other items in the Dodd-Frank Act that will have an effect on private funds and their advisers, including the following.

Systemic Risk Regulation

Beyond recordkeeping and reporting, advisers to private funds and the private funds themselves could be subject to systemic risk-related rulemaking by the Council. For the most part, the Council's powers related to investment advisers and the private funds they advise are limited to the authority to recommend that the SEC pursue certain rulemaking. The SEC currently lacks the direct rulemaking authority to regulate most of the investment behavior of private funds. Therefore, the Council's recommendations may be limited to adjusting the recordkeeping and reporting requirements discussed above. However, investment advisers and investment companies they advise, including private funds, fall within the definition of "nonbank financial company" and are therefore within the jurisdiction of the Council's authority related to systemically significant institutions. A more detailed discussion of the powers of the Council and implications of being deemed systemically significant can be found in the article on the regulation and resolution of systemically significant financial companies, also in this issue.

Beyond recordkeeping and reporting, advisers to private funds and the private funds themselves could be subject to systemic risk-related rulemaking by the Council.

Change in "Accredited Investor" Definition and Regulation D Offerings

Most offerings of private fund interests are done under an exemption from the Securities Act of 1933 provided for in Regulation D, which, among other conditions, requires that the offering be only made to "accredited investors." The Dodd-Frank Act requires the SEC to change the definition of "accredited investor" with respect to natural persons so that the net worth standard of $1 million in Regulation D is calculated without the inclusion of the investor's principal residence. (§413) In addition, the Dodd-Frank Act requires the SEC to promulgate rules expanding the disqualification provisions applicable to issuers seeking to offer securities under any of the exemptions of Regulation D. (§926)

Volcker Rule

The Dodd-Frank Act's so-called "Volcker Rule" could limit the sponsorship of and investment in hedge funds and private equity funds by certain banking institutions. A more detailed discussion of the Volcker Rule can be found in the article on expanded regulation of bank holding companies and savings and loan holding companies, also in this issue.

Conclusion

The Dodd-Frank Act will have a significant impact on private fund managers, particularly those that are currently not registered investment advisers. While the year-long transition period should provide more than enough time for a fund manager to develop compliance policies and register under the Advisers Act, the process should not be delayed. Compliance policies should be developed with care and should reflect the business and investment activities of the firm. Private fund managers that are currently registered should prepare themselves for the likelihood of increased reporting and regulation. ■

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The Dodd-Frank Act's Broker-Dealer Standard of Conduct

by Kenneth J. Berman and Jaime E. Doninger

The Securities and Exchange Commission ("the SEC") has been struggling with the increasing convergence of services provided by investment advisers and broker-dealers for almost a decade. The Dodd-Frank Act writes the next chapter in this story by delivering a solution – of sorts.

Background: Broker-Dealer and Investment Adviser Convergence

In 2005, the SEC promulgated a rule entitled "Certain Broker-Dealers Deemed Not to Be Investment Advisers" (first proposed in 1999) that, among other things, permitted broker-dealers to charge non-commission-based fees to their customers without having to register as investment advisers. The rule also contained disclosure-based conditions that were designed to address the potential for customer confusion concerning the differences between the duties that broker-dealers and investment advisers owe to their clients. The rule came under attack from the financial planning industry, which argued that the rule exceeded the SEC's authority. A 2007 Court of Appeals decision, *Financial Planning Association v. SEC*, agreed with the financial planning industry and overturned the rule.[1]

In the wake of the *Financial Planning Association* decision, the SEC commissioned the RAND Institute for Civil Justice to produce a report on the investment adviser and broker-dealer industries, and the nature of their relationships with customers. The resulting report concluded that " … current laws and regulations are based on distinctions [between broker-dealers and investment advisers] … that date back to the early 20th century and … appear to be eroding today…. [T]he business practices of investment advisers and broker-dealers have become increasingly similar … [and] investors understand little about their differences." The Dodd-Frank Act provides the basis for a framework that adapts the regulatory structure to this convergence – but only after another study takes place.

SEC Study and Report

The Dodd-Frank Act, among other things, requires that the SEC conduct a study, to be completed within 6 months of enactment, to evaluate the effectiveness of existing legal and regulatory standards of care applicable to brokers, dealers and investment advisers and persons associated with them when they are providing personalized investment advice and recommendations about securities to "retail customers" (the "Study"). A "retail customer" is defined as a natural person who receives personalized investment advice about securities primarily for personal, family or household purposes. (§913(a)-(b))

The Dodd-Frank Act's requirements for the Study are unusually detailed. The SEC is required to consider, among other things: (i) the effectiveness of existing legal or regulatory standards of care, including whether there are legal or regulatory gaps, shortcomings or overlaps in such standards of care; (ii) the regulatory, examination and enforcement resources devoted to, and activities of, the SEC and the Financial Industry Regulatory Authority (FINRA); (iii) whether retail investors understand the different standards of care applicable to brokers, dealers and investment advisers and persons associated with them; (iv) whether the existence of different standards of care is a source of confusion for retail customers; (v) the regulatory, examination and enforcement resources devoted to enforce existing standards of

The Dodd-Frank Act provides the basis for a framework that adapts the regulatory structure to [the] convergence [of services provided by investment advisers and broker-dealers]— but only after another study takes place.

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care; (vi) the potential impact on retail customers of imposing on brokers and dealers and persons associated with them the standard of care applied under the Advisers Act; (vii) the potential impact of eliminating the broker and dealer exclusion from the definition of "investment adviser" in the Investment Advisers Act of 1940 (the "Advisers Act"); and (viii) various cost/benefit issues. (§913(c))

The SEC must provide Congress with a report of the Study within six months of enactment of the Dodd-Frank Act (the "Report"). The SEC is to seek public comment in preparing the Report, and the final draft must include a description of the considerations, analysis and public and industry input that the SEC considered in preparing the Report. The Report must include the SEC's findings, conclusions and recommendations, along with an analysis of whether the SEC identified any gaps, shortcomings or overlaps in existing legal or regulatory standards in the protection of retail customers relating to the standards of care from brokers, dealers and investment advisers and persons associated with them. (§913(d))

Additional SEC Rulemaking Authority: Harmonized Rules, Harmonized Enforcement

Under the Dodd-Frank Act, the SEC may, but is not required to, commence rulemaking to address the legal or regulatory standards of care for brokers, dealers and investment advisers, and persons associated with them, in light of the findings of the Study. (§913(f))

The Dodd-Frank Act provides the SEC with two new grants of rulemaking authority, thus seeming to eliminate questions regarding the SEC's statutory authority to address the issue. A new provision of the Securities Exchange Act of 1934 (the "Exchange Act") provides that the SEC " … may promulgate rules to provide that … the standard of conduct for [a] broker or dealer with respect to [a retail] customer shall be the same as the standard of conduct applicable to an investment adviser under … the Advisers Act."

