THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

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OVERVIEW

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. This major piece of legislation will affect not only banks and other traditional financial institutions, but also private equity and hedge funds, investment advisers, broker-dealers, “end users” of derivatives, and all public companies. Although the Dodd-Frank Act is now the law of the land, numerous questions and uncertainties remain. Many of the Act’s requirements will be fleshed out through agency rulemaking proceedings over the coming months and, in some cases, years.

Covington has prepared a number of advisories addressing specific provisions of the Dodd-Frank Act. A brief summary of each of these advisories is provided below, and the full text follows.

- **Systemic Risk Regulation and Orderly Liquidation of Systemically Important Firms.** Discusses new powers of Federal government to identify systemically important financial firms and subject them to heightened prudential regulation by the Federal Reserve. Also describes new regime for the liquidation of systemically important financial firms outside of traditional bankruptcy processes.

- **Revisions to Bank Holding Company Act, Other Banking Reforms and Federal Bank Regulatory Agency Restructuring.** Describes the realignment of jurisdictions of federal bank regulatory agencies and key changes to federal bank holding company and bank regulatory requirements.

- **New Rules for Derivatives.** Describes new regulatory framework governing derivatives, including new clearing and trading requirements, new capital and margin standards, and important exceptions for end users of derivatives.

- **Final Volcker Rule Provisions.** Summarizes the Volcker Rule provisions of the Act, which will impose limits on the ability of banking entities and nonbank financial companies designated for systemic regulation to engage in proprietary trading or sponsor or invest in private equity or hedge funds.

- **Executive Compensation and Corporate Governance.** Describes the Act’s “say-on-pay” and other new executive compensation and corporate governance requirements for public companies, as well as describing new authority of Federal regulators to restrict “excessive” compensation at a wide variety of financial firms.

- **Advisers to Private Investment Funds.** Discusses new SEC registration and reporting requirements for advisers to private equity funds and hedge funds and other provisions applicable to funds.

- **Enhanced Protection of Investors and Other Changes to Securities Regulations.** Discusses several important investor protection features added by the Act as well as related changes to securities regulations, including new whistleblower provisions, further regulation of credit rating agencies, and enhanced oversight of municipal advisors.

- **Enhanced Protection for Whistleblowers Against Employer Retaliation.** Describes enhanced protections under the Act to whistleblowers against retaliation by employers.

- **Dodd-Frank Beefs Up SEC and CFTC Enforcement.** Summarizes the Act’s key provisions enhancing the SEC’s and CFTC’s enforcement powers, including expanded liability for aiding and abetting and control persons.
- **New Disclosure Rules Relating to Extractive Industries.** Summarizes new disclosure obligations created by the Act for companies engaged in the commercial development of oil, natural gas and other minerals, operators of coal and other mines, and persons that use certain minerals originating in the Democratic Republic of the Congo.

- **Bureau of Consumer Financial Protection.** Describes new independent bureau within the Federal Reserve System having broad regulatory, supervisory, and enforcement authority over entities engaged in providing consumer financial products and services.
SYSTEMIC RISK REGULATION AND ORDERLY LIQUIDATION OF SYSTEMICALLY IMPORTANT FIRMS

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act institutes the most wide-ranging changes to the banking, securities, derivatives, and financial services industries since the 1930s. This advisory briefly summarizes the new law’s key provisions providing for systemic risk regulation and the orderly liquidation of systemically important firms.

Highlights of the Systemic Risk and Orderly Liquidation Provisions

- Establishes a new council of federal and state financial regulators (Financial Stability Oversight Council) to monitor risks to U.S. financial stability; designate systemically important financial firms for enhanced prudential regulation by the Federal Reserve; and make recommendations to primary financial regulatory agencies to apply new or heightened prudential standards to existing financial institutions or existing financial activities.

- Subjects both systemically important financial firms designated by the Council and bank holding companies with more than $50 billion in assets to enhanced prudential regulation, including enhanced risk-based capital, liquidity, leverage, risk-management, and resolution plan requirements.

- Establishes an orderly resolution regime outside of the traditional bankruptcy process, to be administered by the Federal Deposit Insurance Corporation (FDIC) as receiver, for systemically important financial firms.

- Assesses certain creditors, financial companies, and bank holding companies to pay for the orderly liquidation of a systemically important financial firm in the event that the costs of the liquidation exceed the firm’s assets.

Systemic Risk Regulation

Financial Stability Oversight Council

The Financial Stability Oversight Council is to be chaired by the Secretary of the Treasury, and its voting members consist of the Chairman of the Federal Reserve Board of Governors, Comptroller of the Currency, Director of the newly created Bureau of Consumer Financial Protection, Chairman of the Securities and Exchange Commission, Chairperson of the Federal Deposit Insurance Corporation, Chairperson of the Commodity Futures Trading Commission, Director of the Federal Housing Finance Agency, Chairman of the National Credit Union Administration Board, and an independent director with insurance expertise appointed by the President. The Council’s non-voting members are the Director of the newly created Office of Financial...
The purposes of the Council are to identify 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, or that could arise outside the financial services marketplace; to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and to respond to emerging threats to the stability of the United States financial system.

