



Congress Enacts Sweeping Financial Reform

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Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010: Congress Enacts Sweeping Financial Reform

Duane Morris has issued further Alerts on many of the broad topics addressed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, accessible at www.duanemorris.com/FinancialReform.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Act”) became law. The U.S. Congress designed the Act to address what it perceived to be a vast number of failures that led to the worst financial crisis since the Great Depression. The Act contains sweeping reform of many aspects of the greater financial system in the United States. It affects the banks, investment funds, insurance companies, investment advisors, corporations and credit-rating agencies that operate within the financial system as well as the regulatory bodies that oversee the system itself. From the elimination of the decades-old U.S. Office of Thrift Supervision and the creation of new regulatory bodies in its place to the required registration of advisors to private investment funds, the Act also changes the nature, number and identity of the agencies that regulate and the institutions that are regulated.

The Act requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and its participants, and more than 250 instances of rulemaking. The most focused period of this regulatory activity is the next 18 months. Congress has given the agencies considerable discretion in designing the final rules, such that the eventual impact of the Act may be difficult to foresee from its text. However, regulations are likely to be adopted in stages, which may afford market participants the opportunity to analyze each successive regulation and adopt new procedures and behavior where required.

The Act addresses the following topics; for further information on a particular topic, please click on its hyperlinked title to access a detailed *Alert*:

1. [The Regulation of Derivatives and Swap-Trading Provisions.](#)

The Act provides for sweeping reforms that include substantial regulation of the over-the-counter (OTC) derivative market. Financial institutions that fit within the Act’s definition

of swap dealer or major swap participant will be subject to new requirements that could include: registration, capital and margin, reporting and recordkeeping, as well as new business-conduct standards that prohibit such entities from dealing in “abusive” swaps. The new requirements will require insured financial institutions to push out many derivatives to separately capitalized affiliates as well as prohibit the federal government from bailing out swap dealers or major swap participants. Participants in derivative trades may also be required to clear many or all of their swaps through a central clearing house. The Act divides oversight jurisdiction of the derivative market between the U.S. Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC and, collectively with the SEC, the “Commissions”) and also delegates to the Commissions the authority to promulgate rules and regulations to govern the derivative markets. Thus, the effect of the Act on derivative practices may depend substantially on the enactment and implementation of such rules and regulations.

2. The Volcker Rule and Improvements in the Regulation of Banking Entities and Nonbank Financial Companies Supervised by the Board of Governors of the Federal Reserve System.

Under section 619 of the Act, known as the “Volcker Rule,” banking entities, including insured depository institutions, bank holding companies and their bank and nonbank affiliates or subsidiaries, will no longer be permitted to engage in “proprietary trading,” defined as engaging for the trading account of an entity in any transaction to purchase or sell a security. A banking entity will be permitted to make and retain an investment in hedge funds and private equity funds for the purposes of establishing those funds and providing them with sufficient initial equity to permit them to attract unaffiliated investors, or for the purpose of making a *de minimis* investment in such funds. However, each investment made for the purpose of establishing such a fund must be reduced to not more than three percent of the total ownership interest in that fund within one year after the fund’s date of establishment, and all of a banking entity’s investments in hedge funds and private equity funds, in the aggregate, must be “immaterial” (as that term will be defined by rule) and in no event exceed three percent of the banking entity’s Tier 1

capital. Except as otherwise specified, a banking entity will not be permitted to act as a general partner of, or sponsor, any hedge fund or private-equity fund. Nonbank financial companies supervised by the Board of Governors of the Federal Reserve System that, except as otherwise permitted, engage in proprietary trading, or that take or retain an equity or other ownership interest in or sponsor a hedge fund or private-equity fund, will be required to satisfy additional capital requirements as if such nonbank financial companies were banking entities. Regulations to be issued by the Federal Reserve Board, the SEC and the CFTC will be necessary to carry out the provisions of the Volcker Rule.

3. Too-Big-to-Fail Bailout Avoidance Provisions.

The Act establishes a process by which the FDIC oversees the orderly liquidation of failed or failing financial companies whose potential collapse may constitute a risk to the U.S. financial system as a whole. In establishing an orderly liquidation fund, it also prevents the use of any taxpayer funds for such liquidation. These mandates respond to concerns that federal regulators had insufficient authority over nonbank financial institutions during the 2008 financial crisis and that the behavior of too-big-to-fail nonbank institutions has inappropriately drained away taxpayer dollars. These systemically significant institutions can now be liquidated under the Act's new procedures rather than under existing bankruptcy laws. While the Act provides key new tools for federal authorities, the Act also appears to create uncertainty on whether a company would be subject to an FDIC-controlled receivership action or a chapter 7 or 11 liquidation or reorganization. In addition, the Act permits the Board of Governors of the Federal Reserve System, in certain instances, to break up bank holding companies with total consolidated assets of \$50 billion or more as well as nonbank financial companies that pose a "grave threat" to U.S. financial stability, even if such institutions are not insolvent.

4. Creation of the Consumer Financial Protection Bureau.

Title X establishes the Bureau of Consumer Financial Protection. The Bureau will have the authority to regulate and enforce substantive standards for any person that engages in

the offer or sale of a financial product or service to any consumer. The Bureau is also granted authority to supervise covered persons, such as large banks, savings associations and credit unions that offer consumer financial products and services and the power to enforce federal consumer financial laws. To that end, the Bureau is authorized to issue rules, orders and guidance to implement federal consumer financial law and bring enforcement actions to uphold federal consumer financial law.

The Bureau will have the power to enforce consumer financial laws in a number of ways, including assessing civil money penalties which can range up to \$1 million per day in some cases, disgorgement for unjust enrichment, and restitution. The Bureau will also have the power to institute civil investigations, demand documents and information, issue subpoenas, conduct hearings and adjudication proceedings, issue cease-and-desist orders, and commence civil actions. The Bureau is tasked to: (1) conduct financial education programs; (2) collect and forward complaints to agency regulators; and (3) collect, monitor and publish information about the functioning of the market for consumer financial products. The rules to be implemented by the Bureau under this Act will have a significant impact on the financial industries that market to consumers.

5. Registration of Advisors to Private Investment Funds and Pools, and of Small Advisory Firms.

By eliminating the decades-old exemption from investment advisor registration for small advisory firms and for advisors to private-investment funds, the Act will require thousands of firms to register as investment advisors. Beyond the fact of registration, these firms will become subject to the pervasive regulatory scheme that limits incentive-based compensation, requires detailed reporting and documentation, and imposes other restrictions on otherwise-common business practices. In addition, the Act requires the collection of systemic-risk data on such private funds, including portfolio and trading information.

6. Creation of the Federal Insurance Office and the Financial Stability Oversight Council.

The Act creates the Financial Stability Oversight Council, composed of existing regulators, to monitor and address systemic risks to the United States' financial stability.

The Act also creates the Federal Insurance Office within the Treasury Department to monitor the insurance industry and to work with the Financial Stability Oversight Council to identify insurers that could impact U.S. financial stability.

7. Capital Requirements for Financial Institutions.

Title I of the Act implements increased oversight of the capital requirements of financial institutions, requiring: (i) appropriate minimum leverage capital and risk-based capital levels on a consolidated basis for insured depository institutions, depository-institution holding companies and nonbank financial companies supervised by the Board of Governors of the Federal Reserve System; (ii) a study, and a report to Congress, relating to the feasibility of a contingent capital requirement for nonbank financial companies supervised by the Board of Governors and large, interconnected bank holding companies; and (iii) annual analyses by the Board of Governors that evaluate whether nonbank financial companies supervised by the Board of Governors and larger bank holding companies have the capital, on a consolidated basis, necessary to absorb losses as a result of adverse economic conditions, and annual or semi-annual stress tests by the entities themselves.

Title VI of the Act requires that bank holding companies and savings and loan holding companies that wish to expand the financial services of their bank subsidiaries are well capitalized and well managed, and imposes a heightened standard of review regarding the capitalization of a bank resulting from a merger or acquisition. Title VI also requires bank holding companies and savings and loan holding companies to serve as a source of financial strength for their subsidiaries that are depository institutions, and, for an insured depository institution that is not the subsidiary of a bank holding company or a savings and loan holding company, that any entity that directly or indirectly controls the insured depository institution serve as a source of financial strength for the depository institution.

8. Modifications to the U.S. Federal Reserve's Emergency Lending Authority.

The Act limits the Federal Reserve's ability to lend to individual companies outside a program or facility that provides for broad-based eligibility, which may prevent the possibility of cherry-picking one company over another on an individual basis.

Furthermore, the revised section 13(3) prohibits the Federal Reserve from lending to insolvent borrowers. The Act makes similar changes to the FDIC's emergency lending power, whereby the FDIC must create a widely available program to guarantee obligations of solvent insured depository institutions or holding companies once a determination has been made that a liquidity event exists. In an effort to ensure accountability of the Federal Reserve, the Act requires that the U.S. Government Accountability Office (GAO) audit the loans and other financial assistance authorized under the Federal Reserve's section 13(3) emergency lending authority.

9. Consumer Financial Protection Act of 2010 Institutes First Federal Regulation of Debit Card Interchange Fees.

The Act represents the federal government's first significant foray into the interchange fees on card transactions. The Federal Reserve Board has nine months to promulgate regulations intended to make interchange fees "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." The expectation appears to be that direct regulation of interchange fees on debit-card transactions would exert indirect pressure on the fees relating to credit cards. The Act also expands the Electronic Fund Transfer Act to put limitations on agreements between merchants and payment networks. Networks may no longer use their agreements to prevent merchants from offering discounts to consumers who pay with debit cards and other forms of payment that involve lower fraud-risk and, hence, lower cost to the merchant and others in the process. The Federal Reserve Board is also required to establish long-needed fraud-reduction standards and to create incentives for issuers, merchants and networks to comply with them.

10. Corporate Governance and Executive Compensation Provisions for Public Companies.

The corporate governance provisions in Title IX require shareholder proxy access,

expand compensation disclosure, institute say-on-pay votes, prohibit brokers from voting street-name shares on say-on-pay and other significant matters, mandate membership and operation of compensation committees, strengthen proxy disclosure, and amend securities transaction reporting under sections 13 and 16 of the Securities Exchange Act of 1934. The Act also vests broad rule-making discretion in the SEC, and therefore the exact impact of the Act will not be known fully for some time.

11. Mortgage Reform and Anti-Predatory Lending Act.

Title XIV of the Act sets forth minimum underwriting standards for home mortgages and requires lenders to ensure a borrower's credit-worthiness by verification of income, employment status and credit history. The Act also prohibits steering incentives and restricts other forms of compensation to mortgage brokers and lenders. Additional protections are given to borrowers with "high cost mortgages"; certain prepayment penalties are prohibited or restricted; and an Office of Housing Counseling will be created in the Department of Housing and Urban Development.

12. Municipal Securities.

The Act establishes the Office of Municipal Securities within the SEC, to administer the rules of the SEC concerning the practices of municipal-securities brokers, dealers and advisors and to coordinate rulemaking and enforcement actions with the Municipal Securities Rulemaking Board (MSRB). The Act requires the registration of municipal advisors and imposes a fiduciary duty on such advisors when advising municipal issuers, which would subject such advisors to MSRB rules enforced by the SEC. The Act changes the composition of the MSRB's board of directors so that the majority of members are independent of municipal-securities brokers, dealers and advisors.

13. Credit Rating Agencies.

The Act responds to the part credit-rating agencies played in the recent financial crisis. Regulations on this subject are to be promulgated by the SEC within a year of the Act's enactment. The SEC will have a newly created Office of Credit Ratings to oversee the (currently 10) Nationally Recognized Statistical Rating Organizations (NRSROs). The

regulations appear to be meant to achieve transparency around the NRSROs' management and rating processes, internal controls over the consistent implementation of the rating process, and avoidance of the conflicts of interest that have beset the agencies. There will be a comprehensive application process and a requirement for annual recertification of the NRSROs. The provision that garnered reactions from three of the agencies within hours of President Obama's signing of the Act relates to an amendment to the Exchange Act allowing investors to bring private suits against rating agencies for a knowing or reckless failure to: (1) follow their own published methodologies for evaluating credit risk or (2) verify independent sources of information upon which they relied. Three rating agencies immediately announced that they would stop rating bonds, while a fourth expressed no concern about being made accountable for its actions.

14. New Whistleblower Incentives and Protections, and More Enforcement Expected.

The Act includes “bounty hunter” provisions to increase the voluntary reporting of securities and commodities violations. Congress did so by significantly enhancing whistleblower rewards and protections. These provisions may pose new and considerable challenges to publicly traded companies – including heightened FCPA risks and costly compliance burdens. The SEC recently paid a whistleblower a \$1 million reward in the *Pequot* matter. Combined with the federal law that criminalizes retaliation against an employee who provides confidential information to the government, or who purloins corporate documents to turn them over to the government, companies may now want to consider assessing how they conduct their business activities, measured by a focused risk metric.

Conclusion

The Act is vast in size and scope, and affects those who operate within the financial system as well as those who regulate it. It addresses both the discrete and the systemic. However, the extent to which the Act truly achieves its goals, addresses the causes of the financial crisis and is able to prevent or mitigate a future crisis remains to be seen. The full impact of the Act will not be

apparent until the regulatory agencies have completed the extensive rulemaking required by its terms.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm’s comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris’ attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies’ interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact [Robert P. Bramnik](#), [Joel N. Ephross](#), [Laurence S. Lese](#), [George D. Niespolo](#), [Marvin G. Pickholz](#), [Loren Schechter](#) or the attorney in the firm with whom you are most regularly in contact.

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U.S. Financial Reform: The Regulation of Derivatives and Swap-Trading Provisions

The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Title VII of the Act, designated the “Wall Street Transparency and Accountability Act of 2010,” will significantly change how derivatives and the market participants that use them will be regulated. Historically, the over-the-counter swaps market has functioned without regulation, with trading taking the form of customized bilateral contracts. Each contract is non-uniform, with varying terms and varying margin requirements. As a result, counterparties throughout the financial system were interconnected with little transparency and a notional amount that often was not indicative of actual economic exposure. The U.S. Congress, in passing Title VII, has instituted a new framework to manage “systemic risk”¹ within the financial system. Title VII will require more derivative transactions to be executed on regulated exchanges and electronic trading platforms, and to be centrally cleared through regulated clearinghouses. Many key details of Title VII will be defined and interpreted through the regulatory rulemaking process and are not set forth in the Act itself. Title VII will, among other things:

- Require banks to push out certain swap-dealing activities that do not constitute “bona fide hedging and traditional bank activities”;
- Establish a comprehensive framework for the registration and regulation of dealer and “major” nondealer market participants regarding their “swap” activity;
- Exempt companies that use swaps to hedge “commercial risk”² (end users) from the clearing and exchange-trading requirements, but not from margin requirements;
- Require derivatives that are capable of being cleared, to be cleared and traded on an exchange; and

- Require regulators to set minimum capital requirements and minimum initial and variation margin requirements.

Title VII gives the U.S. Commodity Futures Trading Commission (CFTC) and the U.S. Securities and Exchange Commission (SEC) (collectively, the “Commissions”) one year to enact most of the required rulemaking and regulations. Title VII categorizes the derivatives transactions within its scope as either “swaps,” which are subject to primary regulation by the CFTC; “security-based swaps,” which are subject to primary regulation by the SEC; or “mixed swaps,” which are subject to joint regulation by the CFTC and SEC. Because many of the requirements of Title VII are nearly identical for both swaps and security-based swaps, for ease of presentation, unless otherwise indicated, the term “swaps” is used in this *Alert* to refer to both “swaps” and “security-based swaps.”

Pushing Out Swaps Activity

Title VII requires banks to push out “riskier” trades – defined as those that a bank is not permitted to hold under the National Bank Act, including non-cleared credit default swaps (CDS), CDS against asset-backed securities, commodity and agriculture swaps, equities, energy swaps, and metal swaps excluding gold and silver – into a separately capitalized affiliate. Failure to make the push-out will cause the bank to lose federal assistance, including FDIC insurance and access to the Federal Reserve’s discount windows.

Title VII allows banks to engage in certain swaps (defined as “bona fide hedging and traditional bank activities”) including interest rate swaps, foreign exchange swaps and forwards, credit swaps, gold and silver, investment grade CDS and other transactions used to hedge the bank’s own risk.

The provisions of Title VII are designed to curb systemic risk by reducing the ability of the insured banks to engage in proprietary trading, including swaps, and also to prohibit the federal government from bailing out a “swaps entity” (as defined below). For further information on the Act’s prohibitions on insured banks’ proprietary trading, please see our *Alert* “[The Volcker Rule](#)”

and Improvements in the Regulation of Banking Entities and Nonbank Financial Companies Supervised by the Board of Governors of the Federal Reserve System.”

The push-out provision will take effect on July 21, 2012; and all existing swaps contracts in effect as of that date, including those entered into during the transition period, will be grandfathered. The transition period will be set by the applicable bank regulator and, as such, there is no set transition period applicable to all contracts.

Who Is Affected?

In addition to the push-out provision, the Act also mandates regulation of market participants and establishes new categories of regulated entities, including “swaps entities.” A “swaps entity” is any “swaps dealer” or “major swap participant” (MSP) that is required to be registered by Title VII.

A “swaps dealer” is an entity whose business is based on entering into swaps, who represents itself as a dealer of swaps, who creates a market in swaps or who engages in activities that create a trade reputation of being a dealer. Title VII provides that the relevant Commission must provide an exemption from registration for dealers that engage in a “de minimis quantity of swap dealing,” which will be defined through Commission rulemaking, in connection with transactions with or on behalf of customers. The definition of “swaps dealer” remains subject to further clarification by the Commissions’ regulations.