A parallel provision of the Advisers Act provides that the SEC " … may promulgate rules that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers … shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." The standard of conduct under the Advisers Act rule (and therefore the standard applicable to broker-dealers) is to be no less stringent than that applicable to investment advisers under general anti-fraud provisions of the Advisers Act. (§913(g)-(h))

In each case, it is worth noting that the SEC can impose the new standard of conduct on dealings with any customers of clients – not simply retail customers.

The Dodd-Frank Act directs the SEC to enforce violations of the standard of conduct applicable to broker-dealers to the same extent as it will enforce violations of the standard of conduct applicable to investment advisers. (§913(g))

Limitations on SEC's Rulemaking Authority

The Dodd-Frank Act does impose certain limitations on the scope of the standard that the SEC may establish:

- The receipt of compensation based on fees, commissions or other standards of compensation may not, in and of itself, be considered a violation of the standard the SEC establishes;
- A broker-dealer or registered representative will not have a continuing duty of care or loyalty to the customer after providing personalized investment advice; and
- The meaning of the term "customer" may not include an investor in a private fund managed by the adviser, where such private fund has entered into an advisory contract with the adviser. (§913(g)-(h))

Moving Forward

It is premature to speculate on the rules that the SEC might adopt after the Study, pursuant to its new authority. What is clear is that these provisions should not be dismissed as requiring just another study, as the SEC staff is likely to find itself under considerable pressure to conclude that regulatory gaps exist and should be addressed through rulemaking. Financial service firms should continue to monitor this issue closely, as further developments are likely. ■

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[1] *482 F. 3d 481 (D.C. Cir. 2007).*

Significant Issues for Broker-Dealers in the Dodd-Frank Act

by Linda Lerner and Erzsébet Karkus

Brokers and dealers will be affected in a variety of ways by the Dodd-Frank Act. One of the most hotly debated issues, applying fiduciary standards to the relationship between broker-dealers and their customers, is the subject of a required study. Any fiduciary standard proposed by the Securities and Exchange Commission ("SEC") to be imposed on broker-dealers will doubtless be the subject of extensive commentary by the industry as well as investors and is discussed in the article on the broker-dealer standard of conduct, also in this issue. In this article we comment on some of the other significant issues that will present business and legal challenges to broker-dealers.

Additional Oversight and Obligations for Certain Broker-Dealers

Some systemically significant broker-dealers may be subject to supervision by the Board of Governors of the Federal Reserve System (the "FRB") and may have additional obligations under Title I of the Dodd-Frank Act if a given broker-dealer is designated by the Financial Stability Oversight Council (the "Council") as a nonbank financial company that must be supervised by the FRB. A broker-dealer can be so designated if the Council (by a two-thirds vote) determines that material financial distress of the broker-dealer, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the broker-dealer, *could* pose a threat to the financial stability of the United States. (§§113(a)(1) and (2) and 113(b)(1)) This vague standard provides a great deal of latitude to the Council in making its determination. Given recent notable broker-dealer failures, the Council may err on the side of caution in making its determinations. A nonbank financial company that is proposed to be so designated is entitled to notice of the proposed designation and an opportunity to be heard, and may seek judicial review of the Council's determination under an arbitrary and capricious review standard. (§§113(e), 113(h)). However, under this standard, it will be difficult to overturn the Council's determination. The Dodd-Frank Act contemplates exemptions of nonbank financial companies from FRB supervision, but the criteria for such exemptions remain to be determined. (§170(a))

A broker-dealer designated as a nonbank financial company supervised by the FRB will be subject to mandatory heightened regulatory standards, including registration with the FRB, additional reporting requirements, examinations and potential enforcement actions by the FRB, risk-based capital and leverage requirements, liquidity requirements, risk management requirements, resolution plan and credit exposure report requirements, concentration limits, and stress tests, as described below. If the FRB determines that a designated broker-dealer poses a "grave threat" to U.S. financial stability, the FRB may proscribe certain activities. Optional requirements that may be imposed by the FRB include contingent capital requirements, enhanced public disclosure, and short term debt limits. These requirements are discussed in more detail in the article on the regulation and resolution of systemically significant financial companies, also in this issue. These enhanced standards may restrict a broker-dealer's ability to conduct its business and may result in some unusual obligations when compared to other entities covered by the Dodd-Frank Act. For example, if a broker-dealer, having no ties to a bank, is designated as a nonbank financial company supervised by the FRB, it is possible that it could be subject to higher capital requirements than a bank.

A broker-dealer designated as a nonbank financial company supervised by the FRB will be subject to mandatory heightened regulatory standards ....

Stress tests of designated broker-dealers must be conducted annually by the FRB, as well as semi-annually by such broker-dealers. Broker-dealers that have total consolidated assets of more than $10 billion and are regulated by a primary federal financial regulatory agency, including the SEC, must conduct annual stress tests. The results of stress tests must be reported to the FRB and the SEC. (§165(i))

A broker-dealer that is (i) a designated nonbank financial company supervised by the FRB or (ii) a subsidiary of (A) such a company or (B) a bank holding company with total consolidated assets of $50 billion or more or a nonbank financial company supervised by the FRB may be required to submit additional reports to the Council. (§116(a))

A publicly traded broker-dealer with $10 billion or more in total consolidated assets and that is supervised by the FRB must establish a risk committee within one year after a determination of FRB supervision. (§§165(h)(1) and 165(h)(2)(A))

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Stock Loans

The Dodd-Frank Act amends Section 10 of the Exchange Act to make it unlawful to effect, accept or facilitate a transaction involving the loan or borrowing of securities in contravention of SEC rules, adding to the SEC's armamentarium in dealing with stock loan transactions. (§984(a)) Within 2 years of the enactment date of the Dodd-Frank Act (the "Enactment Date"), the SEC is required to adopt rules that increase the transparency of stock loan transactions to both broker-dealers and investors. Increased transparency could enhance the ability to trace and/or recover securities so loaned and enable regulators to assess whether additional regulation is needed. However, any limitations imposed on stock loan business, which is a significant source of revenue for many firms, could diminish the profitability of this line of business. (§984(b))

If a substantial number of customers prohibit their fully paid securities from being loaned by their broker, the ability of broker-dealers to lend stocks could decline, and, as a result, the profitability to broker-dealers of their stock loan business could decline.

