ARNOLD & PORTER LLP

Status of US Financial Reform Legislation: Systemic Risk, Derivatives, Consumer Protection and Investment Advisers

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This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and does not constitute legal advice.

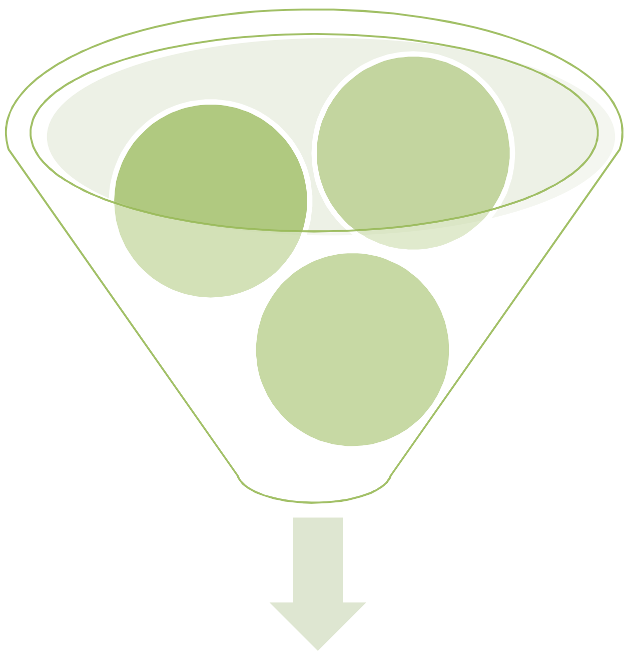
You should consult with counsel to determine applicable legal requirements in a specific fact situation.

Goals

- Reduce contagion risks from "systemically significant" financial firms
  - Including clearer resolution / liquidation process
- Enhanced regulation / oversight of -
  - consumer financial products
  - over-the-counter derivatives
  - fund advisers
  - ratings agencies
- Align compensation and governance, to avoid excessive risk taking
- Reduce risks posed by securitizations

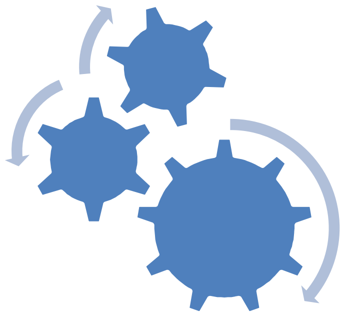
Status

- **Obama Administration:**
  - June 2009, released the concept paper "*Financial Regulatory Reform: A New Foundation*.
- **House of Representatives:**
  - December 2009, passed the "*Wall Street Reform and Consumer Protection Act.*"
- **Senate:**
  - March 15, 2010, Senator Dodd introduced "*Restoring American Financial Stability Act of 2010*".



Reduce Contagion / Systemic Risk

- Systemic Risk Regulator
  - Each plan would create a systemic risk regulator
    - Financial Stability Council / Financial Stability Oversight Council
    - Chair – Secretary of the Treasury
  - Identify and regulate systemically significant financial firms
    - Including financial activities of non-bank financial companies
    - Respond to emerging system-wide risks
  - Create a liquidation fund ($50 - $150 bn)
  - Main differences between plans:
    - Which entities are subject to designation
    - Role of the Federal Reserve
    - Consequences of designation as "significant"



Reduce Contagion / Systemic Risk

- Consequences of Being Designated as a Company that may be of Systemic Risk:
  - stricter standards (capital, leverage, liquidity, resolution plan, concentration limits, risk management, transfer of assets, or termination of activities)?
  - Supervision / regulation as if it were a financial holding company (financial activities)?
  - wall off financial activities from non-financial activities?