An MSP is a non-swaps dealer entity that maintains a “substantial position” – which will be defined through Commission rulemaking – in swaps (excluding positions held for “hedging or mitigating commercial risk” and positions held by employee benefit plans for hedging purposes) that could have “serious adverse effects” on U.S. market stability; or that is highly leveraged, is not subject to bank regulators’ capital requirements and maintains a substantial position in swaps. Title VII mandates that the SEC and CFTC clarify the scope and reach of the definition of an MSP through regulation.

The definition of an MSP is likely to be significant because it may include hedge funds, and if it does, it would subject hedge funds to capital requirements that are mandated by Title VII to take into account “the risks associated with other types of swaps . . . engaged in and the other activities conducted by [the hedge fund or other nonbank MSPs] that are not otherwise subject to regulation.” In other words, in such circumstances, capital requirements may be based on the entity’s entire operations.

Clearing and Exchange Trading

The cornerstone of Title VII is the centralized clearing requirement. Centralized clearing is mandated for all swaps that the CFTC or the SEC determines should be cleared through a registered clearinghouse, and that are otherwise accepted by one or more clearinghouses for clearing. Transactions that are subject to mandatory clearing are also required to be traded on a designated contract market or “swap execution facility” (for “swaps”) or a national securities exchange or “security-based swap execution facility” (SEF) – meaning a facility that accepts bids and offers made by multiple participants (for “security-based swaps”) – unless no such venue accepts the transaction. If neither an exchange nor an SEF is willing to list the swap, counterparties to the contract would nevertheless be required to comply with any relevant CFTC or SEC recordkeeping and reporting requirements, as well as applicable capital and margin requirements.

Highly customized swaps that are not suitable for clearing may still be executed; however, such swaps must be reported to a trade repository or to the applicable Commission. Moreover, swap dealers and major swap participants (MSPs), discussed below, entering into non-cleared swaps may face potentially significant margin requirements.

End-User Exemption

End users are exempt from the centralized clearing requirement if they:

1. Are not financial entities,
2. Are using the swap to hedge commercial risk, and

3. Notify the relevant Commission on how they generally meet their financial obligations related to entering non-cleared swaps in a manner to be determined by the Commission.

The term “financial entity” includes swaps dealers, MSPs, commodity pools, private funds (as defined in the Investment Advisers Act of 1940), employee-benefit plans and persons predominantly engaged in activities that are in the business of banking or in activities that are financial in nature, excluding certain captive finance affiliates. Title VII requires the Commissions to consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions.

Margin and Capital Requirements

Title VII requires that regulators of financial institutions must, upon consultation with the Commissions, set minimum capital and initial and variation margin requirements for banking institutions. The Commissions will set the requirements for nonbank institutions, which are to address systemic risk resulting from a high volume of derivatives activity, securities borrowing and lending, repossessions, and activity that, if stopped, would create a substantial disruption in financial markets. Title VII requires that such requirements must permit the use of noncash collateral to satisfy margin requirements. The Commissions are given broad discretion in determining the appropriate regulations regarding margin requirements.

Title VII currently does not provide an exemption from the margin requirements for an end user who is a counterparty to a swap. Additionally, Title VII contains no provision exempting swaps entered into pre-enactment from the margin requirements for uncleared swaps under the Act.

Business-Conduct Requirements

Title VII requires registered swaps dealers and MSPs to conform to any business-conduct standards set by the Commissions pertaining to fraud, supervision, adherence to position limits and any other matter that the Commissions determine to be appropriate. Additionally, Title VII imposes stiffer conduct requirements on swaps dealers and MSPs that deal with “special entities” – *i.e.*, pension funds; endowments; retirement plans; and federal, state and local government

agencies and entities – including an obligation to make detailed disclosure to the special entity of the swaps dealer’s capacity for each transaction. The extent of the business-conduct requirements may depend in large part on the Commissions’ interpretation of the aforementioned business-conduct standards and their enactment of such rules and regulations.

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For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact [Joel N. Ephross](#), [Miriam O. Hyman](#), [F. Reid Avett](#), any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

As required by United States Treasury Regulations, you should be aware that this communication is not intended by the sender to be used, and it cannot be used, for the purpose of avoiding penalties under United States federal tax laws.

Notes

1. “Systemic risk” is not defined in the Act, but is commonly defined as the risk inherent to the entire market or entire market segment.
2. Financial risk assumed by a party extending credit without collateral or a means of recourse.

U.S. Financial Reform: The Volcker Rule and Improvements in the Regulation of Banking Entities and Nonbank Financial Companies Supervised by the Board of Governors of the Federal Reserve System

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Section 619 of the Act, also known as the “Volcker Rule,” will limit proprietary trading, defined below, by U.S. banks and their affiliates (“Banking Entities”) and nonbank financial companies supervised by the Board of Governors of the Federal Reserve System (“Board”).

The intended purposes of the Volcker Rule are to:

- Promote and enhance the safety and soundness of banking entities;
 - Protect taxpayers and consumers by minimizing the risk that insured depository institutions and their affiliates may engage in unsafe or unsound activities;
 - Limit the inappropriate transfer of federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the federal government to unregulated entities;
 - Reduce conflicts of interest between the self-interests of banking entities and nonbank financial companies supervised by the Board, and the interests of their customers;
 - Appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and the U.S. financial system;
 - Limit activities that have caused, or that might reasonably be expected to create, undue risk or loss in banking entities and nonbank financial companies supervised by the Board;
- and

- Appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under the Volcker Rule.

Under the Volcker Rule, banking entities – as defined below – with a few exceptions, cannot:

- Engage in proprietary trading; or
- Acquire or retain any equity, partnership or other ownership interest in or sponsor a hedge fund or a private equity fund.

Under the Volcker Rule, with a few exceptions, any nonbank financial company supervised by the Board that engages in proprietary trading or that takes or retains any equity, partnership or other ownership interest in, or sponsors a hedge fund or a private equity fund, will be required, by rule, to satisfy additional capital requirements for and meet additional quantitative limits on proprietary trading and taking or retaining any equity, partnership or other ownership interest in, or sponsorship of, a hedge fund or a private equity fund, as if the nonbank financial company supervised by the Board were a banking entity.

“Proprietary trading” is defined as engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative or contract, or any other security or financial instrument specified by rule of a federal banking agency, the U.S. Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC).

Subject to any limitations or restrictions that the appropriate federal banking agencies, the SEC and the CFTC may determine, permitted proprietary trading activities include:

- Trading in U.S. government or government agency securities;
- Trading in connection with underwriting or market-making-related activities designed not to exceed the reasonably expected near-term demands of clients, consumers or counterparties;

- Risk-mitigating hedging activities in connection with and related to individuals or aggregated positions, contracts or other holdings of banking entities designed to reduce specific risks;
- Trading securities on behalf of customers;
- Investments in small-business investment companies designed primarily to promote the public welfare;
- Transactions by a regulated insurance company for its general account.

The appropriate federal banking agencies, the SEC and the CFTC are required to issue regulations that will limit the activities permitted by the Volcker Rule. No transaction or activity may be deemed to be a “permitted activity” if the transaction or activity:

- Would involve or result in a material conflict of interest (to be defined by rule) between the banking entity and its clients, customers or counterparties. (Note that the Volcker Rule in this and the following bullet-points references only “banking entities” and not more expansively “nonbank financial companies supervised by the Board”);
- Would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (to be defined by rule);
- Would pose a threat to the safety and soundness of the banking entity; or
- Would pose a threat to the financial stability of the United States.

Notwithstanding the express references in the above bullet-points to “banking entity,” a later section of the Volcker Rule expressly provides that “the prohibitions and restrictions under this section [of the Volcker Rule] shall apply to activities of a banking entity or nonbank financial company supervised by the Board.”

The Volcker Rule defines “banking entities” as:

- Any insured depository institution;
- Any company that controls an insured depository institution or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and

- Any affiliate or subsidiary of any such entity.

A banking entity will be permitted to make and retain an investment in hedge funds and private equity funds for the purposes of establishing those funds and providing them with sufficient initial equity to permit them to attract unaffiliated investors, or for the purpose of making a *de minimis* investment in such funds. However, each investment made for the purpose of establishing such a fund must be reduced to not more than three percent of the total ownership interest in that fund within one year after the fund's date of establishment, and all of a banking entity's investments in hedge funds and private equity funds, in the aggregate, must be "immaterial" (as that term will be defined by rule) and in no event exceed three percent of the banking entity's Tier 1 capital.

Provisions to implement the Volcker Rule are subject to further study and regulatory action. By January 21, 2011, the Financial Stability Oversight Council, established by the Act and chaired by the Secretary of the Treasury, must study and make recommendations on the implementation of the Volcker Rule. Within nine months of the completion of this study, the federal banking agencies, the SEC and the CFTC, must consider the findings of the Financial Stability Oversight Council and adopt rules to carry out the provisions of the Volcker Rule ("Final Rules"). The Volcker Rule goes into effect the earlier of:

- Twelve months after the date of the issuance of the Final Rules; or
- July 21, 2012.

About Duane Morris

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For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact [John W. Kauffman](#), [Michael W. Wong](#), any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

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U.S. Financial Reform: Too-Big-to-Fail Bailout Avoidance Provisions

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Title II of the Act, designated “Orderly Liquidation Authority” – effective July 21, 2010 – establishes what is intended to be an orderly liquidation process for “financial companies” whose collapse or potential collapse are determined to constitute a risk to the financial system as a whole. Such systemically significant institutions would be liquidated under these new procedures, rather than being treated under existing bankruptcy laws. (The intent of Act is that most-failing financial companies will continue to be administered under existing bankruptcy laws.)

A “financial company” is defined as any of the following:

- A bank holding company (as defined in the Bank Holding Company Act of 1956);
- A company that (A) derives 85 percent or more of its annual gross revenues from, or of which at least 85 percent of its consolidated assets are related to, activities that are financial in nature (as defined in the Bank Holding Company Act – this would include, among other things, lending; exchanging; transferring; investing for others; insuring or indemnifying against loss, harm or damage; acting as principal, agent or broker; underwriting, dealing in or making a market in securities; or providing financial, investment or economic advisory services); and (B) the newly created Financial Stability Oversight Council, by a vote of at least two-thirds of its nine members (including the chairperson, the Secretary of the Treasury), determines should be supervised by the Board of Governors of the Federal Reserve System (the “Board of Governors”) because its failure or financial distress could pose a risk to the financial stability of the United States;

- Any company predominantly engaged in activities that the Board of Governors has determined are financial in nature (for purposes of the Bank Holding Company Act); and
- Any subsidiary of any company described above that is predominantly engaged in activities that Board of Governors has determined are financial in nature or incidental thereto for purposes of the Bank Holding Company Act (excluding subsidiaries that are insured depository institutions or insurance companies).

If the Treasury Secretary, in consultation with the President (and following receipt of a recommendation described in the next paragraph), determines that a financial company is in default or is in danger of default and, among other things, that the failure of the financial company would have significant adverse effects on financial stability in the United States, the Secretary must notify the company of such determination and of its intention to appoint the FDIC as receiver. (Such a determination may occur before or after a financial company has commenced bankruptcy proceedings.)

If the board of directors of the subject company consents to such appointment, the Treasury Secretary is required to appoint the FDIC as receiver. (The Act creates a specific safe harbor providing that the members of the board of directors of a financial company will not be liable to the company's shareholders or creditors for acquiescing in or consenting in good faith to the appointment of the FDIC as receiver.)

Absent such consent, the Treasury Secretary is required to file a sealed petition with the U.S. District Court for the District of Columbia (the "District Court") seeking an order authorizing the Secretary to appoint the FDIC. The petition will be granted by operation of law within 24 hours after filing unless the District Court rules that the Treasury Secretary's determinations that the company in question is a financial company and is in default or may potentially default were "arbitrary and capricious." The "arbitrary and capricious" standard appears to give the Secretary considerable discretion in making its determinations and will be difficult for a company to overcome.

The Treasury Secretary cannot make a determination described in the previous paragraph unilaterally. The Secretary must first receive a recommendation from the Board of Governors and from the FDIC, based upon a vote of at least two-thirds of the Board of Governors and the board of the FDIC, unless (a) the company in question is a broker dealer, in which case, the written recommendation must come from the SEC and from the Board of Governors, upon votes of at least two-thirds of the members of the SEC and the Board of Governors; or (b) the company in question is an insurance company, in which case, the director of the Federal Insurance Office and the Board of Governors, based on a two-thirds' vote, must make the recommendation. (The Federal Insurance Office is a new office established by the Act within the Department of the Treasury for the purpose of monitoring the insurance industry.)

The Treasury Secretary or the affected company may, no later than 30 days after the date of the District Court's ruling, file an appeal of such ruling with the U.S. Court of Appeals for the D.C. Circuit ("Court of Appeals"), and such an appeal must be considered on an expedited basis. However, if the District Court grants the Secretary's petition, the FDIC's authority to begin acting as receiver will commence immediately – the District Court's decision is not subject to any stay or injunction pending the appeal. Thus, it is possible that the orderly liquidation process could be under way by the time the Court of Appeals issues a ruling. The Court of Appeals' scope of review is limited to deciding whether the Treasury Secretary's determinations that the company fits the definition of a "financial company" and is in default or in danger of default were arbitrary and capricious.

As a result of this new orderly liquidation regime, creditors of and other transactional counterparties with systemically important financial companies will need to consider, as part of their risk assessment, the possibility that the financial company may enter bankruptcy proceedings, or instead may become subject to the liquidation process under the Act, and to consider how their rights may differ under each scenario.

The FDIC, acting as receiver, has a broad array of powers over the financial company. These powers are similar to those the FDIC has over failed FDIC-insured depository institutions, with

some differences. The Act states that, in taking actions as receiver, the FDIC must, among other things:

- Ensure that the shareholders of the financial company do not receive payment until after all other claims and the “Orderly Liquidation Fund” (see below) are fully paid;
- Ensure that unsecured creditors bear losses in accordance with the applicable priority of their claims;
- Ensure that the members of the board of directors and the management of the financial company who were responsible for the failed condition of the company are removed; and
- Not take an equity interest in or become a shareholder of the financial company.

The Act notes that all companies placed into receivership under the Act’s provisions should be liquidated, and that no taxpayer funds should be used to prevent any such liquidation.

A new segregated fund, called the Orderly Liquidation Fund, has been established to enable the FDIC to carry out its authorities under Title II of the Act. Once the FDIC submits to the Treasury Secretary a plan for the orderly liquidation of a financial company satisfactory to the Secretary, the FDIC may issue obligations to the Treasury Secretary, the proceeds of which are deposited into the Fund until needed. The maximum amount of obligations that the FDIC may issue with regard to a financial company may not exceed 10 percent of the total consolidated assets of the financial company during the first 30 days of liquidation proceedings, and may not exceed 90 percent of the fair value of the total consolidated assets of the financial company available for repayment following the initial 30-day period. Obligations so incurred by the FDIC have priority over other claims against the company, including administrative expenses.

If necessary in order to enable the FDIC to repay its obligations to the Treasury within 60 months of the date of issuance, the FDIC is required to impose assessments (i) on any claimant of the financial company that received amounts in excess of liquidation value of its claim; and if this is not sufficient to enable the FDIC to recover the amount of its obligations, (ii) on financial companies having consolidated assets of \$50 billion or more and nonbank financial companies supervised by the Board of Governors. Any assessments on such financial companies are to be

made on a graduated basis, with companies having greater assets and risk being assessed at a higher rate.

Title I of the Act includes provisions permitting the Board of Governors, in certain instances, to break up certain large, complex financial institutions even if they are not insolvent. If the Board of Governors determines that a bank holding company with total consolidated assets of \$50 billion or more or a nonbank financial company that is under the supervision of the Federal Reserve poses a “grave threat”¹ to U.S. financial stability, the Board of Governors, following an affirmative vote of at least two-thirds of the voting members of the Financial Stability Oversight Council, is required to:

- Limit the ability of the company to merge, consolidate or otherwise become affiliated with another company;
- Restrict the ability of the company to offer one or more financial products;
- Terminate one or more activities of the company; and
- Impose conditions on the manner in which the company conducts one or more activities.

If the Board of Governors is considering such mitigatory action against a company, it is required, in consultation with the Financial Stability Oversight Council, to notify the institution and provide an explanation of the basis for its proposed mitigatory action. The company may, no later than 30 days after the date of receipt of such notice, request an opportunity for a hearing before the Board of Governors to contest the proposed mitigatory action. The Board of Governors must issue a final decision no later than 60 days following such a hearing (or, if no hearing was held, the date of its notice to the company). Unlike the process described in Title II for the appointment of the FDIC as receiver of a failing or failed financial company, the Act does not specify a judicial appeal process of a final decision of the Board of Governors.

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For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact [Lee J. Potter, Jr.](#), [Benjamin A. Haverstick](#), any [member](#) of the [Corporate Practice Group](#) or the attorney in the firm with whom you are most regularly in contact.