Under the Dodd-Frank Act, customers must be notified that they have the right to refuse to have their fully paid securities used in connection with stock lending transactions. (§929X(c)) If a substantial number of customers prohibit their fully paid securities from being loaned by their broker, the ability of broker-dealers to lend stocks could decline, and, as a result, the profitability to broker-dealers of their stock loan business could decline. Furthermore, any significant diminution in securities available to be borrowed arising from additional regulation limiting stock loans or from customers declining to make their securities available to be borrowed could negatively impact the ability to effect short sales.

Short Sales

The SEC is required to adopt rules requiring broker-dealers to publicly disclose, no less than monthly, information regarding short sales, including, by security, the aggregate amount sold short. (15 U.S.C. 78m(f), *as amended by* §929X(a)) The Dodd-Frank Act amends Section 9 of the Exchange Act to prohibit manipulative short selling and the SEC is required to adopt rules to ensure that private enforcement remedies are available. (15 U.S.C. 78i, *as amended by* §929X(b)) Thus, broker-dealers will need to be even more vigilant in surveilling for manipulative short selling and will be required to file reports on Form SAR as appropriate.

The Dodd-Frank Act requires the SEC to conduct another study on short selling, to examine short sale transaction settlement in greater detail and to assess the feasibility of a voluntary program for publicly traded companies regarding the marking of transactions in their shares to better indicate if a transaction is related to a short sale. This provision presumably would allow companies that suspect they are the subject of manipulative short selling to examine the facts more easily and to seek remedies against those who engage in manipulative short selling. (§417)

Proprietary Trading

The Dodd-Frank Act prohibits proprietary trading by a broker-dealer affiliated with a bank or bank holding company. Exemptions to this prohibition include investing in government issued securities, market making, risk mitigating hedging, agency (customer) transactions, investments in certain small business investment companies, very limited transactions related to sponsored hedge funds, foreign trading if the broker-dealer's parent is a non-U.S. entity and other transactions as determined by regulation. (§619) The provisions of the Dodd-Frank Act dealing with proprietary trading are discussed in more detail in the article on expanded regulation of insured depository institutions and their holding companies, also in this issue.

Under the Dodd-Frank Act, the Government Accountability Office (the "GAO") is required to undertake a study of the risks and conflicts posed by proprietary trading activities of insured depository institutions and their affiliates, bank holding companies and their subsidiaries, financial holding companies and their subsidiaries and any other entity designated by the U.S. Comptroller General. The costs and benefits of options for mitigating such risks and conflicts of interest, and for improving disclosure and systems and controls to monitor and contain risks and conflicts of interest must also be analyzed. The study must consider current practices, the advisability of a complete ban, limitations on the scope of permissible proprietary trading, additional capital requirements, enhanced restrictions on transactions between affiliates, enhanced accounting disclosures, enhanced public disclosure and other

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options. The GAO's report must be delivered to Congress within 15 months after the Enactment Date. (§989) The adoption of any additional limitations on proprietary trading, a very significant source of profitability for a number of financial institutions, could have a substantial negative economic impact on broker-dealers that engage in and/or effect such trades.

Municipal Advisors

The Dodd-Frank Act creates a new category of regulated persons, "Municipal Advisors," that will be regulated by the Municipal Securities Rulemaking Board. A "Municipal Advisor" is a person, other than a municipality or its employee, that (i) provides advice to or on behalf of a municipal entity or to a person obligated to support payments with respect to municipal financial products or the issuance of municipal securities, including advice regarding structure, timing, terms, and other similar matters or (ii) solicits a municipal entity with respect to services to be provided. (15 U.S.C. §78o–4, *as amended by* §975(e)) Municipal Advisors are deemed to owe a fiduciary duty to entities they advise. (15 U.S.C. §78o–4(b), *as amended by* §975(b)(2)(L) and 15 U.S.C. §78o–4(c), *as amended by* §975(c)) Broker-dealers are excluded from the definition of Municipal Advisors and thus may not be subject to such a fiduciary standard. Municipalities may wish to rely on an advisor that is a fiduciary and therefore may choose to obtain advisory services from Municipal Advisors rather than broker-dealers, if broker-dealers are not subject to a fiduciary standard with respect to municipalities.

The adoption of any additional limitations on proprietary trading, a very significant source of profitability for a number of financial institutions, could have a substantial negative economic impact on broker-dealers that engage in and/or effect such trades.

Protection of Seniors

The Dodd-Frank Act makes grants available to state governmental authorities and their subgrantees to create and enhance laws and programs designed to combat the misleading use of designations implying that a financial advisor has expertise in issues affecting seniors unless the advisor has been granted a certificate (i) by a regionally accredited academic institution, (ii) that meets the standards under the North American Securities Administrators Association's Model Rule on the Use of Senior-Specific Certifications and Professional Designations or the National Association of Insurance Commissioners' (the "NAIC's") Model Regulations on the Use of Senior-Specific Certifications and Professional Designations in the Sale of Life Insurance and Annuities or (iii) that was issued by a state. (§989A and §989J) This issue has received increased attention from state regulators in the last few years and broker-dealers will need to be vigilant in reviewing sales material, business cards and the like of their registered representatives to prevent violations of current and any expanded laws and regulations.

Equity indexed annuities and policies do not vary according to a separate account and thus are exempt securities. It remains to be seen whether these products will be further regulated by state insurance regulators.

Are Equity Indexed Annuities Securities?

The Dodd-Frank Act clarifies that an insurance or endowment policy or annuity contract or optional annuity contract, the model value of which does not vary according to the performance of a separate account and satisfies standard nonforfeiture laws or similar requirements of the applicable state at the time of issue or, in the absence of applicable standard nonforfeiture laws or requirements, satisfies the NAIC Standards, is an exempt security under Section 3(a)(8) of the Securities Act of 1933. Equity indexed annuities and policies do not vary according to a separate account and thus are exempt securities. It remains to be seen whether these products will be further regulated by state insurance regulators. (§989J)

Foreign Broker-Dealers

In determining whether to permit a foreign person or its affiliate to register as a broker-dealer or succeed to the registration of an existing U.S. broker-dealer, or to terminate

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any such registration, the SEC may consider whether, for a foreign person or its affiliate that presents a risk to the stability of the U.S. financial system, the home country of the foreign person has adopted, or has made demonstrable progress toward adopting, appropriate regulation to mitigate such risk. (§173(c)) The degree of risk to the stability of the U.S. financial system required to be presented by the foreign entity or its affiliate is not defined, nor does the Dodd-Frank Act define the standards for appropriate foreign risk mitigation regulation or demonstrable progress toward adoption of such regulation.

Lending Limits on National Banks

The Dodd-Frank Act revises the lending limits applicable to national banks with respect to credit exposure from repos and stock loan business activities. (12 U.S.C. §84(b), *as amended by* §610) To the extent that broker-dealers rely on national banks for loans for such activities, and those banks are more limited in their ability make loans for such purposes, broker-dealer repo and stock loan activities and related revenues from these activities may be negatively impacted.