Designation of Systemically Important Financial Firms for Federal Reserve Regulation

The Council, by a vote of at least two-thirds of the voting members including an affirmative vote by the Secretary of the Treasury, may designate a “U.S. nonbank financial company” or “foreign nonbank financial company” for supervision and prudential regulation by the Federal Reserve (a Designated Company) if the Council determines that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to the financial stability of the United States.

- A “U.S. nonbank financial company” is a company incorporated or organized under the laws of the United States or any state that is predominantly engaged in financial activities. A “foreign nonbank financial company” is a company incorporated or organized in a country other than the United States that is predominantly engaged in, including through a branch in the United States, financial activities.

- In designating a nonbank financial company for supervision and prudential regulation by the Federal Reserve, the Council must consider the company’s leverage; the extent and nature of the company’s off-balance sheet exposures; the extent and nature of the company’s transactions and relationships with other significant nonbank financial companies and significant bank holding companies; the importance of the company as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the U.S. financial system; the importance of the company as a source of credit for low-income, minority, or underserved communities; the extent to which the company’s assets are managed rather than owned by the company; the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; the degree to which the company is already regulated by a primary financial regulatory agency (e.g., the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Securities and Exchange Commission, the Commodity Futures Trading Commission), the amount and types of the company’s liabilities, including the company’s reliance on short-term funding; and any other risk-related factors that the Council deems appropriate.

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1 The Act establishes the Office of Financial Research within the Department of the Treasury to serve as the Council’s economic and statistical research arm and to collect information on the U.S. economy and from systemically important financial firms.
To avoid evasion of the Council’s authority to designate nonbank financial companies, the Council is authorized upon a vote of at least two-thirds of the Council including an affirmative vote of the Secretary of the Treasury to subject any company’s financial activities to supervision and prudential regulation by the Federal Reserve if (1) material financial distress at the company or the company’s nature, scope, size, scale, concentration, interconnectedness, or mix of financial activities would pose a threat to U.S. financial stability and (2) the company is organized or operates in such a manner as to evade designation by the Council.

The Federal Reserve is required to promulgate regulations on behalf of the Council setting forth criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank financial companies from supervision by the Federal Reserve.

After the Council votes to designate a nonbank financial company for supervision and prudential regulation by the Federal Reserve, the Council must provide written notice of the proposed determination to the company. The company may request a written or oral hearing to contest the Council’s determination within 30 days of receipt of the Council’s written notice. If a hearing is requested, the Council is to provide one within 30 days of the request. The Council must make a final determination not later than 60 days after the hearing. The Council can waive or modify this timeframe if such waiver or modification is necessary or appropriate to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the United States. A nonbank financial company may, within 30 days of the Council’s final determination, bring an action in the U.S. district court for the district in which the company’s home office is located or in the U.S. District Court for the District of Columbia for an order requiring that the Council’s final determination be rescinded on the grounds that the determination is arbitrary and capricious.

Enhanced Supervision and Prudential Regulation for Designated Companies and Bank Holding Companies with Over $50 Billion in Assets

Heightened Prudential Standards. The Federal Reserve is required to establish for Designated Companies and bank holding companies with more than $50 billion in assets (an Interconnected Bank Holding Company) prudential standards with respect to risk-based capital, leverage limits, liquidity requirements, risk management requirements, resolution plans, credit exposure report requirements, and concentration limits that are more stringent than the standards applicable to financial companies and bank holding companies that do not present similar risks to U.S. financial stability. The Federal Reserve may also establish additional prudential standards with respect to contingent capital requirements, enhanced public disclosure requirements, and short-term debt limits. The Federal Reserve may establish an asset threshold above $50 billion in defining what is an Interconnected Bank Holding Company, but only in regard to requirements relating to contingent capital, resolution plans, credit exposure reporting, concentration limits, enhanced public disclosure, and short-term debt limits. The Council is authorized to make recommendations to the Federal Reserve concerning these prudential standards as well as an asset threshold higher than $50 billion for bank holding companies.

Reports, Examination, Enforcement. The Federal Reserve may require Designated Companies to submit reports under oath to the Federal Reserve concerning the company’s financial condition and compliance with the Act, and the Federal Reserve also can examine Designated Companies. The Federal Reserve is authorized to take enforcement action against a Designated Company in the same manner as if the Designated Company were a bank holding company.

Treatment as Bank Holding Companies. Designated Companies are treated as bank holding companies for purposes of Section 3 of the Bank Holding Company Act regulating bank acquisitions.
- **Nonbank Acquisitions.** Designated Companies, as well as Interconnected Bank Holding Companies, must provide written notice to the Federal Reserve in advance of acquiring a direct or indirect ownership interest in a company with $10 billion in assets or more that is engaged in financial in nature activities.

- **Mitigation of Grave Threats to U.S. Financial Stability.** If the Federal Reserve determines that a Designated Company or Interconnected Bank Holding Company poses a grave threat to U.S. financial stability, the Federal Reserve, upon a two-thirds vote of the Council, may limit the company’s ability to merge with, acquire, consolidate with, or become affiliated with another company; restrict the company’s ability to offer certain financial product or products; require the company to terminate one or more activities; impose conditions on the manner in which the company conducts one or more activities; or, if these actions are inadequate, require the company to sell assets or off-balance-sheet items to unaffiliated entities.