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Note

1. Section 121(a). This term is not defined in the Act.

U.S. Financial Reform: Creation of the Consumer Financial Protection Bureau

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Title X of the Act is known as the “Consumer Financial Protection Act of 2010.” This portion of the legislation establishes the Bureau of Consumer Financial Protection (the “Bureau”), an independent bureau within the U.S. Federal Reserve to regulate consumer financial products and services that are offered or provided for use by consumers primarily for personal, family or household purposes, or that are delivered, offered or provided in connection with a consumer financial product or service. The Bureau will be led by a director appointed by the President and confirmed by the U.S. Senate. Title X transfers to the Bureau numerous consumer protection responsibilities currently managed by the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Federal Trade Commission and the U.S. Department of Housing and Urban Development. The Bureau will have the authority to regulate and enforce substantive standards for any person that engages in the offer or sale to any consumer of a financial product or service, including:

- Extending credit and servicing loans, including acquiring, purchasing, selling, brokering or other extensions of credit;
- Extending or brokering leases of personal or real property that are the functional equivalents of purchase finance arrangements;
- Providing real estate settlement services;
- Engaging in deposit-taking activities, transmitting or exchanging funds;
- Selling, providing or issuing stored-value or payment instruments;
- Providing check cashing, check collection or check guaranty services;

- Providing financial advisory services (other than those relating to securities regulated by the SEC);
- Collecting, analyzing, monitoring or providing consumer report information or other account information (including credit history of consumers);
- Collecting debt relating to any consumer financial product or service; and
- Such other financial product or service as may be defined by the Bureau.

The Bureau is also granted authority to supervise “covered persons” (defined as any person, including affiliates, that engages in offering or providing a consumer financial product or service), such as large banks, savings associations and credit unions that offer consumer financial products and services, and the power to enforce federal consumer financial laws. To that end, the Bureau is authorized to issue rules, orders and guidance to implement federal consumer financial laws and bring enforcement actions to uphold federal consumer financial laws. The Bureau will have the power to enforce consumer financial laws in a number of ways, including civil money penalties that can range up to \$1 million per day in some cases, disgorgement for unjust enrichment and restitution.

Title X defines the **purposes, objectives and functions** of the Bureau, as follows:

As its legislated **purposes**, the Bureau is tasked to seek to implement and, where applicable, enforce federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services, and that the markets for those products and services are fair, transparent and competitive.

Title X provides, as its specified **objectives**, that the Bureau is authorized to exercise its authorities under federal consumer financial law for the purposes of ensuring that, with respect to consumer financial products and services:

- Consumers are provided with timely and understandable information to make responsible decisions about financial transactions;
- Consumers are protected from unfair, deceptive or abusive acts and practices, and from discrimination;

- Outdated, unnecessary or unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens;
- Federal consumer financial law is enforced consistently in order to promote fair competition; and
- Markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

As specified in Title X, the primary **functions** of the Bureau are:

- Conducting financial education programs;
- Collecting, investigating and responding to consumer complaints;
- Collecting, researching, monitoring and publishing information relevant to the functioning of markets for consumer financial products and services to identify risks to consumers and the proper functioning of such markets;
- Supervising covered persons for compliance with federal consumer financial law, and taking appropriate enforcement action to address violations of federal consumer financial law;
- Issuing rules, orders and guidance implementing federal consumer financial law; and
- Performing such support activities as may be necessary or useful to facilitate the other functions of the Bureau.

The rulemaking authority provided under Title X enables the Bureau to prescribe rules and issue orders and guidance in its administration of federal consumer financial laws in conjunction with the relevant agency regulators or other appropriate federal agencies. In this regard, the Bureau's director may prescribe rules and issue orders and guidance, as may be necessary or appropriate to enable the Bureau to administer and carry out the purposes and objectives of the federal consumer financial laws, and to prevent evasions thereof. The Bureau is required to consult with the appropriate prudential regulators or other federal agencies prior to proposing a rule and during the comment process regarding consistency with prudential, market, or systemic objectives administered by such agencies. Notwithstanding any other provisions of federal law, for purposes of assuring compliance with federal consumer financial law and any regulations

thereunder, the Bureau is given the exclusive authority to prescribe rules subject to those provisions of law. However, the newly created nine-member Financial Stability Oversight Council may, by two-thirds' vote, set aside all or part of a final regulation prescribed by the Bureau, if it concludes that the regulation in question would put the safety and soundness of the banking system or the stability of the financial system of the United States at risk.

As a means to prevent unfair, deceptive or abusive acts or practices, the Bureau is authorized to take action to prevent a covered person or service provider from committing or engaging in an unfair, deceptive or abusive act or practice under federal law in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. In this regard, the Bureau is authorized to prescribe rules applicable to a covered person or service provider identifying as unlawful unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. Title X provides that the Bureau will have no authority to declare an act or practice in connection with a transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service, to be unlawful on the grounds that such act or practice is **unfair**, unless the Bureau has a reasonable basis to conclude that:

- The act or practice causes or is likely to cause substantial injury to consumers that is not reasonably avoidable by consumers; and
- Such substantial injury is not outweighed by countervailing benefits to consumers or to competition.

Additionally, Title X provides that the Bureau will have no authority to declare an act or practice **abusive** in connection with the provision of a consumer financial product or service, unless the act or practice:

- Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
- Takes unreasonable advantage of:

- A lack of understanding on the part of the consumer of the material risks, costs or conditions of the product or service;
- The inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or
- The reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

Title X authorizes the Bureau to prescribe rules to ensure that the features of any consumer financial product or service, both initially and over the term of the product or service, are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service, in light of the facts and circumstances. Therefore, in prescribing rules for this purpose, the Bureau is required to consider available evidence about consumer awareness, understanding of, and responses to disclosures or communications about the risks, costs and benefits of consumer financial products or services.

Title X also grants the Bureau the power to institute civil investigations, demand documents and information, issue subpoenas, conduct hearings and adjudication proceedings, issue cease-and-desist orders and commence civil actions. In this regard, the Bureau may use its subpoena power to collect information regarding the business conduct and practices of covered persons. In an apparent effort to detect risks to consumers, the Bureau may require periodic reports from covered persons and may conduct examinations of covered persons to assess compliance with federal consumer financial laws. The Bureau's supervisory activities are to be coordinated with agency regulators and state bank-regulatory authorities and use existing reports to the fullest extent possible. Title X is silent with respect to private rights of action. In administrative proceedings brought thereunder, Title X authorizes the appropriate court or the Bureau to grant any appropriate legal or equitable relief with respect to a violation of federal consumer financial law, including:

- Rescission or reformation of contracts;
- Refund of moneys or return of real property;

- Restitution;
- Disgorgement or compensation for unjust enrichment;
- Payment of damages or other monetary relief;
- Public notification regarding the violation, including the costs of notification;
- Limits on the activities or functions of the person; and
- Civil money penalties, as specified in Title X, including a penalty of up to \$1 million for each day for which a knowing violation continues.

Notwithstanding these remedies, Title X provides that no exemplary or punitive damages will be available for violations of consumer financial law.

As a means of protecting employees who report violations of consumer financial laws by their employer, Title X provides that no covered person or service provider is permitted to terminate or in any other way discriminate against, or cause to be terminated or discriminated against, any covered employee or any authorized representative of a covered employee by reason of the fact that the employee or representative, whether at the initiative of the employee or in the ordinary course of the duties of the employee (or any person acting pursuant to a request of the employee), has:

- Provided, caused to be provided, or is about to provide or cause to be provided, information to the employer, the Bureau, or any other state, local or federal government authority or law enforcement agency relating to any violation of, or any act or omission that the employee *reasonably believes* to be a violation of, any provision of Title X or any other provision of law that is subject to the jurisdiction of the Bureau, or any rule, order, standard or prohibition prescribed by the Bureau;
- Testified or will testify in any proceeding resulting from the administration or enforcement of any provision of Title X or any other provision of law that is subject to the jurisdiction of the Bureau, or any rule, order, standard or prohibition prescribed by the Bureau;
- Filed, instituted or caused to be filed or instituted any proceeding under any federal consumer financial law; or

- Objected to, or refused to participate in, any activity, policy, practice or assigned task that the employee (or other such person) *reasonably believed* to be in violation of any law, rule, order, standard or prohibition, subject to the jurisdiction of, or enforceable by, the Bureau.

The Bureau is required to report to Congress on a semi-annual basis and provide Congress the following:

- A discussion of the significant problems faced by consumers in shopping for or obtaining consumer financial products or services;
- A list of the significant rules and orders adopted by the Bureau, as well as other significant initiatives conducted by the Bureau, during the preceding year and the plan of the Bureau for rules, orders or other initiatives to be undertaken during the upcoming period;
- An analysis of complaints about consumer financial products or services that the Bureau has received and collected during the preceding year;
- A list, with a brief statement of the issues, of the public supervisory and enforcement actions to which the Bureau was a party during the preceding year;
- The actions taken regarding rules, orders and supervisory actions with respect to covered persons that are not credit unions or depository institutions; and
- An analysis of the efforts of the Bureau to fulfill the fair lending mission of the Bureau.

Title X also charges the Bureau with adopting regulations to require that interchange fees charged or received by issuers of debit cards will be reasonable and proportional to the costs incurred by such issuers.

The Bureau is limited with regard to certain entities regulated by others, such as companies regulated by state insurance commissions. In addition, while subject to relevant Bureau regulations, certain merchants are exempt from the Bureau's supervision and enforcement.

Title X also mandates a large number of unrelated studies, including:

- The Department of the Treasury being tasked with a study to end the conservatorship of Fannie Mae and Freddie Mac;
- The Bureau conducting a number of studies relative to credit scores; and
- The U.S. Sentencing Commission reviewing the guidelines for securities fraud.

These studies indicate that the full scope of Title X is yet to be determined. The rules that are implemented and the reaction to the studies will clarify the full scope of Title X. However, it appears that Title X is likely to have a significant impact on covered industries.

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U.S. Financial Reform: Registration of Advisors to Private Investment Funds and Pools, and of Small Advisory Firms

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Title IV of the Act codifies the “Private Fund Investment Advisers Registration Act of 2010” (“Title IV”), a bill aimed at the regulation of private investment funds, including hedge funds and private equity funds. Title IV goes beyond this objective and will also require numerous small domestic and non-U.S. advisory firms to register as investment advisers. That status may have potentially adverse impacts on compensation formulas and the costs of compliance with the pervasive system of regulation of financial intermediaries.

The new legislation will significantly alter the regulatory landscape by requiring most advisors to hedge funds and trading funds as well as many smaller equity advisers to register with the U.S. Securities and Exchange Commission (the “SEC”) as investment advisers and provide information about their trades and portfolios. Most currently private funds will also be required to report on membership and portfolio information. Title IV provides for greater state supervision over investment advisers and enhances government oversight and rulemaking authority related to private funds. The key changes effected by this legislation are summarized below.

SEC Registration Requirements

Elimination of the “Private Adviser” Exemption

Perhaps the most consequential provision of Title IV is the elimination of the “private adviser” exemption. Under law prior to enactment of Title IV, advisors – including advisors to private investment funds – who have fewer than 15 clients during the preceding 12 months and do not

hold themselves out to be investment advisors are exempt from registering with the SEC as investment advisers under the Investment Advisers Act of 1940 (as amended, the “Investment Advisers Act”). Because most private investment funds were considered only one person – or client – advisors to such funds and pools could typically take advantage of the exemption to avoid registration. By eliminating this exemption, the new law will subject not only advisors to private hedge funds and trading funds, but also countless “small” and “family” advisors, to registration.

Title IV eliminates the availability of the intrastate exemption for advisors of private funds whose clients all reside within the advisor’s home state and limits the registration exemption for investment advisers that are registered with the Commodities Future Trading Commission. As a consequence, not only will thousands of smaller advisory firms be required to register, but they will also become subject to the substantive rules and regulations that impact registered investment advisers. These regulations will limit performance-based compensation platforms and require enhanced and formalistic disclosure documents, specific books and records and standardized reporting obligations.

Limited “Foreign Private Adviser” Exemption

Title IV requires SEC registration of a foreign advisor, unless it is exempt from registration by satisfying the definition of a “foreign private adviser” where the foreign adviser: (1) has no place of business in the United States; (2) has fewer than 15 clients in total who are domiciled in or residents of the United States; (3) has aggregate assets under management attributable to U.S. clients and U.S. investors in “private funds” advised by it of less than \$25 million (or such higher amount as the SEC may deem appropriate); and (4) neither (i) holds itself out generally to the U.S. public as an investment adviser, nor (ii) acts as an investment adviser to any investment company registered under the Investment Company Act of 1940 (as amended, the “Investment Company Act”) or a business-development company registered under the Investment Company Act.

While many smaller non-U.S. advisors may be able to take advantage of this exemption, the majority of advisors to private funds may find the \$25 million amount of assets too limiting. Beyond the fact of registration, these newly registered advisors will be required to review their fee structures to ensure compliance with the Investment Advisers' Act limitations and to create the various disclosure documents and comply with the SEC rules and regulations concerning books, records and reporting of business and investment operations.

Other Limited Exemptions

While many previously exempt advisors of private investment funds will now be required to register with the SEC, Title IV creates the following exceptions:

- Any investment advisor that acts solely as an advisor to private funds¹ and has assets under management in the United States of less than \$150 million is exempt from registration.
- Title IV provides an exemption from SEC registration for advisors to “venture capital funds,” as such term is to be defined by the SEC one year from the date of enactment.
- Title IV excludes “family office” from the definition of “investment adviser.” The term “family office” will also be defined by SEC rulemaking, but it should be consistent with the SEC’s previous exemption policy for family offices and take into account the “range of organization, management, and employment structures and arrangements employed by family offices.” The SEC’s definition must include a grandfathering provision for certain advisors that were not registered or required to be registered under the Investment Advisers Act on January 1, 2010, because they provide advice solely to natural persons who invested with the family office prior to January 1, 2010, were “accredited investors” under the Securities Act of 1933 (the “Securities Act”) and were officers, directors or employees of such family office at the time of their investment. There are other requirements for covered family offices. Any persons excluded from the definition of investment adviser as a result of this exception remain subject to the antifraud provisions of the Investment Advisers Act.

- Any advisor, other than a business-development company, that solely advises certain small-business investment companies licensed (or applying for a license) under the Small Business Investment Act of 1958 is exempt from registration with the SEC.

Advisors that are exempt under these provisions will still be required to maintain such records and provide such reports as the SEC “determines necessary or appropriate in the public interest or for the protection of investors.”

State Registration Requirements

Under the provisions of Title IV, any private-fund advisor or manager with assets under management of at least \$100 million will be required to register as an investment adviser with the SEC. Advisors that do not meet the \$100 million threshold for SEC registration, and are not otherwise qualified to register with the SEC, may be subject to registration with one or more states depending on the laws of those states.

An advisor that is required to register with multiple states, and that is not otherwise eligible to register with the SEC, may register with the SEC if it has assets under management of greater than \$25 million but not more than \$100 million and would otherwise be required to register with 15 or more states.

Recordkeeping, Reporting and Disclosure Requirements

The Act creates the Financial Stability Oversight Council (the “Council”) to assess systemic risk issues. Under Title IV, registered investment advisers to private funds will be required by the SEC to provide to the Council the data necessary for the Council to monitor systemic risk issues. These advisors will also be required to maintain records and file reports with the SEC “as necessary or appropriate in the public interest and for the protection of investors.”

Registered investment advisers will be required to maintain records and file with the SEC disclosure reports about their private funds regarding: (a) the amount of assets under management and use of leverage (including off-balance-sheet leverage); (b) counterparty credit risk exposure; (c) trading and investment positions; (d) valuation policies and practices of the

fund; (e) types of assets held; (f) side arrangements or side letters providing favorable terms for certain investors; (g) trading practices and (h) all other information that the SEC determines, in consultation with the Council, to be “necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.”

The SEC is required under Title IV to inspect the books and records of private funds maintained by an investment adviser, and provide an annual report to Congress describing how the SEC has used the data collected to monitor the markets for the protection of investors and the integrity of the markets.

Title IV modifies the Investment Advisers Act by adding an additional exception to the rule that client information is confidential, which would enable the SEC to require the disclosure by SEC-registered investment advisors of client information “for purposes of assessment of potential systemic risk,” as well as in connection with enforcement proceedings and investigations.

However, as a way to alleviate concerns of advisors and managers of the potential that registration and reporting of their proprietary trading and portfolio information could permit third parties to reverse-engineer or copy their investment strategies and methodologies, Title IV adds a provision to the Freedom of Information Act that would exempt such information from the disclosure obligations of that law. “Proprietary information” of an investment adviser as defined by Title IV includes sensitive, non-public information regarding: (i) the investment or trading strategies of the investment adviser; (ii) analytical or research methodologies; (iii) trading data; (iv) computer hardware or software containing intellectual property and (v) any additional information the SEC determines to be proprietary.

Further SEC Rulemaking

The new law is not the final word on financial regulatory reform. The U.S. Congress has granted the SEC broad authority to make rules and regulations defining technical, trade and other terms set forth in Title IV. Two key terms that will be defined by the SEC include “venture capital fund” and “family office.” The SEC has discretion to ascribe different meanings to these terms, and the scope of future regulations may not be as broad or deep as the current exemptions found

in Title IV. The SEC is also authorized to prescribe registration and examination procedures for advisors to mid-sized private funds, taking into account the size, governance and investment strategy of the funds to determine whether they pose systemic risk. While the impact this may have on fund investments and operations is unknown, in the SEC's September 2003 report on hedge funds, the SEC conceded that it did not understand how private trading funds worked or why their investment portfolios consistently outperformed the portfolios of registered investment companies. The SEC contended that substantial governmental oversight was required to ensure that the credit, investment and other risks borne by such investment funds were understood by government regulators. This suggests that the new government procedures may be significant and pervasive.

Title IV also requires the SEC to adjust the net-worth standard for an "accredited investor" under Regulation D of the Securities Act. Under the Securities Act, accredited investors include natural persons with income in each of the two most-recent years in excess of \$200,000 (or \$300,000 for a couple) or with a net worth of \$1 million either individually or jointly with the person's spouse. Title IV requires the SEC to adjust this accredited investor standard by excluding the value of a person's primary residence from the net-worth threshold. This standard would be subject to periodic adjustment by the SEC, but the SEC would not be able to make adjustments for four years after enactment. The standard would apply to new investors and to current investors making additional purchases, unless the SEC otherwise provides by rule or order. In addition, Title IV directs the SEC to adjust the "qualified client standard" set forth in the Investment Advisers Act for inflation not later than one year after the date of enactment and every five years thereafter.