Restrictions on Mandatory Arbitration

The SEC may issue rules restricting mandatory arbitration agreements between broker-dealers and clients. (§921) Litigation is frequently more expensive and drawn out than arbitration and is governed by stricter rules of evidence. Any proposed change in this area will evoke substantial comment from the industry as well as investors.

Recordkeeping Requirements for Custodians

The Dodd-Frank Act expands recordkeeping and examination requirements for custodians that hold property of clients of investment companies or investment advisers. (§929Q)

Broker-Dealer Financial Oversight

A major issue raised by the Madoff case was the quality of the firm's financial statements, which were audited by a very small auditing firm with limited resources. The Dodd-Frank Act amends the Sarbanes-Oxley Act to require that broker-dealers be audited in accordance with Public Company Accounting Oversight Board ("PCAOB") standards. The PCAOB may establish rules to inspect auditors of broker-dealers, which rules must be subject to public notice and comment and approved by the SEC. Additionally, the PCAOB is required to add independence standards to its other standards for auditors. Broker-dealers are required to pay a proportionate share of PCAOB assessments. We note that currently all non-publicly traded broker-dealers are required to be audited by auditing firms that are registered with the PCAOB. (§982)

Broker-Dealer Insolvency

The FDIC may appoint itself as receiver if a broker-dealer becomes insolvent and the FDIC and the Treasury Secretary jointly determine that such action would avoid or mitigate serious adverse effects on the financial stability or economic condition of the U.S. and the action would facilitate orderly liquidation of the insolvent broker-dealer. (§210(a)(1)(E) However, Securities Investor Protection Act ("SIPA") rules, including customer protection rules, will continue to apply.

SIPA Amendments

The Dodd-Frank Act increases Securities Investor Protection Corporation assessments from $150 minimum annual assessment to 0.02 percent of the member's gross revenues derived from the securities business. (15 U.S.C. §78ddd(d)(1)(C), *as amended by* §929V(a)) SIPA protection for customer cash assets is increased from $100,000 to $250,000. (15 U.S.C. §78fff-3, *as amended by* §929H(a))

> **To the extent that broker-dealers rely on national banks for loans for [repos and stock loan business] activities, and those banks are more limited in their ability make loans for such purposes, broker-dealer repo and stock loan activities and related revenues from these activities may be negatively impacted.**

Clearing Firms

Title VIII of the Dodd-Frank Act provides that a clearing firm that is designated by the Council as systemically significant (a "Designated Clearing Firm") will be subject to enhanced prudential standards. The standards may include: risk management policies and procedures; margin and collateral requirements; participant or counterparty default policies and

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The Dodd-Frank Act makes fundamental changes in the regulatory landscape for broker-dealers that will have material legal and financial effects on their business.

procedures; the ability to complete timely clearing and settlement of financial transactions; capital and financial resource requirements for designated financial market utilities; and other standards necessary to achieve the objectives and principles of the standards. (§805) The standards governing the conduct of "designated activities" related to clearance and settlement by financial institutions will, where appropriate, establish a threshold as to the level or significance of engagement in the activity at which a financial institution will become subject to those standards. (§805(e)) The SEC, the Commodity Futures Trading Commission and FRB must develop risk management programs to be submitted to Congress within a year of the Enactment Date. (§813)

Designated Clearing Firms will be examined annually to assure compliance with these standards and firms that provide services to Designated Clearing Firms may be examined as well. (§807) Designated Clearing Firms must obtain permission from their supervisory agencies to modify their rules that affect risk management. The FRB has been granted authority to commence or participate in such examinations, obtain information, require records to be kept and bring enforcement actions against Designated Clearing Firms. Thus, the FRB may step in if it disagrees with the supervisory agency or determines that the supervisory agency has failed to act as needed.

The FRB may authorize a federal reserve bank to grant a systemically significant clearing firm discount and borrowing privileges in unusual or exigent circumstances, if such clearing firm is unable to borrow from its usual lenders. (§806(b))

SEC Compliance Examiners

Under the Dodd-Frank Act, examination of broker-dealers will be performed by the staff of the Division of Trading and Markets of the SEC. (§965)

Bureau of Consumer Financial Protection

Title X establishes the Bureau of Consumer Financial Protection (the "Bureau") within the FRB. If a broker-dealer issues credit cards, it will be subject to the Bureau's supervision. (§§ 1002(6), 1024)

Conclusion

The Dodd-Frank Act makes fundamental changes in the regulatory landscape for broker-dealers that will have material legal and financial effects on their business. Firms that are subject to FRB supervision will face limits on engaging in historically profitable activities and will be subject to substantial additional regulatory requirements, while their competitors that are not so restricted or not subject to new standards and regulation will benefit from decreased competition and less regulation than their larger or bank-affiliated counterparts. Nevertheless, all brokerage firms, whether or not under FRB supervision, will have to adapt to increased surveillance and reporting obligations in such areas as stock loans, short sales and senior professional designations, as well as to any fiduciary standard of care owed to customers that may be imposed by SEC regulation. Finally, the potential elimination of mandatory arbitration may impose substantially increased costs on broker-dealers when dealing with customer complaints. ■

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In addition, in order to prevent large bank holding companies that are not bank-centric from liquidating or selling their banks to avoid these new heightened standards, the Dodd-Frank Act provides that any financial firm that (i) was a bank holding company with at least $50 billion of consolidated assets on January 1, 2010, (ii) received Troubled Asset Relief Program ("TARP") funds, and (iii) thereafter ceased to be a bank holding company will nonetheless automatically be deemed systemically significant and subject to the heightened oversight and regulation.

For a nonbank financial company (as defined below), the designation is less formulaic or certain and the process is more complicated. As described in the next section, a new regulatory body, the Financial Stability Oversight Council (the "Council"), will be responsible among other things for identifying such companies. Collectively, the bank holding companies meeting the tests described under the previous paragraph and the nonbank financial companies designated as described below will be subject to FRB supervision under the heightened standards discussed later in this article.

Designation and Regulation of Systemically Significant Financial Companies

Title I establishes a broad framework for identifying, applying heightened supervision and regulation to, and (as necessary) limiting the size and the activities of, systemically significant financial companies.