- **Resolution Plan and Credit Exposure Reports.** The Federal Reserve is required to require Designated Companies and Interconnected Bank Holding Companies to submit a plan for the company’s rapid and orderly resolution in the event of material financial distress, as well as submit reports on the company’s credit exposure to other Designated Companies and Interconnected Bank Holding Companies as well as other Designated Companies’ and Interconnected Bank Holding Companies’ exposure to the company. The Council may make recommendations to the Federal Reserve concerning this requirement.

- **Concentration Limits and Short-term Debt Limits.** The Federal Reserve is required to prescribe standards that prohibit Designated Companies and Interconnected Bank Holding Companies from having credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus of the company. The Federal Reserve also may prescribe limitations on the amount of short-term debt, including off-balance sheet exposures, that may be held by a Designated Company or Interconnected Bank Holding Company. The Council is authorized to make recommendations to the Federal Reserve concerning these requirements.

- **Risk Committee.** The Federal Reserve must require Designated Companies that are publicly traded to establish a risk committee to be responsible for the oversight of the enterprise-wide risk management practices of the Designated Company and that has a minimum number of independent directors as prescribed by the Federal Reserve.

- **Stress Tests.** Designated Companies and Interconnected Bank Holding Companies must submit to annual stress tests to be conducted by the Federal Reserve to evaluate whether the company has capital necessary to absorb losses that result from adverse economic conditions. In addition, all financial companies with more than $10 billion in assets and that are regulated by a primary Federal financial regulatory agency must conduct self-stress tests, to be prescribed and defined by regulations issued by such agencies.

- **Leverage Limitation.** The Federal Reserve must require Designated Companies and Interconnected Bank Holding Companies to maintain a debt-to-equity ratio of no more than 15-to-1, upon a determination that the company poses a grave threat to U.S. financial stability and that such requirement is necessary to mitigate risks presented by such company to U.S. financial stability.

- **Early Remediation Requirements.** The Federal Reserve, in consultation with the Council and FDIC, is to prescribe regulations establishing requirements for early remediation of financial distress at a Designated Company or Interconnected Bank Holding Company.

- **Establishment of Intermediate Holding Company.** The Federal Reserve may require Designated Companies that conduct both financial and non-financial activities to establish and conduct all financial activities in or through an intermediate holding company established by Federal
Reserve regulation. Internal financial activities, such as internal treasury, investment, and employee benefit functions, may continue to be performed in the Designated Company itself.

- **Study on Contingent Capital Requirement.** The Council is to conduct a study on the feasibility, benefits, costs, and structure of a contingent capital requirement for Designated Companies and Interconnected Bank Holding Companies.

### Additional Standards Applicable to Activities or Practices for Financial Stability Purposes

- The Council may provide for more stringent regulation of a financial activity by issuing recommendations to the primary financial regulatory agencies, including state insurance regulators, to apply new or heightened standards and safeguards for a particular financial activity or practice conducted by a financial institution.

### Leverage and Risk-Based Capital Requirements

- The Federal banking agencies are required to establish minimum leverage capital requirements and minimum risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies, and Designated Companies. These minimum leverage capital requirements may not be less than the generally applicable leverage capital requirements currently in effect for insured depository institutions. In effect, these requirements restrict depository institution holding companies’ and Designated Companies’ ability to include in Tier 1 capital certain hybrid instruments such as trust-preferred securities.

- These minimum leverage and risk-based capital requirements are to be phased in over a three year period with respect to debt or equity instruments issued before May 19, 2010. In addition, depository institution holding companies with less than $15 billion in assets are permanently exempt from these new capital requirements with respect to debt or equity instruments issued before May 19, 2010.

### Orderly Liquidation of Systemically Important Firms

#### Orderly Liquidation Regime

- The purpose of the orderly liquidation regime is to provide authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard. The Act requires such authority to be exercised in a manner so that creditors and shareholders bear the losses of the financial company, management responsible for the financial company’s condition is not retained, and the appropriate agencies take steps to assure that all parties having responsibility for the financial company’s condition bear losses consistent with that responsibility.

- The FDIC and the Federal Reserve are authorized to recommend that the Secretary of the Treasury appoint the FDIC as receiver for a financial company upon a vote of at least two-thirds of the members of the Federal Reserve Board of Governors and two-thirds of the members of the FDIC board of directors. Upon such recommendation, the Secretary is to appoint the FDIC as receiver for a financial company if the Secretary, in consultation with the President of the United States, determines that the financial company is in default or in danger of default; the failure of the financial company and its resolution under otherwise applicable Federal or state laws would have serious adverse effects on U.S. financial stability; no viable private sector alternative is available to prevent the financial company’s default; any impact of taking action on the claims or interests of creditors, counterparties, and shareholders is appropriate; use of the orderly liquidation authority would avoid or mitigate such adverse effects; a Federal regulatory agency
has ordered the company to convert all of its convertible debt instruments that are subject to being converted by the regulatory order; and the company satisfies the definition of “financial company.”