Finally, as relevant to fund advisors and managers, Title IV allows the SEC in its discretion to promulgate rules to require advisors to take steps to safeguard client assets over which they have custody, including requiring verification by an independent public accountant.

Transition Period

Title IV will become effective one year after its enactment. However, any investment advisors seeking to voluntarily register prior to the enactment date may do so, subject to the existing rules of the SEC.

Enforcement Activities and Investigations

Congress and the SEC have devoted much attention to private funds during the past few years. The increasing scope of registration and reporting obligations that are likely to be imposed on advisors to private funds through Title IV are also likely to increase investigatory and enforcement actions by both the SEC and state regulators.

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For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact [Robert P. Bramnik](#), [Jennifer Briggs Fisher](#), any [member](#) of the [Broker-Dealer and Securities Regulation Practice Group](#), any [member](#) of the [Corporate Practice Group](#) or the attorney in the firm with whom you are most regularly in contact.

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Note

1. Under Title IV, a “private fund” is defined as any investment fund that would be an “investment company,” as defined under the Investment Company Act, but is exempt either because it has fewer than 100 investors or because all of the investors are “qualified purchasers,” which is a higher standard of qualification than an “accredited investor.”

U.S. Financial Reform: Creation of the Federal Insurance Office and the Financial Stability Oversight Council

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Title V of the Act, designated the Federal Insurance Office Act of 2010, creates a new office within the U.S. Department of the Treasury (the “Department”), known as the Federal Insurance Office (FIO), which will be focused solely on the insurance industry, will act as the monitor of systemic risk within that industry and will provide for certain reforms to state practices concerning nonadmitted insurance and reinsurance. Title V also creates a nine-member Financial Stability Oversight Council, led by the Secretary of the Treasury, charged with monitoring systemic risk for the overall U.S. financial system. After the defaults in the insurance industry in 2008 and the subsequent bailouts by taxpayers, Congress became concerned that insurance oversight by the states was ineffective and needed help from the federal government. This *Alert* discusses the impact of Title V on the insurance industry and highlights its most significant provisions.

Title V’s Impact on the Insurance Industry

While the advent of the FIO signals the federal government’s involvement in the insurance industry, the FIO, at this time, principally serves to monitor, collect and report on the industry without the authority to act unilaterally. In this limited capacity, the FIO presents an additional layer of inspection of the insurance industry, falling short of an outright interference in the way in which insurers conduct business. It remains to be seen how far Congress may seek to expand the FIO’s authority in the coming years and whether the FIO will emerge as a regulatory body.

Subtitle B assigns primary authority to the home state in transactions concerning nonadmitted insurance (of the insured) and the domiciliary state in those transactions concerning reinsurance

(of the reinsurer), which underscores Congress' objective of creating universal and uniform practices in these areas.

Subtitle A: The Federal Insurance Office Act of 2010

The Secretary of the Treasury (the "Secretary") is tasked with appointing the Director of the FIO (the "Director"). The FIO is permitted to utilize resources available to the Secretary, including personnel so designated by the Secretary.

The FIO's Functions

Under section 313(c), the FIO, as directed by the Secretary, is endowed with a host of authoritative and advisory functions. The FIO has the authority to:

- Monitor the insurance industry, including the assessment of potential systemic crisis within the industry or the U.S. financial system;
- Monitor certain underserved communities' and consumers' access to affordable insurance products (with the exception of health insurance);
- Recommend that an insurer (and its affiliates) be subjected to regulation by the Board of Governors of the Federal Reserve System through designation as a nonbank financial company by the Financial Stability Oversight Council;
- Assist the Secretary with the administration of the Terrorism Insurance Program established by the Terrorism Risk Insurance Act of 2002;
- Address international insurance matters through coordination of federal endeavors, development of federal policy, representation in the International Association of Insurance Supervisors and assistance to the Secretary in the negotiation of covered agreements;
- Render preemption determinations vis-à-vis the states;
- Consult on insurance issues of national and international importance with the states; and
- Perform any other duties and authorities assigned by the Secretary.

The FIO's advisory functions, set forth in section 313(c)(2), include advising the Secretary on both domestic and international insurance policy issues. In addition, the Director is tasked with advising the Financial Stability Oversight Council.

In order to perform these functions, the FIO is permitted to obtain data and information from the insurance industry, insurers and affiliates – with the exception of certain small insurers and their affiliates – and analyze and disseminate such data and information. To this end, the FIO is given the power to subpoena and, if necessary, enforce the subpoena in the appropriate U.S. district court. The agency disclosure requirements set forth in 5 U.S.C. § 552, which governs “Public information; agency rules, opinions, orders, records, and proceedings,” apply to any data or information provided by insurers or affiliates of the FIO. To further these endeavors, the FIO may become party to information-sharing agreements with state insurance regulators as long as such agreements comply with federal law and do not waive or affect federal or state privileges with respect to the shared information. The FIO may also issue reports as necessitated by the aforementioned functions.

In an effort to protect insurers and affiliates from potentially burdensome data collections, the FIO is required to first pursue the data and information through public channels, such as the appropriate federal agency and state insurance regulator and any other publicly available source. Only after consulting these sources and upon the Director's determination that such data and information are publicly unavailable, may the Director seek the data and information from the insurer and affiliate, subject to the requirements of the Paperwork Reduction Act. In the event the insurer or affiliate produces nonpublicly available data or information to the FIO, such production would neither impact any applicable federal or state privilege nor would it impact any confidentiality agreement already in place.

The FIO's Scope

The scope of the FIO's authority is quite broad and limited only to the extent provided in section 313(d), which excepts health insurance, long-term care insurance that is not bundled with life or annuity insurance, and crop insurance from the FIO's authority.

The FIO's Impact on the States' Insurance Measures

The Director is responsible for making preemption determinations where a state insurance measure is less favorable to a non-U.S. insurer subject to a covered agreement than a U.S. insurer and an inconsistency exists with the covered agreement, subject to certain delineated limitations. The Director is not authorized to preempt state measures governing rates, premiums, underwriting or sales practices; coverage requirements; applications of antitrust laws; or capital or solvency measures (except to the extent such measure is more favorable to a U.S. insurer).

Covered agreements are agreements on insurance or reinsurance matters, entered into and negotiated by the Secretary and U.S. Trade Representative on behalf of the United States, between the United States and foreign government(s), authority(ies) or regulatory entity(ies) that provide protection to consumers similar to state insurance or reinsurance regulations. Title 31, section 321(a) of the U.S. Code has been amended to include a provision that requires that the Secretary advise the President on domestic and international insurance policy issues.

Section 313(f)(2) sets forth the procedure to be followed by the FIO in the event of a possible preemption. Prior to making a preemption determination, the Director is required to notify and consult with the state and the U.S. Trade Representative, publish a *Federal Register* notice, provide interested parties time to submit comments to the FIO and consider any such comments. In the event that the Director decides there is an inconsistency warranting preemption, the Director is required to notify the state, set a reasonable period of time prior to the effective date, and notify the U.S. House of Representatives (Committees on Financial Services, and Ways and Means) and the Senate (Committees on Finance and on Banking, Housing and Urban Affairs). At the conclusion of the period designated by the Director, assuming the inconsistency still exists, the determination becomes effective and the Director is required to notify the state and publish notice of the preemption in the *Federal Register*.

However, states retain their general supervisory or regulatory authority of the insurance business. In addition, the federal financial regulatory agencies and the U.S. Trade Representative retain their previously existing authority, among other things, to develop and coordinate policy

(including international trade policy), negotiate with foreign governments and regulatory entities, and ensure uniformity on international regulatory agreements through preemption.

The FIO's Reporting Responsibilities

The Director is required to report annually all preemption actions to the President, the House of Representatives (Committees on Financial Services, and Ways and Means) and the Senate (Committees on Finance and on Banking, Housing and Urban Affairs). In addition, the Director is required to submit an annual report on the insurance industry to the President, the House of Representatives (Committee on Financial Services) and the Senate (Committee on Banking, Housing and Urban Affairs) and respond to any committee questions.

The Director is also tasked with reporting on the global reinsurance market and the impact of Part II (Reinsurance) of the Nonadmitted and Reinsurance Reform Act of 2010 by dates set forth in section 313(o).

Finally, the Director is commissioned to study and report on ways to modernize and improve insurance regulation.

Subtitle B: State-Based Insurance Reform

The Nonadmitted and Reinsurance Reform Act of 2010 (“Subtitle B”) will become effective, if not otherwise so specified, 12 months following enactment of the Act.

Part I: Nonadmitted Insurance

Section 527(11) defines a “nonadmitted insurer” as “an insurer not licensed to engage in the business of insurance in [a] State but. . . does not include a risk retention group.”

Pursuant to section 521(a), the home state of the insured has exclusive authority to require a premium tax payment on nonadmitted insurance, because the home state of the insured would presumably bear the financial responsibility if the insurer defaulted. The allocation of premium taxes on nonadmitted insurance may be established by a compact among the states. It appears to

be Congress' intent for a nationwide system to be adopted for reporting, payment, collection and allocation for nonadmitted insurance.

In addition, pursuant to section 522, the home state of the insured has exclusive authority over the placement of nonadmitted insurance and governs the licensing of surplus lines brokers. State laws, rules or regulations that limit the placements of workers' compensation insurance or excess insurances for self-funded workers' compensation plans with nonadmitted insurers' are expressly not preempted by section 522.

Section 523 requires states to participate in the national insurance producer database of the National Association of Insurance Commissioners (NAIC) within two years following enactment of Subtitle B. In the event a state fails to participate, the state is prohibited from collecting fees related to licensing surplus line brokers.

Section 524 prohibits states from imposing nonadmitted insurer eligibility requirements that do not conform with the Non-Admitted Insurance Model Act unless the state has adopted the nationwide system set forth in section 521(b)(4). Furthermore, section 524 prohibits states from refusing to allow surplus line brokers to place or procure nonadmitted insurance from a nonadmitted insurer listed on the NAIC's Quarterly Listing of Alien Insurers.

Section 525 governs the procurement and placement of nonadmitted insurance by surplus line brokers for purchasers who are deemed "exempt commercial purchasers" under section 527(5). Such applications for nonadmitted insurance are streamlined in that they do not require the surplus line broker to first conduct a due diligence search of admitted insurers as long as the surplus line broker discloses the availability of admitted insurers and the exempt commercial purchaser confirms in writing the request for nonadmitted insurance.

Section 526 requires that the Comptroller General of the United States, in consultation with the NAIC, complete a study of the nonadmitted insurance market, which will be submitted to the Senate Committee on Banking, Housing, and Urban Affairs and the House of Representatives Committee on Financial Services within 30 months of the effective date of Subtitle B.

Section 527 provides the definitions applicable to part I of Subtitle B.

Part II: Reinsurance

Section 531 governs credit for reinsurance and provides that as long as a ceding insurer's domiciliary state is NAIC-accredited or has similar financial solvency requirements, credit may not be denied for reinsurance by any other state. A nondomiciliary state's laws, regulations, provisions and other actions concerning reinsurance contractual disputes are preempted, with the exception of certain taxes and assessments.

Section 532 addresses the regulation of financial solvency of reinsurers, which rests in the province of the reinsurer's domiciliary state, as long as that state is NAIC-accredited or has similar solvency requirements. Where the reinsurer's domiciliary state is vested with such accreditation or similar solvency requirements, no other state is permitted to require the production of any additional financial information from the reinsurer. However, nondomiciliary states may receive a copy of the financial statement filed by the reinsurer with its domiciliary state.

Section 533 provides the definitions applicable to part II of Subtitle B.

Part III: Rule of Construction

Any conflicts between Subtitle B and antitrust laws will be resolved in favor of the antitrust laws. In addition, the sections and subsections of Subtitle B are severable in the event that a portion therein is deemed unconstitutional.

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For Further Information

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U.S. Financial Reform: Capital Requirements for Financial Institutions

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Title I of the Act, designated the “Financial Stability Act of 2010” (the “Financial Stability Act”) creates the Financial Stability Oversight Council (the “Council”) and gives broad authority to the appropriate federal banking agencies to mandate minimum leverage capital requirements and risk-based capital requirements for insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board of Governors of the Federal Reserve System (the “Board”).

Title VI of the Act, designated the “Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010” (the “Improvements Act”), mandates stronger capitalization for all insured depository institutions, depository institution holding companies and any company that controls an insured depository institution, and provides that any company in control of an insured depository institution be accountable for the financial strength of that entity.

Financial Stability Act

The Financial Stability Act implements increased oversight of the capital requirements applicable to insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board. The Council has been tasked with identifying risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies. The Financial Stability Act gives the Council broad authority to make recommendations to the Board regarding heightened prudential standards for, among other things, risk-based capital, leverage capital and contingent capital.

Minimum Leverage and Risk-Based Capital Requirements

The Financial Stability Act mandates that each federal banking agency set appropriate minimum leverage capital and risk-based capital levels, on a consolidated basis, for insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board. It also mandates that the Board establish prudential standards for nonbank financial companies supervised by the Board and bank holding companies with total assets of \$50 billion or greater that, subject to certain exceptions, include risk-based capital requirements and leverage limits. In addition, the Financial Stability Act sets the floor for both leverage and risk-based capital requirements based on the minimum capital requirements established by the appropriate federal banking agencies under section 38 of the Federal Deposit Insurance Act. Subject to the recommendations of the Council, each federal banking agency must develop capital requirements applicable to insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board that address, at a minimum, risks arising from (i) significant volumes of activity in derivatives, securitized products purchased and sold, financial guarantees purchased and sold, securities borrowing and lending, and repurchase agreements and reverse purchase agreements; (ii) concentrations in assets for which the values presented in financial reports are based on models rather than historical cost or prices deriving from deep and liquid two-way markets; and (iii) concentrations in market share for any activity that would substantially disrupt financial markets if the institution is forced to unexpectedly cease the activity. In developing these capital requirements, each federal banking agency is required to take into consideration the risks posed by the activities of each institution on not only the institution itself but also to public and private stakeholders in the event of adverse performance, disruption or failure of the institution.

The minimum leverage and risk-based capital requirements discussed above will be applicable as follows:

- Debt or equity instruments issued on or after May 19, 2010, by insured depository institution holding companies or nonbank financial companies supervised by the Board will be deemed to have become subject to the requirements as of May 19, 2010;

- For debt or equity instruments issued before May 19, 2010, by depository institution holding companies or nonbank financial companies supervised by the Board, any regulatory capital deductions imposed by the requirements will be phased-in over a period of three years commencing on January 1, 2013, provided that capital deductions that would be required for other institutions will not be required for depository institution holding companies with total consolidated assets of less than \$15 billion as of December 31, 2009, or organizations that were mutual holding companies as of May 19, 2010; and
- Depository institution holding companies that were not supervised by the Board as of May 19, 2010, will (other than as described in (i) and (ii) above) become subject to the requirements on July 21, 2015; and certain foreign bank holding company subsidiaries of foreign banking organizations will (other than as described in (i) above) become subject to the requirements on July 21, 2015.

Investments in financial subsidiaries that insured depository institutions are required to deduct from regulatory capital pursuant to the Federal Deposit Insurance Act do not have to be deducted from regulatory capital by depository institution holding companies or nonbank financial companies supervised by the Board, unless required by the Board or the primary regulatory agency in the case of nonbank financial companies supervised by the Board.

The minimum leverage and risk-based capital requirements imposed by the Financial Stability Act will not be applicable to:

- Debt or equity instruments issued to the United States or any agency or instrumentality thereof pursuant to the Emergency Economic Stabilization Act of 2008, and prior to October 4, 2010;
- Any federal home loan bank; or
- Any small bank holding company that is subject to the Small Bank Holding Company Policy Statement of the Board of Governors, as in effect on May 19, 2010.

Off-Balance-Sheet Activities

Each bank holding company with \$50 billion or greater in total consolidated assets and each nonbank financial company supervised by the Board must include off-balance-sheet activities¹ in its computation of capital for purposes of meeting its applicable capital requirements.

Contingent Capital Requirement

The Council is required to conduct a study, and submit a report to Congress no later than July 21, 2012, relating to the feasibility, benefits, costs and structure of a contingent capital requirement for nonbank financial companies supervised by the Board and large, interconnected bank holding companies. Subsequent to submitting the Council's report to Congress, the Board is authorized to issue regulations, and the Council is authorized to make recommendations to the Board, to require any of the aforementioned entities to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress.

Stress Tests

The Board, in coordination with the appropriate primary financial regulatory agencies and the Federal Insurance Office, is required to conduct annual analyses that evaluate whether nonbank financial companies supervised by the Board and bank holding companies with total consolidated assets equal to or greater than \$50 billion have the capital, on a consolidated basis, necessary to absorb losses as a result of adverse economic conditions. In addition, each nonbank financial company supervised by the Board and bank holding company with \$50 billion or more in total consolidated assets will be required to conduct semiannual stress tests. Any other financial company that has total consolidated assets of more than \$10 billion and is regulated by a primary federal financial regulatory agency will be required to conduct annual stress tests, in accordance with regulations to be prescribed by its primary financial regulatory agency in coordination with the Board and the Federal Insurance Office.