Overview of Financial Stability Oversight Council

To implement this new systemic regulatory regime, the Dodd-Frank Act relies on the Council to identify systemic risks and systemically significant financial companies, and on the FRB to regulate and supervise the systemically significant financial companies. The Council will be comprised of ten voting members: the Treasury Secretary (who serves as Chairperson of the Council); the Chairpersons of the FRB, the Federal Deposit Insurance Corporation (the "FDIC"), the Securities and Exchange Commission (the "SEC"), the Commodity Futures Trading Commission (the "CFTC") and the National Credit Union Administration Board; the Comptroller of the Currency; the Director of the Federal Housing Finance Agency; the Director of the new Bureau of Consumer Financial Protection (created under Title X); and an independent member appointed by the President with the advice and consent of the Senate, who has insurance expertise. The Council will also have five nonvoting members: the Director of the new Office of Financial Research in the Treasury Department, the Director of the new Federal Insurance Office in the Treasury Department (the "FIO"), and a state insurance commissioner, a state banking supervisor and a state securities commissioner (each of the latter three serving for a two-year term). (§111) The Council now is of a size that suggests that it may itself be too-big-to-fail, or at least too big to operate efficiently.

[T]he Dodd-Frank Act relies on the Council to identify systemic risks and systemically significant financial companies, and on the FRB to regulate and supervise the systemically significant financial companies.

The Dodd-Frank Act provides the Council with a wide remit involving duties that are both general and specific. Among its general duties, the Council is to identify and monitor risks to the financial system arising from large, interconnected bank holding companies and nonbank financial companies; to collect data through and otherwise provide direction to the Office of Financial Research; to identify gaps in regulation that could pose risks to U.S. financial stability; to monitor domestic and international regulatory proposals and developments, including insurance and accounting developments; to identify threats that arise outside the financial services marketplace; to eliminate expectations on the part of shareholders, creditors and counterparties of such companies that they will be shielded from losses in the event of failure; and to respond to emerging threats to the stability of the U.S. financial system. The Council through the Office of Financial Research will have broad authority to require reports and collect data from nonbank financial companies and bank holding companies alike. The Council will also have the authority to request the FRB to examine any nonbank financial company for the purpose of determining whether the company should be supervised as systemically significant. (§112) The Treasury Secretary, as Chairperson of the Council, is also directed to consult regularly with the financial regulatory entities and other appropriate organizations of foreign governments or international organizations on matters relating to systemic risk to the international financial system.

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Of the Council's specific duties, the most important is to designate nonbank financial companies for supervision by the FRB, as further described below. The Council also has the duty to make recommendations to the primary financial regulatory agencies to apply new or heightened standards to financial activities or practices that could create or increase risks of significant liquidity, credit or other problems spreading among bank holding companies and nonbank financial companies, U.S. financial markets or low-income, minority or underserved communities. The Council is required to consult with the primary financial regulatory agencies and provide public notice and opportunity for comment for any proposed recommendation. A recommendation from the Council would not be binding upon the primary financial regulatory agencies, but any agency declining to follow the recommendation would have to provide a written explanation for its decision. (§120) In addition, the Treasury Secretary, as Chairperson of the Council, must carry out periodic studies of the economic impact of possible financial services regulatory limitations intended to reduce systemic risk and report to Congress on the results of these studies, initially not later than the end of the 180-day period beginning on the date of enactment of the Dodd-Frank Act and not later than every 5 years thereafter. (§123)

Designation of Systemically Significant Nonbank Financial Companies

A large financial institution can be subject to heightened regulation either (i) in the case of a nonbank financial company, by being designated by the Council as a nonbank financial company supervised by the FRB or (ii) by being a bank holding company with $50 billion or more in total consolidated assets. This section focuses on the designation process of nonbank financial companies as systemically significant.

For purposes of Title I, a "nonbank financial company" is defined to mean any company that is predominantly engaged in financial activities, other than: a bank holding company; a foreign banking organization treated as a bank holding company; an SEC-registered national securities exchange, clearing agency, security-based swap execution facility or security-based swap data repository (or a non-bank holding company parent thereof); a CFTC-registered derivatives clearing organization, swap execution facility or a swap data repository (or a non-bank holding company parent thereof); or a board of trade designated as a contract market (or parent thereof). A company is deemed to be predominantly engaged in financial activities if its annual gross revenues from, or its consolidated assets related to, activities that are financial in nature as defined in section 4(k) of the Bank Holding Company Act of 1956 (the "BHCA") and from ownership of any depository institutions represent 85 percent or more of its consolidated annual gross revenues or 85 percent or more of its consolidated assets. (§102) Under this definition of nonbank financial company, an insurance holding company, hedge fund or mutual fund complex, for example, might qualify as a financial company and thus potentially become subject to designation by the Council for supervision by the FRB.

The Council, by a vote of at least two-thirds of its voting members (including an affirmative vote of the Treasury Secretary), can designate a nonbank financial company as requiring supervision by the FRB if the Council determines that material financial distress at the company or the nature, scope, size, scale, concentration, interconnectedness or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States. In the case of a foreign nonbank financial company, the intent of the Dodd-Frank Act appears to be to limit the direct effects of any such designation to the U.S. activities and subsidiaries of the foreign company. The designation process provides for notice to and opportunity for a hearing by the affected company as well as for judicial review of the Council determination under an arbitrary and capricious standard. As part of the designation process the Council must also consult with the primary financial regulatory agency for each nonbank financial company and subsidiary that is being considered for supervision by the FRB. For purposes of the Dodd-Frank Act, a primary financial regulatory agency means the appropriate federal banking agency, the SEC, the CFTC, a domiciliary state insurance authority or the Federal Housing Finance Agency, as applicable. In the case of a foreign nonbank financial company, the Council would also be required to consult with the appropriate home country supervisor of the foreign company. (§§2, 113)

Of the Council's specific duties, the most important is to designate nonbank financial companies for supervision by the FRB ....

Heightened Regulation of Systemically Significant Financial Companies

Title I provides a commanding role to the FRB in the regulation of systemically significant financial companies (*i.e.*, nonbank financial companies designated as described above, bank holding companies with consolidated assets of $50 billion or more and entities that were bank holding

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companies as of January 1, 2010 with assets of $50 billion or more that accepted TARP funds). For nonbank financial companies in particular, the Council can make recommendations to the FRB on a range of enhanced prudential standards that are to be applied. (§115) A designated nonbank financial company would be required to register with the FRB. (§114) It would also become subject to certain provisions of the BHCA. For example, the nonbank financial company would be treated as a bank holding company for purposes of section 3 of the BHCA, requiring prior approval for any acquisition of 5 percent or more of the voting securities of a bank or bank holding company. (§163). The nonbank financial company would also be required to provide prior notice to the FRB before acquiring any voting shares of a company engaged in certain financial activites and having consolidated assets of $10 billion or more. (§163) As a general matter, however, a designated nonbank financial company would not have to conform its activities to the restrictions of the BHCA, although the FRB could require the firm to separate its financial activities (other than certain "internal" financial activities) from its non-financial activities by establishing an intermediate holding company to conduct its financial activities, and must do so if the FRB determines that such an intermediate holding company is necessary to supervise appropriately the firm's activities that are determined to be financial in nature or incidental thereto or to ensure that supervision by the FRB does not extend to the commercial activities of the firm. A company that directly or indirectly controls such an intermediate holding company is required to serve as a source of strength to the intermediate holding company. (§167)