Reduce Contagion / Systemic Risk

- Special Resolution Authority
  - Would be available if a financial company
    - is determined by Treasury to be in default or danger of default,
    - failure would have severe adverse effects on US stability or economic conditions, and
    - FDIC assistance would avoid or mitigate the adverse effects
  - Procedure similar to bank receivership
  - Can be used only if using the Bankruptcy Code would be “systemically destabilizing”
  - Insurance companies are exempt
    - remain subject to state liquidation laws
- Living will / funeral plan

Reduce Contagion / Systemic Risk

- Volcker-lite
  - Volcker plan would prohibit depository institution holding companies from
    - Proprietary trading operations (“unrelated to serving customers”)
    - Owning/investing/sponsoring hedge funds and/or private equity funds
  - Proposed Senate bill
    - If systemically important nonbank financial company or BHC deemed to pose a “grave threat” to U.S. financial stability, then
      - restrictions on any activities or operations
      - proprietary trading investing in or sponsoring hedge funds or private equity funds
      - impose asset sale/breakup

Regulation | Consumer Protection

- Currently, consumer protection diffused among different federal and state regulatory agencies
  - Financial institutions – various federal bank regulatory authorities
  - Non-Financial institutions – state agencies and the FTC

- Increases consumer protection through:
  - Minimum standards, disclosures, fair dealing requirements
  - Creation of a federal consumer financial protection authority
    - But, significant differences between plans
    - ➢ Independent agency *or* part of the Federal Reserve?
    - ➢ Regulatory *and* enforcement powers?
    - ➢ Preemption of state authority?

Regulation | OTC Derivatives

- CFTC / SEC
  - supervise the purchase and sale of over-the-counter (OTC) derivatives
- Registration requirements for:
  - swap repositories,
  - swap dealers,
  - major swap participants, and
  - swap execution facilities
- Extraterritoriality
  - SEC / CFTC may exempt foreign facilities if subject to comparable home country regulation
  - limited exclusions for activities outside the United States that do not have a direct and significant connection in the US
  - Senate version does not address extraterritoriality

Regulation | OTC Derivatives

- Mandatory trading for many swaps on exchanges or swaps execution facilities
- Major swaps dealers and major swap participants:
  - capital requirements,
  - margin requirements,
  - recordkeeping requirements, and
  - reporting requirements
- Hinges on definitions of -
  - swaps dealers
  - major swap participants
- *However,* it is expected that a different version of derivatives provisions of Senate bill will be presented in full committee

Regulation | Private Fund Advisers

- Registration and Regulation
  - eliminates “private adviser” exemption from registration under the Investment Advisers Act of 1940
  - imposes SEC registration, reporting, and record-keeping obligations on advisers to “private funds”
    - aimed at hedge funds
    - private equity funds / family offices *(Dodd version exempts, House does not)*
  - exemptions from registration for:
    - foreign private advisers,
    - advisers to venture capital funds,
    - advisers to small business investment companies, and
    - any adviser that acts solely as an adviser to private funds and has US assets under management of less than $150 million

Regulation | Credit Rating Agencies

- Heightened regulation
  - greater transparency
    - disclose procedures, methodologies, fees
  - reduce conflicts of interest
    - prohibited from consulting to companies that contract for ratings
  - reduce reliance on credit rating agencies
    - “scrubbing” federal regulations that rely on ratings
  - increased liability
    - provides investors with a private right of action against agencies
    - increased Securities Act liability if rating is included in disclosure
  - SEC given greater enforcement tools / examination powers
    - mandatory registration (most are already registered with the SEC)
    - dedicated SEC office

Regulation | Compensation

- Increased Federal role in determining compensation
  - "Say on Pay"
    - must provide shareholders with *non-binding* shareholder vote to approve the compensation of executive
  - compensation committee of independent directors
  - disclose the relationship between executive compensation and financial performance
  - "clawback" of "erroneously awarded" compensation
  - considered "unsafe and unsound practice" for a BHC to provide an employee, director or principal shareholder with compensation that is "excessive"

Regulation | Corporate Governance

- Majority Voting
  - uncontested elections, majority of votes cast
    - director must tender resignation if does not reach majority
  - contested elections, plurality standard
- Disclosure of Chairman / CEO Structure
  - disclose why the same or different persons serve as chairman and CEO
- Does not require -
  - shareholder ratification of classified boards
  - separate investor votes on severance packages
  - independent board chairs

Regulation | Insurance Companies

- Creation of a Federal Insurance Office within Treasury Department :
  - Monitor industry and insurance issues
  - Make recommendations on specific insurance companies becoming subject to stricter standards
  - May pre-empt state insurance measures