Hybrid Capital Study

The Financial Stability Act requires that the Comptroller General, in consultation with the Board, the Comptroller of the Currency and the Federal Deposit Insurance Corporation, conduct a study to determine whether hybrid capital instruments, such as trust preferred securities, should be included as a component of Tier 1 capital for banking institutions and bank holding companies when determining their compliance with minimum capital requirements. The study is also to examine the differences between the components of capital permitted for insured depository institutions versus those permitted for companies that control insured depository institutions. A report on the findings from this study is due by January 21, 2012.

Currently, the U.S. Federal Reserve allows bank holding companies to count trust preferred securities as Tier 1 capital. Under this structure, the trust's common securities are held by the bank holding company. The trust preferred securities are issued to investors for cash. The trust then lends this cash to the bank holding company, taking in return a long-term, junior subordinated note. The junior subordinated note typically provides for interest deferral of at least five years. Trust preferred securities permit the bank holding company to deduct interest on the subordinated note in an amount equal to distributions on the trust preferred securities, resulting in tax deductible equity.

Improvements Act

The Improvements Act is intended to ensure that all insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board are financially stable, and places responsibility on their controlling entities.

The Improvements Act amends both the Bank Holding Company Act and the Home Owners' Loan Act to require that bank holding companies and savings and loan holding companies that wish to expand the financial services of their bank subsidiaries are well capitalized and well managed. Previously, only the subsidiary banks were required to be well capitalized and well managed.

In addition, the Improvements Act imposes a heightened standard of review regarding the capitalization of a bank resulting from a merger or acquisition. Previously, the reviewing agency required the resulting bank to be *adequately* capitalized and *adequately* managed, but the standard has been increased to require that a *well* capitalized and *well* managed bank will result from the merger or acquisition. The effect of this heightened standard is that insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the Board will now be required to maintain capital levels that exceed the current minimum capital levels set by the appropriate federal agencies to effectuate a merger or acquisition.

In an attempt to mitigate the financial stress on financial institutions caused by an economic downturn, the Improvements Act requires the applicable federal regulatory agencies to adjust the minimum capital requirements for insured depository institutions, bank holding companies and savings and loan holding companies, so that they are countercyclical, requiring less capital during periods of economic contraction and more capital during periods of economic expansion.

Perhaps one of the most significant changes to the regulation of capital requirements under the Improvements Act is that bank holding companies, savings and loan holding companies and any other companies that directly or indirectly control an insured depository institution will now be held accountable for the financial stability of their subsidiaries. The Improvements Act requires that the applicable federal banking agencies require bank holding companies and savings and loan holding companies to serve as a source of financial strength for their subsidiaries that are depository institutions. If an insured depository institution is not the subsidiary of a bank holding company or a savings and loan holding company, the appropriate federal banking agency for the insured depository institution must require any entity that directly or indirectly controls the insured depository institution to serve as a source of financial strength for the depository institution. The phrase “source of financial strength” is defined to mean the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the

insured depository institution. The appropriate federal banking agencies are required to implement rules to this effect no later than July 21, 2012.

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Notes

1. Section 165(k)(3) of the Financial Stability Act defines off-balance-sheet activities as an existing liability of a company that is not currently a balance-sheet liability, but may become one upon the happening of some future event, including the following transactions, to the extent they may create a liability:
 - (i) direct credit substitutes in which a bank substitutes its own credit for a third party, including standby letters of credit,

- (ii) irrevocable letters of credit that guarantee repayment of commercial paper or tax-exempt securities,
- (iii) risk participations in bankers' acceptances,
- (iv) sale and repurchase agreements,
- (v) asset sales with recourse against the seller,
- (vi) interest rate swaps,
- (vii) credit swaps,
- (viii) commodities contracts,
- (ix) forward contracts,
- (x) securities contracts, and
- (xi) such other activities or transactions as the federal banking agencies may, by rule, define.

U.S. Financial Reform: Modifications to the U.S. Federal Reserve's Emergency Lending Authority

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Among other things, the Act amends section 13(3) of the Federal Reserve Act, relating to the U.S. Federal Reserve's emergency lending authority, and requires a one-time audit of the Federal Reserve's loans and financial assistance provided during the period from December 1, 2007, through the date of enactment of the Act. Many of the specifics of the Act will be set forth in policies and procedures that will be designed and implemented by administrative agencies, and are not set forth in the Act itself. The summary below highlights the key elements of this portion of the Act:

- **Limit of Lending Authority.** Section 13(3) of the Federal Reserve Act previously provided assistance to any “individual, partnership, or corporation,” but now provides assistance to a “participant in any program or facility with broad-based eligibility,” with the intent of preventing assistance that inappropriately favors one or more specific participants over other institutions.
- **Overview.** The Board of Governors of the Federal Reserve System (the “Board”) is required to establish by regulation, in consultation with the Secretary of the Treasury, policies and procedures designed to ensure that any emergency lending program or facility is for the purpose of providing liquidity to the financial system – and not to aid a failing financial institution. Such policies and procedures are also required to ensure that the security for repayment of any emergency loan is adequate to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion.

- Policies and procedures will require that a Federal Reserve Bank assign value to all collateral for a loan executed by a Federal Reserve Bank under an emergency lending program.
- The Board is required to establish procedures to prohibit borrowing from programs and facilities by a borrower that is insolvent (such as a certification from the chief executive officer of the borrower that the borrower is solvent).
- The Federal Reserve will no longer be able to lend to individual companies outside a program or facility with broad-based eligibility, such as its historical loans to Bear Stearns, AIG and Citigroup.
- **Approval of the Secretary of the Treasury.** Programs or facilities established under the Federal Reserve's emergency lending authority will require the prior approval of the Secretary of the Treasury and may not exist indefinitely.
- **Board Report.** Within seven days after the Board authorizes any loan or other financial assistance under its emergency lending authority under section 13(3) of the Federal Reserve Act, the Board is required to provide a report to the U.S. Senate and House of Representatives containing: (i) the justification for such assistance; (ii) the date and amount of the assistance; (iii) the form in which such assistance was provided; and (iv) the material terms of such assistance. The Chairman of the Board may request that the identity of the participants, the amounts borrowed by each participant and the identifying details concerning the assets or collateral in connection with such program or facility be kept confidential, in which case such information shall be made available to the chairpersons or ranking members of the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.
- **U.S. Government Accountability Office (GAO) Review.** The Comptroller General may conduct reviews of the Board, a Federal Reserve Bank or a credit facility for the purpose of assessing the following with respect to a credit facility or a covered transaction: (i) its operational integrity, accounting, financial reporting and internal controls; (ii) the effectiveness of the credit facility's or covered transaction's security and collateral

policies in mitigating risk to taxpayers; (iii) whether the credit facility or the conduct of a covered transaction favors one or more specific participants over other institutions; and (iv) policies governing the use, selection or payment of third-party contractors. The Comptroller General is required to submit a report to Congress within 90 days after the date such review is completed. The Comptroller General is required to release a nonredacted version of the report on a credit facility one year after the effective date of the termination – a credit facility will be deemed to have terminated 24 months after the date on which the credit facility ceases to make extensions of credit – by the Board of the authorization of the credit facility or two years after the calendar quarter in which a covered transaction was conducted. Release of a nonredacted version of a report by the Comptroller General regarding covered transactions must occur upon the release of the information by the Board.

Public Access to Information

- **General.** The Board is required to publish on its website (i) reports prepared by the Comptroller General; (ii) annual financial statements prepared by an independent auditor of the Board; (iii) section 13(3) reports to the Committee on Banking, Housing, and Urban Affairs of the Senate; and (iv) other information the Board believes might assist the public in understanding the accounting, financial reporting and internal controls of the Board and the Federal Reserve Banks.
- **Transparency – Release of Information.** The Board is required to disclose certain information, including counterparties and information about amounts, terms and conditions of emergency credit facilities; discount window lending programs; and open market operations authorized or conducted by the Board or a Federal Reserve Bank on an ongoing basis, with specified time delays. The Board is required to disclose such information on the date that is one year after the effective date of the termination by the Board of the authorization of the credit facility.

Emergency Financial Stabilization

- **General.** The FDIC is required to create a widely available program to guarantee obligations of solvent insured depository institutions and solvent depository institution holding companies during times of severe economic distress, except that a guarantee of obligations under this section may not include providing equity in any form.
- **Policies and Procedures.** The FDIC is required to establish by regulation, in consultation with the Secretary of the Treasury, policies and procedures governing the issuance of deposit guarantees. The terms and conditions of any guarantee program are required to be established by the FDIC, with the concurrence of the Secretary of Treasury. The use of a guarantee program requires a determination by both the FDIC (upon a vote of no fewer than two-thirds of the members of the FDIC then serving) and the Board (upon a vote of no fewer than two-thirds of the members of the Board then serving) that “(i) a liquidity event exists; (ii) failure to take action would have serious adverse effects on the financial stability or economic conditions in the United States; and (iii) actions authorized under section 1105 are needed to avoid or mitigate potential adverse effects on the United States financial system or economic conditions.” The Secretary of the Treasury is required to determine the maximum amount of the guarantee, in consultation with the President of the United States, to be approved by the joint resolution of Congress. Requests for resolutions of authority are to be considered by Congress in an expedited manner. The Act provides that if a request is received by the Senate while it is adjourned or recessed for more than two days, the Senate is required to convene no later than the second calendar day after receipt. Congress is required to move to proceed to the consideration of the joint resolution between the fourth and seventh day after Congress receives the request.
- **Funding.** The FDIC is required to charge fees and other assessments to all participants in the guarantee programs in the amounts necessary to offset projected losses and administrative expenses, and may also borrow funds from the Secretary of the Treasury for purposes of carrying out the guarantee program. The FDIC may also impose a special assessment solely on participants to address any insufficiency in the funding of the

guarantee program for which the Act provides authority. The FDIC may not borrow from the Deposit Insurance Fund.

- **Parallel Federal Deposit Insurance Act Authority.** Upon the enactment of the modifications to section 13(3) of the Federal Reserve Act, the FDIC may no longer exercise its authority under section 13(c)(4)(G)(i) of the Federal Deposit Insurance Act (12 U.S.C. 1823(c)(4)(G)(i)) to establish any widely available debt guarantee program for which such modifications would provide.

Federal Reserve Bank Governance

- **Election of Federal Reserve Presidents.** Presidents of the Federal Reserve Banks will from now on be elected by Class B directors (elected by member banks to represent the public) and Class C directors (appointed by the Board to represent the public) of the member banks, with the approval of the Board. Prior to the Act, presidents of the Federal Reserve Banks were elected by all directors, including Class A directors (elected by member banks to represent member banks).

Establishment of the Position of Vice Chairman

- **Creation of Position of Vice Chairman for Supervision.** The Act creates a new position of Vice Chairman for Supervision (“Vice Chairman”), a person designated by the President of the United States by and with the advice and consent of the Senate. The Vice Chairman is charged with developing policy recommendations for the Board regarding the supervision and regulation of depository institution holding companies and other financial firms supervised by the Board to ensure oversight accountability. The Vice Chairman is required to report to Congress at semiannual hearings regarding Board’s the efforts, activities, objectives and plans.

GAO Audit of the Federal Reserve Facilities

- **Audit of the Federal Reserve.** The Comptroller General is required to conduct a one-time audit of all loans and other financial assistance provided by the Board or a Federal

Reserve Bank and any other program created as a result of any emergency lending authority under section 13(3) of the Federal Reserve Act during the period beginning on December 1, 2007, and ending on the date of enactment of the Act. The audit must commence no later than 30 days after the date of enactment of the Act and is required to be completed no later than 12 months after the enactment of the Act. The Board is required to publish on its website, not later than December 1, 2010, the amounts, terms and conditions of the emergency lending assistance provided.

- **Audit of Federal Reserve Governance.** Not later than one year after the date of enactment of the Act, the Comptroller General is required to complete an audit of the governance of the Federal Reserve Bank system, including a study of the current system for appointing Federal Reserve Bank directors, and examine whether actual or potential conflicts of interest exist. The Comptroller General is required to also examine the establishment and operation of emergency lending facilities. The report on the audit is required to be submitted by the Comptroller General to Congress before the end of the 90-day period, beginning on the date on which such audit is completed.

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For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact [Joel N. Ephross](mailto:Joel.N.Ephross@duanemorris.com), [T. John](mailto:T.John@duanemorris.com)

Lin, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

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U.S. Financial Reform: Consumer Financial Protection Act of 2010 Institutes First Federal Regulation of Debit Card Interchange Fees

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Section 1075 of Title X of the Act, is also known as the “Durbin amendment.” With the Durbin amendment, Congress has instituted the first federal regulation of interchange fees (*i.e.*, fees charged by a cardholder’s, or “issuing,” bank to a merchant’s, or “acquiring,” bank) on debit card purchases. This part of the Act, which will become part of the existing Electronic Fund Transfer Act (EFTA), also represents the first direct federal regulation of agreements between merchants and payment card networks.

While the fee limits of the Durbin amendment apply only to debit cards, and not to credit cards, the new law is also aimed at indirectly regulating credit card interchange fees. By limiting interchange fees on debit card purchases (and, in turn, the amount of the merchant discount retained by banks) to rates that are “reasonable and proportional” to the actual costs incurred by issuing banks as well as restricting limits on merchants from providing discounts for cash, check or debit payments or imposing minimum amounts for purchase by credit card, the law is likely to encourage merchants to provide incentives to customers to use lower-cost payment methods. The full impact of the Durbin amendment is unlikely to be observed until the Board of Governors of the Federal Reserve System (“Board”) promulgates regulations detailing the loosely outlined “reasonable and proportional” standard and other contemplated rules in the Act.

Limitations on Interchange Fees for Debit Card Issuers

Under the new law, interchange fees for purchases made by debit cards (“electronic debit transactions”) are required to be “reasonable and proportional to the cost incurred by the issuer with respect to the transaction.” The Board – the federal agency with jurisdiction under EFTA –

is directed, within nine months of the enactment of the Act, to establish regulations setting forth the “reasonable and proportional” standard. In developing such standard, the law directs the Board to: (1) consider the extent to which electronic debit transactions are comparable with checking transactions that are required to clear without fees; (2) distinguish between actual costs incurred by a debit card issuer for a particular transaction and other costs incurred by the issuer not specific to a transaction; and (3) consult with other regulatory agencies.

Currently, many interchange fee agreements provide for higher fee rates on “card not present” (CNP) transactions, *i.e.*, electronic transactions where the magnetic card strip is not read, due to higher operational costs associated with handling fraud disputes on such transactions. The Act appears to allow the possibility of such rate differences for CNP transactions to continue, but that is likely to depend on the final rules promulgated by the Board. The Act provides that the Board “may allow for an adjustment” to an interchange fee rate if the issuer (1) can demonstrate such adjustment is reasonably necessary to cover costs incurred by the issuer in preventing fraud in electronic debit transactions, and (2) complies with certain fraud-reduction standards to be established by the Board.¹ Such fraud-reduction standards must “be designed to ensure that any fraud-related adjustment of the issuer is limited to” actual costs incurred by the issuer and take into account any fraud-related reimbursements received by the issuer from consumers, merchants or payment card networks. In addition, the fraud-reduction standards must “require issuers to take effective steps” to reduce the occurrence of fraud in electronic debit transactions, including the development and implementation of cost-effective fraud technology.

The Act also grants the Board the power to obtain information from issuers and payment card networks regarding their costs incurred in processing electronic debit transactions and interchange fees received on such transactions in connection with the Board’s promulgation and enforcement of the interchange fee standards. The Board is further directed to disclose a summary of such information to the public on a biannual basis.

In addition to the regulation of interchange fees, the law provides the Board with broad authority to regulate “network fees” (defined as “any fee charged and received by a payment card network”² in connection with an electronic debit transaction) to prevent such fees from being

used as indirect compensation to an issuer for electronic debit transactions. This portion of the Act appears to grant the Board limited authority to regulate fees charged by credit card networks or other payment networks to prohibit indirect compensation for electronic debit transactions – although the effect of such grant will not be known until the Board promulgates the required regulations.

The Act exempts “small issuers” of debit cards (defined as an issuer that, together with its affiliates, has assets of less than \$10 billion). This provision was designed to exempt credit unions and community banks. Debit cards issued by government-administered payment programs and reloadable prepaid gift cards are also exempt, although the exemption will expire after a year for the latter if such prepaid cards impose overdraft fees or ATM withdrawal fees on consumers who use them.

Restrictions on “Exclusivity Arrangements,” Prohibitions on Discriminating Between Payment Types, and Authorization of Minimum Charge Limits

The second part of the Durbin amendment regulates agreements between payment card networks and merchants. Such agreements often impose a number of conditions on debit card and credit card transactions, including placing restrictions on which payment networks may be used; prohibiting merchants from offering discounts for cash or check payments; requiring merchants to accept all cards from a particular network (which may include cards with higher interchange fees); and prohibiting merchants from imposing “minimum purchase” amounts. The Act prohibits “exclusivity arrangements” with respect to debit cards, providing that a payment card network may not directly or indirectly: (1) restrict the number of payment card networks on which a electronic debit transaction may be processed, or (2) restrict merchants from routing electronic debit transactions over any payment card network that may process the transaction. This limitation is intended to allow merchants to select which financial routing method to use for electronic debit transactions (*e.g.*, Cirrus, NYCE, Interlink) based on cost.

Perhaps more significantly, the Act restricts payment card networks from prohibiting merchants from offering discounts or other incentives for payment by cash, check or debit card. Payment

card networks typically prohibit merchants from imposing surcharges on consumers for the use of credit cards or cards with higher interchange fees, such as rewards cards.³ In addition, 10 states have laws prohibiting such surcharges,⁴ although a majority of those states do authorize discounts for cash, check or debit purchases as long as they are offered to all consumers.⁵ The Durbin amendment provides that merchant discounts must comply with these state laws requiring equal availability of discounts to all customers. For the three states that prohibit surcharges but do not permit such discounts – Connecticut, New York and Texas – because such state laws are inconsistent with the new requirements set forth in the Act, pursuant to existing section 919 of EFTA,⁶ they likely will be found to be preempted by the Act.