- For this purpose, a “financial company” is (1) a company incorporated or organized under any provision of Federal or state law, (2) that is a bank holding company, a Designated Company, a company engaged predominantly in financial activities (as defined in section 4(k) of the Bank Holding Company), or any subsidiary of any such company that is predominantly engaged in financial activities (except an insured depository institution or an insurance company), and (3) that is not a Farm Credit System institution, governmental entity, or a government-sponsored enterprise.

- A company is engaged “predominantly in financial activities” for purposes of the orderly liquidation authority if the company’s consolidated revenues from financial activities constitute 85 percent or more of the total consolidated revenues of the company.

A company for which the Secretary of the Treasury has made the required determination is referred to as a “covered financial company.” Covered financial companies are subject to liquidation by the FDIC as receiver for the company; they may not be rehabilitated. (Note, any financial companies that are not “covered financial companies” remain subject to traditional insolvency processes for resolution, with limited exception.) The FDIC takes over the covered financial company’s assets and operates the company with all powers of the company’s members, shareholders, directors, and officers. The FDIC must take action as receiver as necessary for purposes of U.S. financial stability and not for the purpose of preserving the covered financial company; ensure that the covered financial company’s shareholders do not receive payment until all other claims and the Orderly Resolution Fund (discussed below) are fully paid; ensure that unsecured creditors bear losses in accordance with the priority of claims provisions in the Act; ensure that management and board members responsible for the condition of the covered financial company is removed; and not take an equity interest in or become a shareholder of any covered financial company.

- The FDIC is authorized as receiver to make additional payments, beyond the amount that would be allocated under the standard receivership process, to certain claimants (subject to claw back of such additional payments if necessary because available funds for orderly liquidation are otherwise insufficient).

- The FDIC’s appointment as receiver expires after three years but may be extended on specified terms for an additional two years, for a total of five years.

**Orderly Liquidation Fund**

- The Act establishes an Orderly Liquidation Fund (Fund) to pay for the FDIC’s costs and expenses in liquidating covered financial companies. The FDIC is authorized to issue obligations to the Secretary of the Treasury to initially fund the Orderly Liquidation Fund. Amounts in the Fund become available to the FDIC with regard to a covered financial company after the FDIC has developed for the company an orderly liquidation plan acceptable to the Secretary of the Treasury.

- The FDIC is authorized to charge risk-based assessments if such assessments are necessary to repay in full the obligations issued by the FDIC to the Secretary within 60 months of the obligations’ date of issuance. The FDIC is first to charge assessments to claimants to the extent

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2 Covered financial companies that are brokers or dealers are subject to liquidation by the Securities Investor Protection Corporation as receiver for the company.
they received additional payments\(^3\) from the FDIC as receiver (other than excess payments necessary to initiate or continue operations essential to implementation of the receivership) and is second to charge assessments to “eligible financial companies” and financial companies with total assets equal to or greater than $50 billion that are not eligible financial companies.

- For this purpose, an “eligible financial company” is any Interconnected Bank Holding Company or Designated Company.

- In setting the amount of risk-based assessments, the FDIC is to take into account (1) economic conditions generally affecting financial companies so that assessments increase in more favorable economic conditions and decrease in less favorable economic conditions, (2) assessments imposed on a financial company or an affiliate of a financial company that is an insured depository institution, SIPC member, insured credit union, or insurance company subject to state assessments, (3) the risks presented by the financial company to the financial system and the extent to which the financial company has benefited from the orderly liquidation of a covered financial company, (4) any risks presented by the financial company during the 10-year period immediately prior to the appointment of the FDIC as receiver that contributed to the covered financial company’s failure, and (5) other risk-related factors as the FDIC or Council deems appropriate.

**Key Issues for Agency Rulemaking Phase**

The Act leaves many critical issues to be fleshed out in rulemaking proceedings at the Federal Reserve, the FDIC, and other agencies. Among the key issues for the rulemaking phases relating to systemic risk regulation and liquidation of systemically important firms are the following:

**Systemic Risk Regulation**

- Definitional criteria for determining if a company is “predominantly engaged in financial activities” (to be promulgated by the Federal Reserve within 18 months of enactment of the Act).

- Enhanced prudential standards to apply to Designated Companies and Interconnected Bank Holding Companies (to be established by the Federal Reserve, with no statutory deadline).

- Criteria for exempting certain types or classes of nonbank financial companies from supervision by the Federal Reserve (to be promulgated by the Federal Reserve within 18 months of enactment of the Act).

**Orderly Liquidation of Systemically Important Firms**

- Method for determining whether a financial company is “predominantly engaged in financial activities” (to be promulgated by the FDIC in consultation with the Secretary of the Treasury, with no statutory deadline).

- System for assessing financial companies to cover any unrecovered amounts expended by the Orderly Liquidation Fund (to be promulgated by the FDIC in consultation with the Secretary of the Treasury within 18 months of enactment of the Act).

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\(^3\) Additional payments are amounts that claimants received that exceed the amount received by other similarly situated creditors.
If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act imposes new restrictions and an expanded framework of regulatory oversight for many financial institutions, including depository institutions.

The Act will realign, in certain respects, the jurisdictions of the existing bank regulatory agencies and in particular abolish the Office of Thrift Supervision, establish a new federal consumer protection regulator, and a new financial oversight council composed of senior financial policy makers and regulators, as well as make numerous changes in existing federal bank holding company and bank regulatory requirements.