For all systemically significant financial companies, the FRB is required to develop enhanced supervisory and prudential standards. The enhanced standards must be more stringent than those applicable to nonbank financial companies and bank holding companies that do not present similar risks, and must increase in stringency based on certain risk and other considerations specified in the Dodd-Frank Act. In addition, the FRB, on its own or pursuant to a recommendation by the Council, may differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the FRB deems appropriate. (§165)

[T]he FRB, on its own or pursuant to a recommendation by the Council, may differentiate among companies on an individual basis or by category....

Heightened Prudential Standards. The FRB is required to adopt enhanced prudential standards for risk-based capital and leverage limits (unless the FRB, in consultation with the Council, determines that such requirements are not appropriate for a company subject to more stringent prudential standards because of the activities or structure of such company, in which case the FRB must apply other standards that result in similarly stringent risk controls), liquidity limits, overall risk management, resolution plan and credit exposure reports and concentration limits. Computation of capital for purposes of meeting capital requirements is required to take into account off-balance-sheet activities. (§165) The so-called "Collins Amendment" to the Dodd-Frank Act also requires the FRB to impose leverage and risk-based capital requirements on nonbank financial companies supervised by the FRB that are not less than the generally applicable leverage and risk-based capital requirements in effect for insured depository institutions as of the the date of enactment of the Dodd-Frank Act. (§171) The FRB is authorized, but not required, to establish standards for a contingent capital requirement, enhanced public disclosure, short-term debt limits and any other prudential standards that it or the Council determines to be appropriate. The FRB may establish an asset threshold higher than $50 billion for the application of any particular standard regarding contingent capital, resolution plan and credit exposure reports, concentration limits, enhanced public debt disclosures and short-term debt limits, pursuant to a recommendation by the Council. The concentration limit that the FRB must apply would prohibit a nonbank financial company or bank holding company from having a credit exposure to any unaffiliated company that exceeds 25 percent of the capital and surplus (or such lower percentage that the FRB determines) of the company. For this purpose, credit exposure is broadly defined to include, for example, credit exposure resulting from derivative transactions, securities borrowing and lending transactions, and repurchase and reverse repurchase transactions. The FRB may by rule or order exempt transactions in whole or in part from this limit. (§165)

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Heightened Supervisory and Other Standards. The FRB must also require each nonbank financial company or bank holding company that is publicly traded and has total consolidated assets of $10 billion or more to establish a risk committee of its board. (§165(h)) The FRB is required to conduct annual stress tests of nonbank financial companies supervised by the FRB and bank holding companies with assets of $50 billion or more. (§165(i)) The FRB in consultation with the Council and the FDIC is required to prescribe regulations for the early remediation of financial distress at a systemically significant financial company, akin to the prompt corrective action regime that is already applicable to insured depository institutions under the Federal Deposit Insurance Act (the "FDIA"). (§166) Finally, the FRB is directed in consultation with the Council to adopt regulations setting forth criteria for exempting "certain types or classes" of U.S. nonbank financial companies or foreign nonbank financial companies from supervision by the FRB. (§170)

Mitigatory Action for Companies Posing a "Grave Threat" to U.S. Financial Stability. Additional regulatory measures will apply to systemically significant financial companies that pose a "grave threat" to U.S. financial stability. If the FRB determines that a bank holding company with $50 billion or more of consolidated assets or a systemically significant nonbank financial company poses a grave threat to U.S. financial stability, the FRB with the affirmative vote of two-thirds of the Council members must require the company to take mitigatory action to limit the ability of the company to merge with, acquire, consolidate with, or otherwise become affiliated with another company; restrict its ability to offer a financial product or products; terminate one or more of its activities; impose conditions on one or more of its activities; or sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities. The proposed mitigatory action is subject to a notice and hearing process before the FRB. The FRB must also require a bank holding company with $50 billion or more of consolidated assets or a systemically significant nonbank financial company that poses a grave threat to U.S. financial stability to maintain a debt to equity ratio of no more than 15 to 1. (§§121, 165)

Foreign Systemically Significant Financial companies

In exercising its powers under Title I with respect to foreign nonbank financial companies and foreign-based bank holding companies, the FRB is directed to consider principles of national treatment and equality of competitive opportunity as well as the extent to which the foreign company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States. (§§115(b)(2), 121(d), 165(b)(2))

Rulemaking Processes

The rulemaking processes required under Title I are daunting in their number, scope and complexity. The outcome of the rulemaking processes required under Title I will affect the shape of the U.S. financial sector for years to come. With certain exceptions, final rules implementing the provisions of Title I must be adopted not later than 18 months after the date of enactment of the Dodd-Frank Act. (§168) In the case of certain provisions in Title I, however, an earlier or later effective date may apply. For example, the rules for concentration limits will not take effect until 3 years after the date of enactment (subject to a possible additional 2-year extension). (§165(e)(7)) The risk committee requirement for a publicly traded nonbank financial company supervised by the FRB will become effective not later than 1 year after the date that the company is designated by the Council as being subject to supervision by the FRB. (§165(h)(1)) The risk committee requirement for a publicly traded bank holding company with total consolidated assets of $10 billion or more will become effective not later than 15 months after the transfer date (specified in Title III to be one year after the date of enactment of the Dodd-Frank Act with a possible 6-month extension) for the transfer of functions from the Office of Thrift Supervision to the other federal banking agencies. (§165(h)(4)) Various provisions in Title I technically become effective one day after the date of enactment of the Dodd-Frank Act under the general effective date rule in the Dodd-Frank Act. (§4) As a practical matter, however, the effectiveness of these provisions may be dependent upon the issuance of final rules called for in the specific provisions.