In addition to authorizing discounts by merchants for purchases by cash, check or debit card, the Act also restricts payment card networks from prohibiting merchants from imposing minimum dollar amounts for credit card purchases. Such minimum dollar requirements may not exceed \$10; however, the Board may increase such amount by regulation.

Finally, the Act provides that enforcement of the new regulations will be pursuant to the administrative enforcement provisions of EFTA (section 917), rather than the criminal or civil enforcement provisions (sections 915 and 916). Thus, enforcement of the new regulations will be handled solely by the various federal agencies – including the Board – that oversee financial institutions, and not through private lawsuits or criminal actions by the U.S. Department of Justice.

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For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact A. Bruce Bowden, Katherine Nichols, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

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Notes

1. Specifically, the Act directs the Board to consider, in prescribing regulations pursuant to the Act, “the nature, type and occurrence of fraud in electronic debit transactions” and “the extent to which the occurrence of fraud depends on whether authorization” in such transactions “is based on signature, PIN or other means.”
2. A “payment card network” is defined as “an entity that directly, or through licensed members, processors, or agents, provides the proprietary services, infrastructure, and software that route information and data to conduct debit card or credit card transaction authorization, clearance, and settlement, and that a person uses in order to accept as a form of payment a brand of debit card, credit card or other device that may be used to carry out debit or credit transactions.” H.R. 4174, 111th Cong. §1075(c)(11).
3. U.S. Gen. Accounting Office, Report to Congressional Addressees, Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges 38, GAO-10-45 (2009).
4. Those states are: California (Cal. Civ. Code § 1748.1(a)); Colorado (Colo. Rev. Stat. § 5-2-212(1)); Connecticut (Conn. Gen. Stat. Ann. §42-133ff(a)); Florida (Fla. Stat. Ann. § 501.0117(i)); Kansas (Kan. Stat. § 16a-2-403); Maine (Maine Rev. Stat. Ann. tit. 9-A § 8-303(2)); Massachusetts (Mass. Gen. Laws Ann. ch. 140D, § 28A(a)(2)); New York

(N.Y. Gen. Bus. Law § 518); Oklahoma (Okla. Stat. Ann. tit. 14A §§ 2-211, -417); and Texas (Tex. Fin. Code Ann. § 339.001(a)).

5. See Cal. Civ. Code § 1748.1(a); Colo. Rev. Stat. § 5-2-212(2)); Fla. Stat. Ann. § 501.0117(i); Kan. Op. Atty. Gen. 86-115 (1986); Maine Rev. Stat. Ann. tit. 9-A § 8-303(3); Mass. Gen. Laws Ann. ch. 140D, § 28A(b); and Okla. Stat. Ann. tit. 14A §§ 1-301(7), (9), (19).
6. Section 919 provides that EFTA “annul[s], alter[s] and affect[s]” state law relating to electronic fund transfers, “to the extent that those laws are inconsistent with the provisions of” the Act. The Board is authorized to determine whether a state law is preempted, on its own motion or upon request by any financial institution, state or other interested party. 15 U.S.C. § 1693q; 12 C.F.R. § 205.12(b).

U.S. Financial Reform: Corporate Governance and Executive Compensation Provisions for Public Companies

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

The corporate governance provisions discussed in this *Alert* require shareholder proxy access, expand compensation disclosure, institute say-on-pay votes, prohibit brokers from voting street-name shares on say-on-pay and other significant matters, mandate membership and operation of compensation committees, strengthen proxy disclosure, and amend securities transaction reporting under sections 13 and 16 of the Securities Exchange Act of 1934. The Act also vests broad rulemaking discretion in the SEC, which may make it difficult to foresee the full impact of the Act at this time.

Overview of Corporate Governance Provisions

Among many sweeping governance provisions, the Act contains several that may reshape the topography for U.S. public companies. Governance areas addressed in the Act in Title IX – designated the “Investor Protection and Securities Reform Act of 2010” – include:

- granting authority to the SEC to adopt regulations providing shareholder access to the company’s proxy process to nominate directors;
- requiring non-binding mandatory shareholder votes on executive compensation and “golden parachute” payments, as to which matters brokers may not vote undirected shares;
- granting authority to and directing national securities exchanges to mandate compensation “clawback” if executive compensation is based on inaccurate financial statements;

- granting authority to and directing national securities exchanges to require independence of compensation committee members, and to grant committee authority to hire independent compensation consultants;
- directing the SEC to issue rules requiring proxy disclosure regarding (1) compensation, including requirements that companies provide charts comparing executive compensation to stock performance over a five-year period; (2) hedging by employees and directors of the company's equity securities; and (3) whether or not the company has divided the CEO and board chairman roles; and
- altering certain technical provisions of the reporting requirements under sections 13 and 16 of the Exchange Act.

Shareholder Proxy Access

Shareholder access to a public company's proxy process has long been a favored battleground, including in Delaware courts, between shareholder activists and management.

Historically, the SEC permitted exclusion from proxy solicitation materials of any shareholder nominations and proposals that related to bylaw amendments, offering a procedure for outside shareholders to initiate proxy contests. It is unlikely to come as a surprise that the historical exclusion of election proposals has led to litigation, the course of which is likely to be affected by the proxy access rights granted in section 971 under Title IX, Subtitle G of the Act.

Section 971 authorizes the SEC to issue rules permitting shareholder nominations to a public company's board, under such terms and conditions as the SEC determines are in the interests of shareholders and for the protection of investors. The SEC is given the discretionary authority under the Act to exempt a public company or a class of public companies from these shareholder proxy access rights, a discretion that may protect smaller issuers from the expense of repeated shareholder initiatives.

The SEC is likely to promptly exercise its new authority, having already unveiled shareholder proxy access proposals in 2009, and having undertaken two separate, heated public comment periods during which many observers in the business and legal community expressed disapproval

of expanded shareholder rights. The SEC had proposed amendments to Rule 14a-11 that would have granted mandatory proxy access to shareholders who own at least a 1-percent to 5-percent ownership stake (depending on the size of the company) held for at least one year, and amendments to Rule 14a-8 that would have permitted shareholders to place on the corporate agenda bylaw amendments to permit proxy access for director nominations.

It remains to be seen how the SEC will proceed, given the commentary by business groups and counsel that were more receptive to the Rule 14a-8 amendments that contended that such an approach respected the individual profile of each company, rather than imposing a mandatory one-size-fits-all provision. If the SEC adopts only the Rule 14a-8 approach, it also would be acting more consistently with Delaware lawmakers, who in 2009 provided a statutory framework that allows each Delaware-incorporated public company to craft for itself bylaws for shareholder proxy access pursuant to its own individually delineated standards, including standards relating to minimum number of shares owned, length of ownership, submission of specific information regarding the stock ownership of the nominator and the nominee, and reimbursement of reasonable expenses incurred by shareholders who achieve a defined level of success in a proxy contest.

It is possible that the SEC rules eventually enacted based on section 971 could supersede Delaware law only in part by mandating certain aspects of proxy access that could not be made more company-friendly, while leaving other aspects up to state law and a company's governing documents. In the alternative, the SEC could establish an exclusive federal proxy access regime and oust, virtually in their entirety, state corporate laws and customized proxy access by companies and their shareholders.

Executive Compensation

Shareholder "Say on Pay"

In recent years, poor financial performance exacerbated by highly publicized corporate scandals have resulted in increasing shareholder activism seeking greater corporate accountability, notably regarding "say on pay" – a non-binding shareholder vote on executive compensation.

Say-on-pay votes have grown increasingly popular in the last few years. Banks receiving funds under the federal government's TARP program are required to offer say-on-pay votes, and many major companies (notably Aflac, Blockbuster, Colgate-Palmolive, Ingersoll Rand, Microsoft, Motorola and Verizon) have adopted say-on-pay votes.

Section 951 of the Act gives shareholders the right to a non-binding vote on executive compensation not less frequently than once every three years. In addition, not less frequently than once every six years, shareholders would have the right to decide whether the shareholder vote on executive compensation would occur every one, two or three years. Additionally, public companies also will be required to provide detailed disclosures, and a non-binding shareholder vote, regarding "golden parachute" payments in connection with an acquisition, merger or sale transaction.

This section clarifies that these non-binding shareholder votes do not change the fiduciary responsibilities of the company's directors or restrict the ability of shareholders to submit other proposals regarding executive compensation for inclusion in proxy materials. Therefore, whether or not a shareholder say-on-pay proposal passes, the board can continue to determine executive compensation.

Finally, pursuant to SEC rulemaking, institutional investment managers must report at least annually on how they voted on say-on-pay and "golden parachute" resolutions.

These say-on-pay provisions apply to the first annual or other meeting of shareholders occurring after six months from enactment. The SEC has the discretionary authority to exempt a public company or a class of public companies from the shareholder say-on-pay rights.

Decreased Broker Discretion

Under current NYSE Rule 452, brokers may vote uninstructed street-name shares on all "routine" matters, although such votes are not permitted in several areas, including in uncontested director elections or with respect to merger votes, significant changes in the rights of classes of securities, and share-based compensation plans. Section 957 compels the SEC to

require national securities exchanges to prohibit voting customer shares without instruction on the following additional matters: all director elections (except uncontested elections at registered investment companies), any executive compensation (including say on pay, but also even cash plans) and any other “significant matter.”

The SEC must define “significant matter” by rule, with awareness not to make the category so broad as to leave no routine matters such as auditor ratification on the agenda. (In the event of a complete absence of routine matters, broker uninstructed shares would not even count toward a quorum.)

Registrants with significant retail investors should consider the need for increased shareholder outreach and abandonment of “notice-only” e-proxy solicitation in order to achieve sufficient votes at upcoming shareholder meetings.

Compensation “Clawback”

Section 954 of the Act, titled “Recovery of Erroneously Awarded Compensation,” directs the SEC to issue rules for national securities exchanges to adopt listing standards, requiring that listed companies “claw back” or rescind incentive compensation for “executive officers” if such compensation proves to be based on inaccurate financial statements. This requirement would apply to executive officers who received incentive-based compensation, including stock option awards, during the three-year period preceding the date of the restated financial statements, so that any current or former executive officer affected would have to return to the company any excess compensation received as a result of the inaccuracy. Such restatement must be the result of a material noncompliance with any financial reporting requirement, a trigger that would be met almost automatically if in fact a restatement has been effected. This expands section 304 of the Sarbanes-Oxley Act of 2002 (SOX), which requires rescission of bonuses and incentive-based compensation only for the CEO and CFO received during the 12-month period following the date of first public filing of an inaccurate financial statement, and recapture of any profits received from the sale of company securities during such period. A significant aspect of section

954 (as well as with SOX 304) is that Congress purposefully does not require in section 954 a showing of any wrongdoing on the part of the executive.

Independent Compensation Committees

Section 952 of the Act directs the SEC to issue rules for national securities exchanges to adopt listing standards requiring that compensation committees include only independent directors (already required by NYSE and NASDAQ) and have the authority to hire independent compensation consultants. Section 952 sets forth the guidelines for independence, and also requires companies to disclose whether or not the compensation committee retained the services of a compensation consultant, whether the advice of such consultant raised any issue of conflict of interest and how any such conflict was resolved. The SEC has the discretionary authority to exempt a public company or a class of public companies from these compensation committee standards. “Controlled companies” (more than 50-percent controlled by an individual, a group or another issuer) also will be exempt from the requirements of section 952.

Enhanced Proxy Disclosure

Section 953 of the Act directs the SEC to clarify proxy disclosures regarding compensation, including requiring companies to provide charts that compare executive compensation with stock performance over a five-year period. Section 955 directs the SEC to clarify proxy disclosures regarding hedging arrangements of equity securities of the company entered into by employees and directors, while section 972 requires proxy disclosure of the reasons that a company either has or has not designated the same individual as both CEO and board chair. The SEC instituted such a section 972 requirement in December 2009, for proxies solicited after February 28, 2010, as part of its new disclosures aimed at eliciting reasons that the company believes that its board-leadership structure is most appropriate at the time of filing.

Excluded Provision

The final version of the Act omits a previously included provision requiring uncontested director candidates to receive a majority of the votes cast, a standard that many companies already have

adopted. The SEC, in any event, could adopt such a rule, after reviewing investor concerns, through its recently created Investor Advisory Committee.

Reporting Certain Transactions

Section 929 of the Act amends technical aspects of reports required under sections 13 and 16 of the Exchange Act.

Section 13 of the Exchange Act mandates a filing whenever a person or group achieves more than five-percent ownership of a registered securities class. The Act authorizes the SEC to adopt a rule shortening the reporting time period to less than the present statutory 10 days, and deletes filing requirements with the issuer and the exchange, relying solely on a filing with the SEC.

Section 16 of the Exchange Act mandates that officers, directors and holders of more than 10 percent of any registered class of security file statements of securities ownership. The Act authorizes the SEC to adopt a rule shortening the initial filing date to less than the present statutory 10 days, and eliminates notice to any exchange, relying only upon notice to the SEC.

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For Further Information

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Masud-Elias, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

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U.S. Financial Reform: Mortgage Reform and Anti-Predatory Lending Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Title XIV of the Act, designated the “Mortgage Reform and Anti-Predatory Lending Act,” establishes minimum standards for originating residential mortgages, regulates the compensation of mortgage brokers and expands consumer protections and lender disclosure requirements. It also creates an Office of Housing Counseling within the U.S. Department of Housing and Urban Development (HUD). The amendments in Title XIV become effective six to eighteen months after enactment of the Act.

Standards for Residential Mortgage Loans Promulgated

The Act sets forth certain federal standards for residential home loans, designed to ensure that consumers will be informed and will be able to make their mortgage payments. Many of the new standards set forth below are likely to impact the activities of a “mortgage originator,” defined as any person who receives a residential loan application, assists the applicant or negotiates loan terms:

- **Licensing Requirement.** Mortgage originators must be registered and licensed in accordance with applicable state law, and such information must be indicated on all loan documents.
- **Steering Incentives Prohibited.** Mortgage originators cannot steer consumers to a loan they cannot reasonably repay, from a “qualified mortgage” to an “unqualified mortgage” or to any loan that has “predatory characteristics.” The definition of a qualified mortgage sets forth a number of requirements, including that regular payments as provided may not increase the principal balance of the loan so that there cannot be any negative amortization; terms do not require a balloon payment; assets and income must be verified

and documented; debt-to-income ratios must be met; and points and fees may not exceed three percent.

- **Compensation Restrictions.** Mortgage originators may be compensated only from a formulation based on the principal loan amount, although brokers are allowed incentive payments based on the number of loans generated during any specified period of time. “Yield spread premiums” are prohibited, where a broker is paid for giving a higher interest rate to a consumer in exchange for lower up-front costs.
- **Prepayment Penalties Prohibited or Phased Out.** Prepayment penalties are not allowed for non-qualified mortgages. Prepayment penalties on qualified mortgages cannot exceed three percent during the first year of the loan, two percent during the second year of the loan and one percent during the third year. No prepayment penalty is allowed after the third year of the loan.
- **Truthfulness in Loan Application Process.** Mortgage originators are prohibited from mischaracterizing the credit history of an applicant, the residential mortgage loans available or the appraised value of a residential property.
- **Additional Disclosures Required.** Lenders must provide six months’ notice before a hybrid adjustable rate mortgage (ARM) is reset with an estimate of the maximum monthly amount payable and an explanation of other options available to the borrower, such as refinancing, renegotiation of loan terms, payment forbearance and pre-foreclosure sales. In states such as California with an “anti-deficiency law” (where the borrower under certain conditions is not liable for the shortfall between sales price through foreclosure and outstanding mortgage balance), the lender must describe the protection afforded by the law and its significance to the borrower. Lenders are also required to disclose their policy regarding acceptance of partial payments.
- **Expanded Consumer Protections for High-Cost Mortgages.** The Act lowers the threshold of what constitutes a “high-cost mortgage” to those exceeding 6.5 percent on first mortgages and 8.5 percent for subordinate mortgages – and fees and points exceeding 5 percent of the transaction amount. The Truth in Lending Act is amended to provide that high-cost mortgages may not have balloon payments, accelerated

indebtedness, modification and certain other types of fees – and they must provide additional disclosures.

- **Minimum Underwriting Standards for Mortgages.** Lenders must make a “reasonable and good faith determination” that borrowers have “a reasonable ability to repay the loan” based on, among other things, verified credit history, income source and debt-to-income ratio.
- **Appraisal Activity Controls Enumerated.** The use of appraisals is also now further regulated, including such provisions as the requirement of a written appraisal by an independent appraiser before extending credit, a physical property visit in certain circumstances, provision of free copies of the appraisal and a notice of the right to a second appraisal.
- **Penalties for Violating These Rules.** A mortgage originator may be found liable for the greater of actual damages or three times the total amount paid to the mortgage originator, plus costs and attorneys’ fees. This type of provision may provide an opportunity for class action lawsuits.
- **Defense to Foreclosure.** Borrowers may assert violations of the Act by the mortgage originator as a defense of recoupment or set off in a foreclosure action.

Office of Housing Counseling Formed at HUD

The Act creates an Office of Housing Counseling within the Department of Housing and Urban Development. The office is meant to facilitate homeownership, mortgage-related and rental-housing counseling. It will establish standards for materials used in such counseling, promote counseling, conduct education programs and provide financial assistance to organizations providing counseling.