Key Highlights for Revisions to the Bank Holding Company Act and Agency Restructuring

- Creation of two new regulatory bodies, the abolition of one existing bank regulatory agency, and the restructuring of the authority of the remaining three bank regulatory agencies.
- Enhanced supervisory and regulatory authority of the Fed over non-bank subsidiaries of bank holding companies.
- Greater regulation of transactions with affiliates, insiders and of lending limits.
- Increased regulation of bank activities including debit-card interchange fees, mortgage origination and underwriting.
- Expanded opportunities for interstate branching by banks and bank holding companies, but with tighter supervision of capital and management for institutions entering into such transactions.
- Reform of the federal bank regulators’ “bailout” authority.

Restructuring of Existing Bank Regulatory Agencies

Abolition of the Office of Thrift Supervision; Preservation of the Thrift Charter

- OTS is abolished, effective 90 days after the transfer date.
- The federal thrift charter is preserved.

OCC

- OCC retains authority over national banks.
- OCC given OTS regulatory authority over federal savings associations.
- Comptroller directed to appoint new deputy comptroller responsible for the examination and supervision of federal savings associations.
- OCC can continue to charter new federal thrifts.

**FDIC**
- FDIC Board seat held by Director of OTS, given to the Director of the new Consumer Financial Protection Bureau.
- FDIC retains authority over state-chartered insured non-Fed member banks.
- FDIC given authority over state-chartered savings associations.

**Federal Reserve Board**
- Fed retains authority over bank holding companies.
- Fed retains authority over state Fed-member banks.
- Fed given OTS regulatory authority over savings and loan holding companies.

**New Federal Agencies**

**Financial Stability Oversight Council**
- New council composed of the Secretary of Treasury as Chair of the Council, together with the Chairmen of the Fed, SEC, CFTC, FDIC, NCUA, the Directors of FHFA, the CFPB, the Comptroller of the Currency, and a member appointed by the President having insurance expertise.
- Authority to identify as a systemic risk (subject to special prudential regulation) limited to U.S. and foreign nonbank financial companies “predominantly engaged” (as defined in the Act) in the U.S. in activities that are “financial in nature” under Section 4(k) of the BHC Act.
- Special federal regulation triggered “if the Council determines [by 2/3 vote, including an affirmative vote of the Chair of the Council] that material financial distress at the U.S. [or foreign] nonbank financial company . . . could pose a threat to the financial stability of the U.S.”
- Council authorized to recommend to primary federal regulators “new or heightened standards and safeguards” with respect to a “financial activity,” “if the Council determines that the conduct, scope, nature, size, scale, concentration, or inter-connectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities.”

**Bureau of Consumer Financial Protection (CFPB)**
- New independent bureau is established within the Federal Reserve System, headed by a presidentially-appointed Director with Senate confirmation and firewalls to preserve the independence of the Bureau, especially with respect to the issuance of rules and the conduct of enforcement actions.
- Empowered to exercise broad regulatory, supervisory and enforcement authority over “covered persons” and “service providers” with respect to both new consumer financial protection laws and an array of existing consumer financial protection laws (with responsibility for the latter being transferred from the federal banking agencies).
Bank Holding Company Act Revisions

Institutions Exempt From the Definition of “Bank” Under the BHC Act

- Imposition of a three-year moratorium on approval of FDIC insurance applications and Change in Bank Control Act notices for ILCs, credit card banks, and trust companies that would qualify for exception from the BHC Act definition of “bank” and that are or would be controlled by a “commercial company” (i.e., a company that derives more than 15 percent of its annual gross revenues from activities that are not “financial in nature” under the BHC Act), except in the case of an institution in danger of default, or a merger or whole acquisition of the commercial company.

- Direction that the GAO conduct a study to determine whether elimination of bulk of exceptions to BHC Act’s definition of “bank” – including exceptions for credit card banks, ILCs, trust companies, and savings associations – is “necessary ... to strengthen the safety and soundness of institutions or the stability of the financial system.”

- Credit card banks permitted to make credit card loans to small businesses without endangering their exclusion from the definition of a bank under the BHC Act.

New Requirements that BHCs Remain Well-Capitalized and Well-Managed

- BHCs required to be “well-capitalized” and “well-managed” to maintain financial holding company status under BHC Act.

Functional Regulation

- Elimination of strict limitations on Fed exercise of rulemaking, supervisory and enforcement authority over functionally regulated BHC subsidiaries (§ 1848a).

- Fed still required to use, “to fullest extent possible,” examinations and reports of other federal and state regulatory authorities.

Source of Strength

- New provision added to FDI Act that expressly directs federal regulators to require depository institution holding companies to serve as a source of strength for their depository institution subsidiaries; source of strength obligation extends to any company that controls an insured depository institution, even if that company is not itself a registered bank or savings and loan holding company.

Fed Acquisition Approval Requirement For FHCs

- Prior approval requirement imposed on any acquisition of a non-insured depository institution company by a financial holding company where the assets to be acquired exceed $10 billion.