Implications of Heightened Regulation of Systemically Significant Financial Companies

The full implications of the new and enhanced regulatory scheme established in Title I will not be known until the rulemaking processes are complete. Several general observations, however, are in order even at this early point. First, the FRB approach to comprehensive consolidated supervision of its regulated entities will have a profound effect on the regulatory and business operations of nonbank financial companies designated for the first time for such supervision. For an insurance company, hedge fund, mutual fund complex, or other nonbank financial company designated for FRB supervision, the new regime will represent a level of federal supervision and regulation that the company will have never previously experienced. The range of issues that this regulatory regime would present for an insurance company or insurance holding company designated for supervision by the

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FRB is discussed in more detail in the article on the implications of the Dodd-Frank Act for insurers, also in this issue. Second, the FRB approach to supervision has historically and sensibly been bank-centric. The extension of the FRB jurisdiction to nonbank financial companies will present challenges both for the FRB and for the newly regulated entities. Applying bank-centric approaches to diversified financial companies may produce suboptimal results from both a prudential perspective and a competitive perspective. The task of designing prudential rules to cover a diversity of financial companies and business models will require a comprehension of the differences that does not currently reside in any existing regulator. Third, even for bank holding companies that are familiar with comprehensive regulation by the FRB, the new regulatory regime will create significant uncertainty in the near term and, depending upon the results of the ultimate rulemaking, the potential for significant dislocation, divestiture or reorganization of business operations in the long term. The implications of the new regulatory regime for bank holding companies are discussed in more detail in the article on expanded regulation of insured depository institutions and their holding companies, also in this issue.

For an insurance company, hedge fund, mutual fund complex, or other nonbank financial company designated for FRB supervision, the new regime will represent a level of federal supervision and regulation that the company will have never previously experienced.

Resolution of Failing Financial Companies Posing Systemic Risk

Title II creates a new regime for the orderly liquidation of financial companies whose failure would pose systemic risk, in substitution for and displacement of the Bankruptcy Code and state insolvency laws. This new regime is modeled in large part on the provisions in the FDIA for the receivership and liquidation of insured depository institutions, although several changes from the provisions in the FDIA have been made to align the new orderly liquidation authority more closely with the Bankruptcy Code. The new orderly liquidation authority represents a fundamental change in the legal approach to dealing with large financial companies in distress. The premise of this resolution authority is that in dealing with a financial company in distress whose failure would have serious adverse effects on U.S. financial stability, federal authorities need to have a regime that will parallel the resolution authority that the FDIC currently has for insured depository institutions in terms of speed and flexibility and that will facilitate the orderly wind-down of a large complex financial company.

Scope of Potential Application

The scope of the potential application of this new orderly liquidation regime is established initially through the definition of the term "financial company." For purposes of Title II, the term "financial company" means any company organized under federal or state law that is (i) a bank holding company, (ii) a nonbank financial company supervised by the FRB (as provided in Title I), (iii) predominantly engaged in activities that are financial in nature or incidental thereto for purposes of section 4(k) of the BHCA or (iv) a subsidiary of any of the above that is predominantly engaged in financial activities (other than a subsidiary that is an insured depository institution or an insurance company). The inclusion of any financial company predominantly engaged in financial activities (defined to mean deriving at least 85 percent of its total consolidated revenues from financial activities, including from the ownership of a depository institution) assures broad application of the definition and hence broad potential application of the new resolution regime, although the Treasury Department and other sponsors of this new authority have stated that it would be used only in rare occasions. (§201) In addition, the FRB is directed to conduct two studies within 1 year of the date of enactment of the Dodd-

Applying bank-centric approaches to diversified financial companies may produce suboptimal results from both a prudential perspective and a competitive perspective.

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Frank Act, the first regarding the resolution of financial companies under the Bankruptcy Code and potential amendments to the Bankruptcy Code, the second regarding ways to increase and make more effective international coordination of the resolution of financial companies. (§§216-217)

Determination Process

The new orderly liquidation authority can be invoked through a decision process that requires an initial recommendation to the Treasury Secretary from both the Board of Governors of the FRB and the Board of Directors of the FDIC (or, in the case of a broker-dealer or a financial company the largest U.S. subsidiary of which is a broker-dealer, the commissioners of the SEC or, in the case of an insurance company or a financial company the largest U.S. subsidiary of which is an insurance company, the Director of the FIO). Upon such recommendation the Treasury Secretary (in consultation with the President) can make a systemic risk determination, based among other things on whether the financial company is in default or danger of default, whether its resolution under otherwise applicable law would have serious adverse effects on financial stability in the United States and whether the use of the orderly liquidation authority would mitigate these adverse effects. If the board of directors of the financial company acquiesces in the determination, the Treasury Secretary would thereupon appoint the FDIC as receiver for the financial company. If the board of directors does not acquiesce in the determination, the Treasury Secretary must petition the U.S. district court for the District of Columbia for an order authorizing the Secretary to appoint the FDIC as receiver. If the district court does not make a decision on the petition within 24 hours, the petition will be deemed to be granted. The company may take an expedited appeal from the district court decision to the U.S. Court of Appeals and the Supreme Court, but there will be no stay or injunction pending such appeal. (§§202-203)

In addition, the FDIC is authorized to make a special examination of a nonbank financial company supervised by the FRB or a bank holding company with total consolidated assets equal to or greater than $50 billion, whenever the Board of Directors of the FDIC determines that a special examination is necessary for the purpose of implementing its authority to provide for orderly liquidation of any such company under Title II, provided that such authority may not be used with respect to a company that is in a generally sound condition. Before conducting such a special examination, the FDIC must review any available and acceptable resolution plan that the company has submitted, consistent with the nonbinding effect of such plan, and available reports of examination, and must coordinate to the maximum extent practicable with the FRB, in order to minimize duplicative or conflicting examinations. (§172(a))

Special Provisions

Special provision is made in the new orderly liquidation authority for certain types of financial companies. For example, the orderly liquidation authority could be used for an insurance holding company, but not for an insurance company or an insurance company subsidiary of a holding company. Instead, if a systemic risk determination were made as to an insurance company or an insurance company subsidiary of a holding company as described above, the liquidation or rehabilitation of the insurance company would be conducted under the applicable state insolvency or rehabilitation law. If the appropriate state regulatory agency fails to commence the appropriate judicial action under state liquidation or rehabilitation law within 60 days after the Secretary has made a systemic risk determination with respect to the insurance company, the FDIC is given authority under the language of the Dodd-Frank Act to stand in the place of the state regulatory agency and file the appropriate judicial action under state law. A special regime within Title II is also established for the liquidation of a registered broker or dealer that is a member of the Securities Investor Protection Corporation.