Six Studies Ordered Relating to Mortgage Reform

The Act mandates a number of studies and reports relating to mortgage reform, including (1) a study of how best to provide for “widespread use” of shared appreciation mortgages (SAM), where the lender agrees to a lower interest rate in exchange for a share of the appreciated value

of the property; (2) a study to determine the effects of the Act on the availability and affordability of credit for consumers; (3) a study of the “root causes of default and foreclosure of home loans”; (4) a study concerning appraisal approaches and valuation models; (5) a study of interagency efforts to crack down on foreclosure scams and “emerging schemes in the loan modification arena”; and (6) a study of the effect on residential mortgage loan foreclosures and the availability of property insurance because of drywall imported from China between 2004 and 2007.

Possible Impact of the Act on Mortgage Lending

Implementation of the Act and its various terms and conditions as outlined above may result in potentially unanticipated consequences. The cost of obtaining a residential mortgage may increase substantially as lenders are required to meet the new disclosure requirements and the new underwriting standards, which could necessitate hiring additional staff and is likely to require more paperwork. Furthermore, the minimum underwriting requirements, as established by the Act, may limit credit availability. Becoming familiar with all of the regulations that will be enacted by the various regulatory parties created by the Act may invariably result in increased costs. It is important to note that Congress determined it should be necessary for a study to be undertaken to determine the effects of the Act on the availability and affordability of credit.

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For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact Kenneth A. Latimer, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

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U.S. Financial Reform: Municipal Securities

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

This *Alert* summarizes Subtitle H of Title IX, designated “Municipal Securities,” of the Act. References herein are made to sections 975 through 979 of Subtitle H.

The Act establishes a new Office of Municipal Securities (the “Office”) within the U.S. Securities and Exchange Commission (SEC). The Office will administer the rules of the SEC with respect to the practices of municipal securities advisors, brokers, dealers, investors and issuers, and will coordinate with the Municipal Securities Rulemaking Board (MSRB or the “Board”) for rulemaking and enforcement actions.

In order to advance the goal of providing better oversight of the municipal securities industry and regulation of the participants in the municipal securities industry, the Act amends sections 15, 15A, 15B and 17 of the Securities Exchange Act of 1934 (the “Exchange Act”) to require the registration of municipal advisors and imposes a fiduciary duty on municipal advisors and any person associated with them when advising municipal issuers. Municipal advisors, like municipal securities dealers and brokers, are now subject to the same laws, fiduciary requirements and MSRB rules enforced by the SEC. The Act amends section 15(b) of the Exchange Act to define a municipal advisor as a person who provides advice to or on behalf of a municipal entity with respect to municipal financial products or the issuance of municipal securities, including the structure, timing and terms of such financial products. Municipal financial products are municipal derivatives, guaranteed investment contracts and investment strategies. Municipal advisors include financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders and swap advisors. They do not include brokers or dealers serving as underwriters, registered investment advisors providing

investment advice, registered commodity traders providing advice related to swaps, attorneys providing legal advice or engineers providing engineering advice. A municipal advisor and any person associated with a municipal advisor now has a fiduciary duty to any municipal entity it advises and may not engage in any act, practice or course of business that is inconsistent with the municipal advisor's fiduciary duty or that is in contravention of any rules of the MSRB.

Municipal advisors are now, like brokers, dealers or municipal securities dealers, subject to censure, suspension or revocation of registration by the SEC for violations of the law as set out in section 15(b)(4) of the Exchange Act.

By the Act, the MSRB is now required to adopt rules providing for the continuing education of municipal advisors and establishing professional standards for municipal advisors. The MSRB may not, however, impose inappropriate regulatory burdens on small municipal advisors.

The Act alters the composition of the MSRB so that a majority of the minimum 15-member Board are independent of municipal securities brokers, dealers or advisors. The new composition of the Board meets the stated goal of the Act, to ensure that the public interest is better protected on the Board. The Board has a new charge to protect the public interest in addition to municipal entities and investors. The Board will consist of eight individuals known as "public representatives," independent of any municipal securities broker, municipal securities dealer or municipal securities advisor. At least one of the public representatives must be a representative of institutional or retail investors in municipal securities. At least one of the public representatives must also represent municipal entities, and another of the public representatives must have knowledge or experience in the municipal securities industries.

The remaining seven "regulated representatives" will consist of individuals associated with a broker, dealer, municipal securities dealer or municipal advisor. At least one of the regulated representatives will be a "broker-dealer," representative of nonbank brokers, dealers or municipal securities dealers. At least one individual must be a representative of banks, and at least one individual must be associated with a municipal advisor. The number of public representatives on the Board must always exceed the number of regulated representatives.

Under the Act, the Board is authorized, in conjunction with or on behalf of any federal financial regulator, to establish information systems and assess fees for such systems, which will serve as a repository for information from participants in the municipal securities market. The purpose of such repository is to assist the Board and any federal financial regulator or self-regulatory organization. The Board is authorized to provide guidance and assistance to the SEC and Financial Industry Regulatory Authority (FINRA) in examinations and the enforcement of the Board's rules and to retain half of any penalties collected by the SEC in such enforcement actions. The MSRB has expanded authority to regulate the advice provided by municipal advisors to or on behalf of municipal entities and "obligated persons." Obligated persons include any person committed to support the payment of all or part of the obligations on municipal securities. The MSRB is required to meet at least twice yearly with the SEC and FINRA to share information about the interpretation of MSRB rules and examinations, enforcement of such rules and compliance therewith.

The Act directs the U.S. Comptroller General to conduct a study and review of the disclosures required to be made by issuers of municipal securities within two years of enactment of the Act and report to Congress on the results of the study. The study must compare the amount, frequency and quality of disclosures that issuers of municipal securities are required by law to provide for the benefit of municipal securities holders; evaluate the costs and benefits to various types of issuers of municipal securities of requiring issuers of municipal bonds to provide additional financial disclosures for the benefit of investors; evaluate the potential benefit to investors from additional financial disclosures and make recommendations relating to disclosure requirements for municipal issuers, including the repeal or retention of the Tower Amendment, section 15(B)(d) of the Exchange Act. The Tower Amendment restricts the SEC and the MSRP from requiring issuers of municipal securities to file documents with these agencies before their securities are sold. The effect of the Tower Amendment is to place disclosure requirements and burdens on the underwriters of securities, rather than on the issuers. Repeal of the Tower Amendment will likely allow the SEC or MSRP to require issuers to comply with certain disclosure requirements for the benefit of the investing public as well as with generally accepted governmental accounting standards.

The Act also states that within 18 months of enactment, the Comptroller General must submit a report to the U.S. Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services, detailing the needs of municipal security markets and investors and providing recommendations for improvements to transparency, efficiency, fairness and liquidity of trading, as well as the potential uses of derivatives in municipal securities markets.

Within 180 days after the date the Act is enacted, the Comptroller General is also required to conduct a study evaluating the role and importance of the Governmental Accounting Standards Board (GASB) in the municipal securities market and the manner and level at which the GASB has been funded. The Act now grants authority to the SEC to direct FINRA to assess and collect a fee on municipal securities dealers to fund the GASB.

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For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact [Miles Plaskett](#), any [member](#) of the [Corporate Practice Group](#) or the attorney in the firm with whom you are most regularly in contact.

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U.S. Financial Reform: Credit Rating Agencies

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Among the many new regulations included in the Act is a set of regulations that address credit rating agencies. Generally, a credit rating agency researches and reviews the credit-worthiness of corporations, financial institutions, special-purpose entities and governments that issue certain types of financial obligations – including bonds, preferred stock and commercial paper – and then assigns the issuer a credit rating. The determination of credit-worthiness affects both the decision of investors on whether or not to invest in the issuer and the interest rate applied to the debt. In theory, the rating is initiated and paid for by the issuer of the obligation; although in practice, it is usually the investment bank managing the offering on behalf of the issuer that initiates the rating process.

In recent years and as the influence of credit ratings outpaced their reliability, investors have often relied too heavily on favorable ratings in lieu of performing their own independent research and analysis. Additionally, government regulators have become increasingly dependent on the ratings to set regulatory policies for the financial industry. Essentially, investors and government regulators have outsourced to the credit rating agencies their own obligation to perform due diligence into the credit-worthiness of a security or debt issuer.

Background on Credit Rating Agencies and Prior Regulations

Although government regulators have relied on credit rating agencies since the 1930s to manage the amount of risk held by regulated entities, the agencies themselves have largely been exempt from legal regulations that apply to more-traditional forms of investment advice. Instead, legislators have generally depended on the market, rather than the government, to regulate the industry. Additionally, for many years, rating agencies have avoided regulation by claiming

status as “journalists” and maintaining that the First Amendment freedom of the press precludes government regulation of the methodologies and content of their rating opinions. This position was recently debated and generally discredited in a 2009 opinion of the U.S. District Court for the Southern District of New York, in *Abu Dhabi Commercial Bank, et al. v. Morgan Stanley*.¹

It was not until 1975 that the U.S. Securities and Exchange Commission (SEC) began to formally recognize credit rating agencies by establishing a process to designate qualifying agencies as nationally recognized statistical rating organizations (NRSRO). Designation as an NRSRO was desirable to the agencies because it allowed other SEC-regulated entities to rely on the ratings to satisfy some of their own regulatory requirements. Although NRSRO designation allowed for formal government recognition, the program continued to rely primarily on market forces to regulate the industry.

The government’s first effort to impose meaningful regulation on the credit rating industry was in 2006 when, in response to several high-profile corporate scandals, but prior to the recent financial crisis, President Bush signed the Credit Rating Agency Reform Act (CRARA). CRARA, which was intended to improve the quality of ratings by increasing accountability, transparency and competition, gave exclusive authority to the SEC to draft and implement a set of rules that would govern registration, recordkeeping, reporting and oversight for credit rating agencies. With respect to registration, the rules require a credit rating agency seeking NRSRO status to comply with certain registration requirements, including a lengthy application process.

The rules allowed an agency to register separately as an NRSRO to rate five different classes of entities: (1) financial institutions, brokers and dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities; and (5) issuers of government securities, municipal securities or securities issued by a foreign government. There are currently 10 credit rating agencies that have applied for and been granted registration as an NRSRO: A.M. Best Company, Inc.; DBRS Ltd.; Fitch, Inc.; Japan Credit Rating Agency, Ltd.; Moody’s Investor Services, Inc.; Rating and Investment Information, Inc.; Standard & Poor’s Rating Services; Egan-Jones Rating Company; LACE Financial Corp.; and Realpoint LLC.

With respect to recordkeeping, reporting and oversight, the SEC adopted a set of rules that required each NRSRO-designated agency to comply with the following:

- Post specified nonconfidential portions of its registration form on its website within 10 days after being granted the NRSRO designation, including specific information regarding procedures and methodologies for determining ratings.
- Keep and maintain performance-measurement statistics, including downgrade and default rates for three years and disclose this information to the SEC and the public.
- Annually furnish certain financial reports to the SEC, including audited financial statements and an annual certification application.

Despite CRARA's progress in the regulation of credit rating agencies, its effectiveness was limited because CRARA expressly prohibited regulation of the fundamental basis for the agencies' work – their credit rating processes and methodologies.

When the asset-backed structured finance market began to expand in the years leading up to the recent financial crisis, the role of rating agencies in these complex investment instruments became even more influential. Because of the increasing complexity of these structured investments, investors began to rely more heavily on the credit rating agencies to understand the investment instruments and gauge their risk. Even the most complex and risky investments could be sold with a favorable rating from a recognized agency. Although in theory this system would provide sound and objective information for investors, in practice, it did not. Significant conflicts of interest arose because large Wall Street investment firms could direct substantial market share to the agencies that were most likely to issue favorable ratings. Thus, agencies began altering their methodologies and even skewing their assessments to retain the business of large firms that controlled such high volumes of work. As a result, the financial system took on far more risk than it knew or could handle.

When the housing market crashed and individuals began to default on the underlying assets, many of these investment instruments were downgraded, which only accelerated the crisis. As the Senate's Permanent Subcommittee on Investigations has recently exposed, hundreds of

billions of dollars' worth of questionable subprime mortgage-backed securities, which had received triple-A ratings, turned out to be worthless and have since been downgraded to junk status. In 2009, following the collapse of the U.S. housing market and the financial crisis of 2008 and 2009, the SEC made a number of amendments to the implementing rules for CRARA. These amendments were designed to add regulations that required increased disclosure of performance statistics and rating methodologies, public disclosure of a sample of rating actions for each class of credit ratings, enhanced recordkeeping and annual reporting requirements, and additional restrictions that addressed potential and actual conflicts of interest.

Although the 2009 amendments were intended to address many gaps left by CRARA as originally enacted, Congress recently determined that these amendments did not go far enough. Congressional investigators concluded that credit rating agencies had become so influential in the current financial system – and increasingly subject to conflicts of interest – that rating agencies were of “national importance” and stronger government regulation was required. As a result, regulation of the credit rating agencies is a cornerstone of the new Act.

Key Provisions in the Act

As legislators attempted to address the causes of the recent financial crisis, the credit rating industry was specifically targeted for its role. The Act significantly increases the regulation of NRSROs in an attempt to avert further adverse consequences of the mortgage-backed securities crisis that led to the economic crisis and recognize the value of transparent and reliable ratings in the financial system. The major components of the regulation are (1) the creation of a new “Office of Credit Ratings” at the SEC to oversee NRSROs and enforce the rules and regulations concerning NRSROs, (2) the creation of new disclosure requirements that attempt to make ratings and the process of determining ratings more transparent to the public and users of the ratings, (3) provisions that require the implementation of internal controls in the formulation of ratings by NRSROs, (4) provisions that address conflicts of interest inherent in the current business model of NRSROs, and (5) provisions that make it easier for plaintiffs to sue credit rating agencies in certain circumstances. The following paragraphs summarize the key provisions and requirements of the Act relating to NRSROs.

New “Office of Credit Ratings” at the SEC to Oversee Credit Rating Regulations

Section 932(p)(1) of the Act creates an “Office of Credit Ratings” at the SEC that will focus on regulating NRSROs and enforcing the Act’s provisions. The mission of the Office of Credit Ratings will be to protect the users of credit ratings, promote accuracy in credit ratings issued by NRSROs and ensure that such ratings are not unduly influenced by conflicts of interest. The Office of Credit Ratings will have its own director and a compliance staff composed of people with “knowledge of and expertise in corporate, municipal, and structured debt finance.” The Office of Credit Ratings is required to examine NRSROs at least once a year and make key findings public. In connection with its annual examinations, the Office of Credit Ratings will review (1) whether the NRSRO is conducting business in accordance with the policies, procedures and rating methodologies of the NRSRO; (2) the management of conflicts by the NRSRO; (3) the implementation of ethics policies by the NRSRO; (4) the internal supervisory controls of the NRSRO; (5) the governance of the NRSRO; (6) the processing of complaints by the NRSRO; and (7) the policies of the NRSRO governing the post-employment activities of former staff of the NRSRO. The Office of Credit Ratings must issue a public report summarizing the essential findings of all its examinations, the responses by NRSROs to any material regulatory deficiencies identified by the SEC, and whether the NRSROs have appropriately addressed the recommendations of the SEC. The Office of Credit Ratings will have authority to establish rules necessary to enforce the new regulations and be able to establish fines and other penalties for violation of the regulations. The creation of the Office of Credit Ratings addresses the increased focus that the SEC will have on regulating rating agencies, and is intended to ensure that resources are devoted to ensuring compliance with the Act and related rules.

Disclosure and Internal Control Requirements

Section 932 of the Act creates new requirements for the development and maintenance of internal controls in NRSROs and increases the amount of disclosure required by NRSROs. These internal controls and disclosure requirements are designed to allow users of credit ratings to understand how the products they may be investing in are being rated. The internal controls and

disclosures should also allow users of ratings to compare the performance of the NRSROs over time.

Internal Controls. Each NRSRO must establish, maintain, enforce and document an effective control structure governing the implementation of and adherence to policies, procedures and methodologies for determining credit ratings, taking into consideration such factors as the SEC may prescribe by rule. The chief executive officer of each NRSRO must make an annual attestation to the effectiveness of the NRSRO's internal controls. Each NRSRO must complete an annual internal control report that describes the responsibility of management in establishing and maintaining controls and assessing the effectiveness of the internal control structure of the NRSRO.

Disclosure of Credit Rating Methodology. The SEC will prescribe rules to ensure that ratings are produced in accordance with procedures and methodologies that have been approved by the NRSRO board or a body performing a function similar to that of a board. When there are material changes to credit rating procedures and methodologies – including changes to qualitative and quantitative data and models – the changes must be applied consistently to all credit ratings to which the changed procedures and methodologies apply. Additionally, the NRSRO must disclose the reasons for any material change in credit rating procedures and methodologies. Each NRSRO must notify the users of credit ratings of the following: (1) the methodology used with respect to a particular credit rating, (2) any material change made to a procedure or methodology, (3) any significant error that is identified in a procedure or methodology that may result in credit rating changes, and (4) the likelihood that a material change in procedure or methodology would result in a change in current credit ratings.

Form for Disclosure. The SEC will prescribe rules to require NRSROs to publish with each rating a form (in paper or electronic format) disclosing information about (1) the assumptions behind the rating, (2) the data relied upon, (3) whether servicer or remittance reports are used to monitor the rating, and (4) other information to allow investors and users of credit ratings to better understand the rating. The form must discuss (1) the main assumptions underlying the rating, (2) potential limitations of the rating, (3) information on the uncertainty of ratings, (4)

whether and to what extent third-party due diligence reports have been used, (5) data about the issuer used in determining the rating, (6) the NRSRO's assessment of the quality of data available and considered, (7) information related to conflicts of interest and (8) other information that the SEC may require.