- Fed given express statutory authority to consider the “risk to the stability of the United States banking or financial system” when reviewing the acquisition of a non-insured depository institution company by a bank holding company.

Capital Requirements

- Federal bank regulators would be required to impose on all depository institutions and holding companies a generally applicable leverage capital requirement regardless of the size of the
institution and not less than those in effect for insured depository institutions on the date of enactment; effect is to disqualify tier 1 capital treatment for “hybrid” capital items like trust preferred securities issued by bank holding companies. The “regulatory capital deductions” for such hybrid capital instruments issued before May 19, 2009 would be phased in between January 1, 2013 and January 1, 2016. Holding companies with less than $15 billion in assets as of December 31, 2009, would not be forced to make any deductions for instruments issued before May 19, 2009.

- In establishing capital requirements, federal bank regulators required to “seek to make such requirements countercyclical.”

New Fed Assessment Authority

- Fed directed to assess large bank and thrift holding companies (with total consolidated assets in excess of $50 billion) as well as entities subject to systemic regulation by the Council, in an amount that is “equal to the total expenses the Board estimates are necessary or appropriate to carry out the supervisory and regulatory responsibilities of the Board with respect to such companies.”

Other Bank Activity/Bank Holding Company Act Revisions

Enhanced Affiliate Transactions Restrictions

- Restrictions on transactions with affiliates are enhanced by (i) including among “covered transactions” transactions between bank and affiliate-advised investment fund; securities repurchase agreements and derivatives transactions; (ii) adopting stricter collateral rules; and (iii) imposing tighter restrictions on transactions between banks and their financial subsidiaries.

Lending Limits

- National bank lending limits expanded to include credit exposures to counterparties arising from derivative transactions, repurchase agreements, reverse repurchase agreements, and securities lending or borrowing transactions.

- Insured state banks may only engage in derivative transactions if “the law with respect to lending limits” of the state chartering the bank “takes into consideration credit exposure to derivative transactions.”

Insider Transactions

- Derivatives are included within the scope of credit for which member banks must negotiate on market terms for insiders.

- New restrictions on insured depository institutions’ purchases of assets from insiders imposed via the FDI Act; FDIC given rulemaking authority over these new asset-purchase restrictions subject to prior consultation with the OCC and FDIC.

Payment of Interest on Demand Deposits

- Current prohibition on payment of interest on demand deposits (12 U.S.C. § 371a) repealed, effective one year after the date of enactment.
Interstate Branching

- BHC required to be well-capitalized and well-managed to obtain Fed approval of an interstate acquisition.
- For interstate merger transactions, the responsible federal banking agency must conclude the resulting institution will be well-capitalized and well-managed in order to approve the transaction.
- *De novo* interstate branching authorized for national and state banks; current requirement of individual state opt-in eliminated.

Interchange Fees

- Fed directed to establish “reasonable and proportional” interchange fees that large issuers (assets equal to or in excess of $10 billion) and payment card networks may charge with respect to electronic debit transactions.
- Payment card networks prohibited from contractually or otherwise preventing merchants from offering discounts for use of another payment network, payment medium and/or setting minimum and maximum dollar values for the acceptance of any type of payment.
- Regulatory authority of Fed extends to network fees and prevention of exclusive network routing arrangements.

Mortgage Loan Origination and Underwriting

- TILA amended to restrict the payment of fees to real-estate mortgage originators.
- TILA amended to impose minimum underwriting standards on real-estate mortgage creditors, including nonbanks as well as bank creditors and verified ability to pay and income verification.

FDIC Insurance Reforms

- Permanent increase in deposit insurance level to $250,000; retroactive increase for certain failed institutions. Unlimited deposit insurance for noninterest-bearing transaction accounts statutorily mandated effective December 31, 2010, expiring January 1, 2013.
- Deposit insurance assessment base for an insured depository institution equals the institution’s total assets minus the sum of (1) its average tangible equity during the assessment period, and (2) any additional amount the FDIC determines is warranted for custodial and banker’s banks.
- Minimum reserve ratio increased to 1.35 percent of estimated annual insured deposits or assessment base; FDIC directed to “offset the effect” of the increased reserve ratio for insured depository institutions with total consolidated assets of less than $10 billion.
- FDIC authority to suspend dividends from fund to eliminate procyclical assessments.

Bank Agency “Bailout” Reforms

- Fed’s emergency lending authority under Section 13(3) now confined to lending facilities with “broad-based eligibility.”
- FDIC authorized to create “widely-available program” to guarantee obligations of solvent insured depository institutions and solvent depository institution holding companies (including any of their affiliates), but only upon FDIC and Fed determination that there exist “times of severe economic distress.”
Secretary of Treasury may request that FDIC and Fed act to establish such a program upon a determination that there exists a “liquidity event”.

Such a program may not involve receipt of equity; no express exception for the receipt of warrants.

Secretary of Treasury (in consultation with the President) to determine maximum amount initially guaranteed under any such program (and any additional amounts), subject to Congressional disapproval.

FDIC’s current authority to establish such debt guarantee programs under section 13(c)(4)(G)(i) of the FDI Act is limited to institutions that have been placed into receivership (as opposed to solvent institutions and holding companies).