When the FDIC is appointed as receiver, it must consult with the primary financial regulatory agency or agencies for the covered financial company and its covered subsidiaries to ensure an orderly liquidation of such companies and with the primary financial regulatory agency or agencies for the subsidiaries of the covered financial company that are not covered subsidiaries to coordinate the treatment of solvent subsidiaries and the separate resolution of insolvent subsidiaries under other governmental authority. The FDIC is also directed to coordinate to the maximum extent possible with the appropriate foreign financial authorities regarding a liquidation of a company that has assets or operations outside the United States. The provisions for consultation with the primary financial regulatory agencies in the United States and coordination with appropriate foreign authorities do not fully address the complexity of the regulatory and legal regimes that will apply to the situation of a large diversified financial company in a domestic context, let alone in a cross-border context. (§§201(a)(1)(N), 203)

Powers of the FDIC as Receiver

The orderly liquidation regime created under Title II requires the FDIC as receiver to

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liquidate the covered financial company and provides the FDIC with broad powers to effect the liquidation, generally comparable to the powers provided to the FDIC under the FDIA in connection with the liquidation of an insured depository institution. From a creditor's perspective, it is important to recognize that this will be essentially an administrative process with only limited judicial review and little judicial oversight. The FDIC will have broad powers to deal with the assets and liabilities of the financial company, including the power to sell or transfer selected assets and liabilities of the failed company to a new "bridge" financial company or other third party without court approval or consent from creditors or counterparties. The FDIC will also be authorized to treat similarly situated creditors differently and to make "additional payments" to certain categories of creditors, provided that other creditors receive at least as much as they would have received if the company had been liquidated under chapter 7 of the Bankruptcy Code or other similar insolvency laws. The orderly liquidation regime under Title II also has a priority of unsecured claims that differs from that in the Bankruptcy Code, particularly in providing a priority for all claims of the U.S. government second only to administrative expenses. (§210(a)) In addition, while Title II does not impose a haircut on the claims of secured creditors in an orderly liquidation, it does direct the Council to conduct a study within 1 year of the date of enactment of the Dodd-Frank Act evaluating how such a haircut "could improve market discipline and protect taxpayers." (§215)

Under the new liquidation regime, creditors will encounter differences in treatment in process and in certain areas in substance from the treatment they would receive under the Bankruptcy Code. As a general matter it is important to note that while the new liquidation authority is based on a relatively well-established scheme for the resolution of insured depository institutions, this scheme has never been applied to a large, complex bank. The application of the existing FDIC scheme to a large, complex bank would undoubtedly tax the ability of the FDIC to manage the resolution effectively. There is equal reason to question whether the FDIC could effectively manage the liquidation of a large, complex diversified financial company under the new scheme.

Funding and Assessments

The most controversial aspects of the new orderly liquidation authorities have revolved around two questions: whether government funding would be made available to facilitate the orderly liquidation, and if so, how would that government funding be repaid. Title II provides for the establishment of an Orderly Liquidation Fund in the Treasury to cover the costs of the liquidation of a covered financial company. The FDIC as receiver may issue obligations to and borrow funds from the Treasury in the first 30 days of the receivership in an amount equal to 10 percent of the book value of the consolidated assets of the covered financial company and after that 30-day period in an amount equal to 90 percent of the fair value of the consolidated assets of the company that are available for repayment. However, the FDIC may only access this higher amount if an agreement is in effect between the Treasury Secretary and the FDIC that (i) provides a specific plan and schedule to achieve the repayment of the outstanding amount of any borrowing by the FDIC from the Treasury and (ii) demonstrates that income to the FDIC from the liquidated assets of the covered financial company and assessments (as described below) will be sufficient to amortize the outstanding balance within the period established in the repayment schedule and pay the interest accruing on the balance within the time provided for repayment (as described below). (§210(n))

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Title II provides that the FDIC in its corporate capacity must establish an assessment process to repay the obligations issued by the FDIC as receiver in connection with the liquidation of the company. The assessment process is to provide for repayment of the FDIC obligations within 60 months of the date of issuance of the obligations unless the FDIC and the Treasury extend that period. Assessments would be imposed first on those claimants of the covered financial company who received "additional payments" from the FDIC under the special authorities provided in Title II (other than claimants who received such payments because the FDIC determined that the payments were necessary to initiate and continue the operations of the receivership or any bridge financial company). These assessments would recover the amounts that those claimants received in excess of what they would have received solely from the proceeds of liquidation of the assets of the covered financial company. To the extent

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that the assessments against these claimants are insufficient to repay the FDIC obligations, then the FDIC will impose assessments on bank holding companies with consolidated assets of $50 billion or more, non-bank financial companies supervised by the FRB under Title I and other financial companies with consolidated assets of $50 billion or more. Title II directs the FDIC to impose assessments on a graduated basis, with companies having greater assets or risks being assessed at a higher rate. The FDIC is also required to take a series of other risk-based factors into account in establishing the assessment system, with an ultimate objective of ensuring that the assessed financial companies are treated equitably and that the assessment system reflects the differences between the risks, types and structures of the financial companies. (§210(o))

Removal of Additional Special Assessments

In addition to assessments that will be used to repay the obligations issued by the FDIC as receiver in connection with the liquidation of a systemically significant financial institution, the original Conference Report of the Dodd-Frank Act, which was approved early on June 25, 2010 by the House-Senate Conference on H.R. 4173 (the "Conference Committee"), added a "Financial Crisis Special Assessment" that would have been imposed on financial companies with $50 billion or more in consolidated assets and financial companies that manage hedge funds with $10 billion or more of assets under management. The Financial Crisis Special Assessment would have raised the lesser of (i) $19 billion and (ii) the amount necessary to offset 1 1/3 times the amount of any net deficit projected to result from the Dodd-Frank Act through September 30, 2020. On June 29, 2010, however, Senator Scott Brown (R-Massachusetts), who had voted for an earlier version of the Dodd-Frank Act that was passed by the Senate on May 20, 2010, stated that he would vote against the Dodd-Frank Act if it included the Financial Crisis Special Assessment. Later in the day on June 29, the Conference Committee reconvened, removed the provisions related to the Financial Crisis Special Assessment from the bill and added an amendment that accelerates the termination of the Troubled Asset Relief Program and that raises the minimum reserve ratio for the FDIC insurance fund from 1.15 percent to 1.35 percent of estimated insured deposits or the comparable percentage of the assessment base. The intent of the new amendment was to replace the deficit reduction effect that would have been achieved by the Financial Crisis Special Assessment. (§§334, 1302)

[T]he details of many of the new or enhanced regulatory requirements will be dependent on the results of the manifold rulemaking processes upon which federal financial regulators will now embark.

Conclusion

A fundamental objective of the Dodd-Frank Act is to address systemically risky firms through a combination of increased regulation and orderly dissolution in the event of the failure of such firms. While the Dodd-Frank Act establishes the general contours of this new regime, the details of many of the new or enhanced regulatory requirements will be dependent on the results of the manifold rulemaking processes upon which federal financial regulators will now embark. Beyond this, however, the ultimate results of the new regulatory regime will only be fully apparent when tested in the context of the next major financial crisis. ■

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