Transparency of Ratings' Performance. The SEC will prescribe rules that require each NRSRO to “publicly disclose information on the initial credit ratings determined by the [NRSRO] for each type of obligor, security, and money market instrument, and any subsequent changes to such credit ratings.” This disclosure is likely to assist users of credit ratings in evaluating the accuracy of the ratings and comparing the performance of the ratings by different NRSROs.

Third-Party Due Diligence Services for Asset-Backed Securities. Issuers or underwriters of asset-backed securities must make public the findings and conclusions of any due diligence report obtained by the issuer or underwriter. Third-party due diligence services must certify (in a form and content to be established by the SEC) that they have conducted a thorough review of data, documentation and other relevant information necessary for the NRSRO to provide an accurate rating. NRSROs shall make such certifications public, in order to allow the public to determine the adequacy of third-party due diligence services.

Corporate Governance and Management of Conflicts of Interests

The Act also contains provisions that appear to influence the corporate governance of NRSROs to ensure that conflicts of interest are minimized when an NRSRO determines a rating for a product. These provisions include the requirement for independent directors on the board of each NRSRO, increased duties of directors to ensure that the provisions of the Act are followed, the requirement that the sales and marketing functions of an NRSRO are separated from the rating functions of the NRSRO and the requirement that NRSROs consider information in addition to what is received from the issuer.

Independent Directors and Duties of the Board. Each NRSRO must have a board of directors, and at least half the members of the board (but not fewer than two directors) must be independent. A portion of the independent directors must include users of NRSRO ratings. In

order to be considered independent, a member of the board may not – other than in his or her capacity as a member of the board of directors – accept any consulting, advisory or other compensatory fee from the NRSRO, or be a person associated with the NRSRO or with any company affiliated with it. An independent director must also be disqualified from any deliberation involving a specific rating if the independent board member has a financial interest in the outcome of the rating. Independent directors may receive compensation, but such compensation cannot be linked to the business performance of the NRSRO. The term of the independent director is required to be for a fixed term not to exceed five years, and such term may not be renewable. In addition to their overall responsibilities, the board of directors is required to oversee (1) the establishment, maintenance and enforcement of policies and procedures for determining credit ratings; (2) the establishment, maintenance and enforcement of policies and procedures to address, manage and disclose conflicts of interest; (3) the effectiveness of the internal control system with respect to policies and procedures for determining credit ratings and (4) the compensation and promotion policies and practices of the NRSRO.

Conflicts of Interest. The SEC will prescribe rules to prevent the sales and marketing considerations of NRSROs from influencing the production of NRSRO ratings. Such rules will provide exceptions for small NRSROs. Any violation of such rules that affects a rating will be grounds for revocation or suspension of NRSRO registration. The Act also installs a new requirement for NRSROs to conduct a one-year look-back review when an NRSRO employee goes to work for an obligor or underwriter of a security or money market instrument subject to a rating by that NRSRO. The NRSRO is also required to report to the SEC when certain employees of the NRSRO go to work for an entity that the NRSRO has rated in the previous 12 months.

Independent Information. Section 935 of the Act provides that in producing a credit rating, an NRSRO must consider information from a source other than an issuer that the NRSRO finds credible and potentially significant to a rating decision.

Enforcement and Liability

The Act also contains several provisions that appear to allow for greater enforcement of violations by NRSROs. NRSROs will now face the same liability under the securities laws as faced by registered public-accounting firms or securities analysts. Additionally, the SEC has the right to revoke an NRSRO's status under certain circumstances.

Private Actions. Section 933 of the Act amends the Securities Exchange Act of 1934 to allow investors to bring private actions against rating agencies for a knowing or reckless failure (i) to conduct a reasonable investigation of the rated security with respect to factual elements relied upon by its own methodology for evaluating credit risk or (ii) to obtain reasonable verification of such factual elements from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter. Additionally, under section 939(g) of the Act, NRSROs will now be subject to "expert liability" through the nullification of Securities Act Rule 436(g), which previously provided an exemption for credit ratings provided by NRSROs from being considered a part of the registration statement. NRSROs will now face the same type of liability in private securities actions faced by registered public accounting firms or securities analysts under the securities laws.

Right to Deregister. Section 932 of the Act authorizes the SEC to revoke a credit rating agency's NRSRO status for a particular class of securities when an NRSRO has insufficient financial and managerial resources to consistently produce accurate ratings.

NRSROs Required to Refer Tips to Law-Enforcement or Regulatory Authorities. Section 934 of the Act provides that each NRSRO must refer to law-enforcement or regulatory authorities credible information that the NRSRO receives that alleges that an issuer of securities rated by the NRSRO has committed a material violation of law. The NRSRO is not required to verify the accuracy of such information.

Miscellaneous Provisions

Testing and Education. Section 936 of the Act directs the SEC to issue rules to ensure that any person employed by an NRSRO to perform credit ratings meets standards of training, experience and competence necessary to produce accurate ratings, and is tested for knowledge of the credit rating process.

Universal Rating Symbols. Section 938 of the Act requires NRSROs to clearly define any symbols used to denote a credit rating, and apply those symbols in a consistent manner to all types of securities and money market instruments. However, there is no restriction on NRSROs using distinct sets of symbols to denote credit ratings for different types of securities.

Timing of Regulations. Section 937 of the Act directs the SEC to issue final regulations required by the Act not later than one year after the date of enactment of the Act.

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For Further Information

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Note

1. *Abu Dhabi Commer. Bank v. Morgan Stanley & Co.*, 2010 U.S. Dist. LEXIS 59339 (S.D.N.Y. June 15, 2010).

U.S. Financial Reform: New Whistleblower Incentives and Protections, and More Enforcement Expected

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“the Act”) begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Expanded Bounty Hunter Provisions: A Sea Change for SEC and CFTC Enforcement Actions

The Act includes “bounty hunter” provisions to increase the voluntary reporting of securities and commodities violations. The U.S. Congress did so by significantly enhancing whistleblower rewards and protections. These provisions pose new and substantial challenges to publicly traded companies – including heightened Foreign Corrupt Practices Act (FCPA) risks and likely costly compliance burdens. The U.S. Securities and Exchange Commission (SEC) recently paid a whistleblower a reward of \$1 million in the *Pequot* matter. Combined with the federal law that criminalizes retaliation against an employee who provides confidential information to the government, or who purloins corporate documents to turn them over to the government, companies must now take a careful look at how they conduct their business activities, measured by a focused risk metric.

These new whistleblower provisions appear in two main parts – section 922 (related to the SEC) and section 748 (related to the U.S. Commodity Futures Trading Commission, or the “CFTC”). Both offer a bounty of up to 30 percent of collected monetary sanctions over \$1 million recovered by the SEC, the CFTC, the U.S. Department of Justice (DOJ), self-regulatory organizations and other regulators. Congress instructed that the necessary rules implementing these measures must be promulgated within 270 days of the statute’s enactment.

Under the Act, a whistleblower who provides “original information” to the SEC or CFTC¹ leading to a successful enforcement action that imposes monetary sanctions over \$1 million is

eligible for a reward of between 10 percent and 30 percent of the funds collected as sanctions. These provisions are somewhat similar to the whistleblower provisions of the federal False Claims Act (FCA), which the DOJ reports has led to the recovery of \$2.4 billion during 2009, and more than \$24 billion since 1986.² Those FCA whistleblower actions have demonstrably increased the number of agency enforcement proceedings: In the healthcare industry, for example, more than three-fourths of the enforcement actions reported during 2009 relate to actions initiated by whistleblowers.³

A few categories of individuals are excluded by the Act from qualifying for the new bounty hunter provisions:

- individuals who work for the SEC or CFTC;
- auditors who conduct a required audit of the publicly traded company;
- and individuals who are convicted in a proceeding related to the judicial or administrative action for which the whistleblower otherwise could receive an award.

Clearly, potential whistleblowers are not limited to current or former employees. They can be independent contractors, consultants, joint venture partners, sales agents, accountants (if not conducting a required audit), as well as others whose dealings with a company puts them in a position where they can gather and provide original information to government officials in the hope of being financially rewarded.

The “plaintiffs’ bar” now handling *qui tam* work under the FCA is anticipated to take advantage of these new whistleblower provisions. For one reason, the plaintiffs’ bar may find it much easier for whistleblowers to seek bounties under the new provisions because, unlike the FCA’s *qui tam* provisions, whistleblowers under the Act are not required to file and maintain lawsuits in federal court. Consequently, whistleblowers seeking bounties under the new provisions do not have to incur the significant financial burdens that *qui tam* relators and their counsel must shoulder under the FCA. They also do not have to meet the heightened pleading standards imposed by Federal Rule of Civil Procedure 9(b) for suits pleading fraud claims.

Recent FCPA Enforcement

The Act's whistleblower provisions take effect at a time when the DOJ and SEC have already increased resources devoted to FCPA matters. The SEC has added new FCPA enforcement units, while the DOJ has added prosecutors and FBI agents dedicated to FCPA cases – and is filling additional positions. The DOJ has also begun discussions with the IRS Criminal Investigation Division about partnering on FCPA cases around the United States. Moreover, the federal agencies have started to use extensive undercover techniques to uncover FCPA violations.

In a recently publicized FCPA investigation, the DOJ used undercover law-enforcement techniques to uncover allegedly widespread fraud and corruption – which resulted in 22 executives and employees of companies in the military and law-enforcement products industry being charged for their involvement in schemes to bribe foreign government officials. In 2010, the DOJ's Fraud Section has charged 46 individuals with FCPA or bribery-related offenses. And this year may surpass the record set in 2009, when more individuals were charged with FCPA violations than in any prior year (or in the past several years combined) – including CEOs, CFOs and other senior corporate, sales, marketing and finance executives. Assistant U.S. Attorney General Lanny Breuer, in charge of the DOJ's Criminal Division, has warned that “the prospect of significant prison sentences for individuals should make clear to every corporate executive, every board member, and every sales agent that we will seek to hold you *personally accountable* for FCPA violations.” It is anticipated that the new whistleblower provisions will soon increase the number of FCPA matters – already at all-time-high levels – and will also increase other types of securities and commodities fraud investigations and prosecutions.

New Whistleblower Protections

While it is challenging for employers to determine how to best handle whistleblowing employees, the Act has added another layer of enhanced whistleblower protections. Under the Act, a whistleblower now can sue a retaliating employer directly in federal court without first having to exhaust administrative remedies. In addition, existing whistleblower protections under

the Sarbanes-Oxley Act have been clarified to apply to *both* parent companies and affiliates whose financial information is included in consolidated financial statements.

New Requirements for the Natural-Resource Sector

A related provision, section 1504 – designated “Disclosure of Payments by Resource Extraction Issuers” – requires entities engaged in the commercial development of oil, natural gas, or minerals to provide additional information in annual reports filed with the SEC about any payments made by the issuer, a subsidiary or any entity under the issuer’s control to a foreign government, department, agency or instrumentality of a foreign government, or a company owned by a foreign government for the purpose of commercial development of oil, natural gas, or minerals. In connection with section 922 of the Act, this provision may lead to more FCPA investigations and actions.

Section 1504 of the Act amends section 13 of the Exchange Act. Congress instructs the SEC to issue final rules that “require each resource extraction issuer to include in an annual report . . . information relating to any payment made by the resource extraction issuer, a subsidiary of the resource extraction issuer, or an entity under the control of the resource extraction issuer to a foreign government or the [U.S.] Federal Government for the purpose of the commercial development of oil, natural gas, or minerals, including: (i) the type and total amount of such payments made for each project of the resource extraction issuer relating to the commercial development of oil, natural gas, or minerals; and (ii) the type and total amount of such payments made to each government.”

The Act defines “commercial development of oil, natural gas, or minerals” to include “exploration, extraction, processing, export, and other significant actions relating to oil, natural gas, or minerals, or the acquisition of a license for any such activity, as determined by the [SEC].” “Payment” is any remuneration that is “made to further the commercial development of oil, natural gas, or minerals”; and is “not de minimis” and includes “taxes, royalties, fees (including license fees), production entitlements, bonuses, and other material benefits, that the Commission, consistent with the guidelines of the Extractive Industries Transparency Initiative

(to the extent practicable) determines are part of the commonly recognized revenue stream for the commercial development of oil, natural gas, or minerals.”

Aiding and Abetting Liability Authorized for SEC Enforcement Actions

The Act also includes provisions designed to make it easier for the SEC to bring and maintain enforcement actions based on expanded secondary liability. The following new provisions set out the newly expanded authority:

- Section 929M (Aiding and abetting authority under the Securities Act and the Investment Company Act);
- Section 929N (Authority to impose penalties for aiding and abetting violations of the Investment Advisers Act);
- Section 929O (Aiding and abetting standard of knowledge satisfied by recklessness).

Although the Private Securities Litigation Reform Act of 1995 authorized the SEC to charge aider and abettor violations of the Exchange Act in enforcement actions, Congress had required the SEC to demonstrate that defendant(s) knew about the misconduct, which courts interpreted as requiring proof of actual knowledge (and not just recklessness).

While a few senators had strongly supported extending to private litigants the authority to charge and prove secondary aiding and abetting liability in federal securities fraud cases, Congress did not do so in the Act, although it may in the future. Section 929Z of the Act instructs the U.S. Comptroller General to “conduct a study on the impact of authorizing a private right of action against any person who aids or abets another person in violation of the securities laws,” and then report to Congress on its findings within a year.

Similarly, while Congress did not provide private litigants with the same authority as the SEC obtained in the Act (see below) regarding the extraterritorial reach of the federal securities laws in securities fraud actions (*i.e.*, legislatively repealing *Morrison v. National Australia Bank*), it also instructed that a study on this issue be conducted. Section 929Y of the Act instructs the SEC

to solicit public comments, conduct the study, and then provide it to Congress, along with recommendations, within 18 months.

Extraterritorial Reach (Limited Repeal of *Morrison*) for SEC Enforcement Actions

Section 929P(b) of the Act effectively repeals *Morrison v. National Australia Bank*⁴ for certain SEC enforcement actions. It authorizes extraterritorial jurisdiction if the SEC charges violations of the antifraud provisions of the federal securities laws that involve “conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors” or “conduct occurring outside the United States that has a foreseeable substantial effect within the United States.”

What This Means for Companies

In light of the new and potentially sweeping consequences that may result if these new laws are violated – and since publicly traded companies may face many other issues, such as continued participation in government programs; collateral civil litigation; and obligations to shareholders, employees, customers and the public – companies may wish to thoroughly review their existing corporate governance and compliance policies.⁵

Companies may also want to take actions to encourage and enhance the general loyalty of their employees and agents, and to encourage informing the company of potential problems. This may discourage employees from quietly working with the government and plaintiffs’ counsel in the hope of recovering huge bounties at the company’s expense. Legal counsel may provide the necessary perspective and skills, including how to appropriately structure and handle internal investigations, if necessary.⁶ It is likely to be more cost-effective to be proactive than reactive. Today, regulators and the public do not appear too willing to tolerate mistakes, honest or not.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** –

www.duanemorris.com/FinancialReform – which includes videos and the firm’s comprehensive

series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact [George D. Niespolo](#), [Michael E. Clark](#), [Marvin G. Pickholz](#), any member of the White-Collar Criminal Law Group or the attorney in the firm with whom you are most regularly in contact.

As required by United States Treasury Regulations, you should be aware that this communication is not intended by the sender to be used, and it cannot be used, for the purpose of avoiding penalties under United States federal tax laws.

Notes

1. The legislation defines *original information* to mean “information that – “(A) is derived from the independent knowledge or analysis of a whistleblower; (B) is not known to the Commission from any other source, unless the whistleblower is the original source of the information; and (C) is not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media, unless the whistleblower is a source of the information.” See Dodd-Frank Act § 748 (amending the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.*) and Dodd-Frank Act § 922 (amending the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*).
2. The new whistleblower provisions also are similar to the recently modified IRS whistleblower measures.
3. Government investigations frequently trigger collateral private litigation, which is likely to play a much more significant role in the overall enforcement framework. The

government already works with whistleblowers' counsel to identify and prosecute FCA cases, for which there are frequently parallel criminal investigations. The state attorneys general are also allied with private litigants in their enforcement actions. In short, the government now uses the private plaintiffs' bar as an additional resource to leverage limited resources.

4. 561 U.S. ___, No. 08-1191 (June 24, 2010).
5. Federal enforcement agencies, state attorneys general, and the private plaintiffs' bar – primarily *qui tam* and class action counsel – all claim to be an integral part of the enforcement web. To handle an internal investigation involving a public company or one of its officers, employees, or directors against misconduct allegations typically entails negotiating a veritable minefield of legal challenges and business risks. As well as the applicable laws, regulations and policies, the perspectives, values and cultures of the enforcement agencies and any other involved parties often come into play.
6. Even if a company lacks a *legal obligation* to disclose an actual or potential violation, as is often the case, it still may be in its best interest to disclose the information. Many agencies, including the SEC, CFTC, and DOJ, have voluntary disclosure programs to encourage companies to provide such information in return for reduced penalties or non-prosecution agreements. But prosecution is by far *not* the government's only or most potent weapon. The collateral consequences of a prosecution action, such as suspension, debarment, and exclusion, often can be more harmful. Negative press associated with a formal enforcement investigation or prosecution may significantly affect the value of a company's publicly traded securities and lead to higher lending costs, strained shareholder relationships, and morale problems. A fact-specific analysis may need to be performed to assess, among other things, whether an event is so significant that it should be immediately disclosed in light of the history of events, the company's size, its overall profitability and the information already in the public realm.