If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

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NEW RULES FOR DERIVATIVES


- The Act creates an extensive new regulatory framework for “swaps” and “security-based swaps,” capturing substantially all derivatives transactions that previously were exempt from regulation under the Commodity Futures Modernization Act.
- The Act contemplates mandatory clearing and trading on regulated facilities for many derivatives contracts, with an exception for non-financial end users.
- “Swap dealers” and “major swap participants” will be subject, among other things, to capital and margin requirements, business conduct rules and special duties in their dealings with governmental entities, ERISA and governmental plans and endowments. While many end users will not be directly regulated, they often will be affected indirectly as their counterparties become subject to new requirements, in particular with respect to margin rules.
- Other significant provisions include the swaps “pushout” rule, collateral segregation and real-time swap transaction reporting requirements, position limits and large trader reporting, and the application of the securities laws to security-based swaps.
- Significant uncertainties remain to be clarified in rulemaking proceedings. The Act contemplates that its principal provisions will become effective in roughly one year. The coming year will be a period of intense rulemaking efforts, with limited time for the implementation of compliance measures once implementing regulations have been finalized.

Swaps and Security-Based Swaps

The Act aims to sweep the universe of previously unregulated derivatives into the new regulatory framework, and divides this universe into two broad categories:

- **Swaps.** The term “swap” is defined broadly and includes options, swaps and other transactions based on rates, commodities, securities, debt instruments, indices, quantitative measures and other financial or economic interests, subject to certain exceptions. Building upon the definition of previously exempt “swap agreements” under Section 206A of the Gramm-Leach-Bliley Act, the Act brings previously unregulated derivatives into the new framework. Swaps are subject to CFTC jurisdiction. Swaps do not include security-based swaps, as discussed below.
- **Security-Based Swaps.** “Security-based swaps” are swaps based on individual securities or loans, on narrow-based securities indices, or on events affecting individual issuers of securities or issuers of securities in a narrow-based securities index. Security-based swaps are subject to SEC jurisdiction.
The Act seeks to establish parallel rules for swaps and security-based swaps.\(^1\) Mixed swaps, which combine features of swaps and security-based swaps, are to be regulated jointly by the CFTC and SEC. Parties seeking to list or trade novel derivatives products having both commodities and securities features may petition the CFTC and SEC for a determination of the product’s regulatory status. The CFTC and SEC are required to consult and coordinate with one another (and with the federal banking regulators) in exercising their jurisdiction over swaps and may challenge each others’ actions in court in the event of a dispute.

While the basic approach is comprehensive and quite straightforward, the definitional provisions are complex in detail. Care must be taken in evaluating the status of individual derivatives products. For example, the “swap” definition excludes certain transactions that are already regulated as securities, including options on securities and foreign exchange options traded on registered securities exchanges. Other exclusions remove from the scope of the Act commodity and security futures, leverage contracts, and forward transactions for nonfinancial commodities intended for physical settlement, as well as deposit and savings accounts, certificates of deposit and other “identified banking products.” Swaps based on government securities (other than municipal securities) are excluded from the security-based swap definition and thus are subject to regulation by the CFTC.

Foreign exchange swaps and forwards, which were the subject of considerable debate during the legislative process, will be considered “swaps.” The Treasury Secretary may, however, make a reasoned determination based on specified criteria that such transactions, to the extent they are not cleared or traded through regulated facilities, should be exempt. Even if that determination is made, reporting requirements and certain business conduct standards would apply.

Questions of interpretation undoubtedly will arise. For example, the definition of security-based swaps leaves some doubt as to the classification of credit default swaps, in particular credit default swaps based on loans or loan baskets or indices, as swaps or security-based swaps. Similarly, the “swap” definition might be read to encompass certain kinds of insurance contracts, which has added significance given that the Act provides that swaps may not be regulated as insurance under state law. The CFTC and SEC likely will be urged to clarify these and other issues through rulemaking.

**Clearing and Trade Execution**

The effort to require central clearing and exchange trading for many derivative transactions is at the heart of two basic purposes of the Act – reducing systemic risk and increasing market transparency. At the same time, the mandatory clearing and exchange trading provisions have been controversial, in particular due to the increased margin requirements (and hence increased costs) likely to be associated with central clearing.

**Mandatory Clearing**

The Act contemplates that the CFTC and SEC will, on an ongoing basis, review swaps and categories or classes of swaps with a view to determining whether clearing should be required. Factors to be considered include the existence of significant outstanding exposures, trading liquidity and the availability of appropriate operational expertise and resources. Where the CFTC or SEC determine

\[^1\] The rules for swaps are put in place through amendments to the Commodity Exchange Act, and the rules for security-based swaps are embedded in the Securities Act of 1933 (the Securities Act) and Securities Exchange Act of 1934 (the Exchange Act). Because the regimes are nearly identical, for simplicity this Advisory uses the term “swap” to refer to swaps and security-based swaps, unless otherwise indicated. Similarly, this Advisory uses the term “swap dealer” to refer to both swap dealers and security-based swap dealers, and “major swap participant” to refer to both major swap participants and major security-based swap participants.
that a particular type of swap should be cleared but no clearing organization accepts the swap for clearing, the CFTC or SEC are directed to investigate and take appropriate action.\textsuperscript{2} Mandatory clearing will not be applied to existing swap positions, so long as the positions are reported to swap data repositories in a timely fashion under rules to be promulgated by the CFTC and SEC.

Clearing organizations will be required to offset swaps with the same terms and conditions on an economically equivalent basis within the clearing organization, and to provide for non-discriminatory clearing of transactions executed bilaterally or on unaffiliated facilities. In a similar vein, the Act calls on the CFTC and SEC to adopt rules, including possible ownership and control limitations, to mitigate conflicts of interest that may arise with respect to ownership of regulated clearing and trading facilities by bank holding companies, certain non-bank financial institutions, swap dealers and major swap participants.

\textbf{Trade Execution}

Swaps that are required to be cleared must be executed on a designated contract market, securities exchange or swap execution facility, unless no such institution makes the transaction available to trade.

\textbf{End-User Exception}

The end-user exception to the clearing and trade execution requirements was another principal focus of the debate during the legislative process. The Act contains a carefully limited end-user exception for counterparties that are not “financial entities,” are using swaps to hedge or mitigate commercial risks, and have notified the CFTC and/or SEC as to how they generally meet their financial obligations associated with non-cleared swaps.

“Financial entities” that will not benefit from the end-user exception include swap dealers and major swap participants, commodity pools, private funds (including hedge funds), certain employee benefit plans, and persons predominantly engaged in banking or other activities that are financial in nature. Depository institutions, farm credit institutions and credit unions with less than $10 million in assets may be excepted from the “financial entity” designation. Financial entities for this purpose will not include finance subsidiaries, i.e., entities whose primary business is providing financing and who use derivatives to hedge interest rate and foreign currency exposures, at least 90\% of which arise from financing for the purchase or lease of products, at least 90\% of which are manufactured by an affiliate.\textsuperscript{3}

Affiliates of exempt persons may benefit from the end-user exception when hedging or mitigating commercial risks of the exempt person. The exception will not be available if the affiliate is a swap dealer, major swap participant, private fund, commodity pool or bank holding company with more than $50 billion in assets.

Where clearing is not required, the non-swap dealer and non-major swap participant counterparty may nonetheless elect to require that the swap be cleared. More generally, the non-swap dealer and

\textsuperscript{2} Unlike the Administration’s original proposal, the Act contains no reference to whether a particular type of swap transaction has been “standardized.” Similarly, while intermediate versions had made explicit that clearing could be made mandatory only if a clearing organization accepted a given type of swap for clearing, this is less certain under the final Act.

\textsuperscript{3} The special provisions for finance subsidiaries apply only with respect to swaps, and not security-based swaps, presumably because security-based swaps are not used to hedge interest rate and FX risks.
non-major swap participant counterparty may select the clearing organization to be used in clearing a swap.

Issuers that are reporting companies must obtain approval by an appropriate committee of the company’s board or other governing body prior to entering into swaps using the end-user exception.

**Swap Dealers and Major Swap Participants**

The principal targets of the new regulatory requirements are “swap dealers” and “major swap participants.”

**Swap Dealers**

The Act defines “swap dealer” to include any person who holds itself out as a dealer in swaps, makes a market in swaps, “regularly enters into swaps with counterparties as an ordinary course of business for its own account”, or otherwise becomes known as a dealer or market maker in swaps. Persons who enter into swaps for their own account but not as part of a regular business are excluded, as are entities that engage in a de minimis quantity of swap dealing in connection with transactions with or on behalf of their customers. Insured depositary institutions that enter into swaps with customers for whom they are originating loans are also excluded.

It is not clear whether the distinction drawn under the Exchange Act between a “dealer” and a non-dealer “trader” (who buys and sells for its own account but does not provide other services usually provided by dealers, such as providing market quotes) will be applied in this context. The wording of the swap dealer definition is broader than one might have expected, and could be read to cover entities that maintain even relatively small proprietary swap trading books. If construed broadly, this provision could capture a large number of market participants that would not ordinarily view themselves as dealers. Rulemaking in this area will merit particular attention.

**Major Swap Participants**

“Major swap participant” means any person, other than a swap dealer:

- who maintains a substantial position in swaps in any major category determined by the CFTC or SEC, excluding (i) positions held for hedging or mitigating commercial risk and (ii) positions maintained by ERISA plans for the primary purpose of hedging or mitigating risks directly associated with plan operations;
- whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or
- that is a highly leveraged financial entity that is not subject to capital requirements established by an appropriate federal banking agency and that maintains a substantial position in swaps in any major category determined by the CFTC or SEC.

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4 A variety of other market participants will be subject to specific regulation under the Act, including derivatives clearing organizations, swap data repositories and swap execution facilities. These regulations will be of more specialized interest and are not discussed in this Advisory.

5 This exclusion does not apply with respect to institutions that originate security-based swaps for their loan customers, perhaps because the exception was felt to be necessary only for interest rate swaps as the form of swap most commonly entered into for hedging purposes in connection with borrowings.
There is an exclusion for finance subsidiaries, i.e., entities whose primary business is providing financing and who use derivatives to hedge interest rate and FX exposures, at least 90% of which arise from financing for the purchase or lease of products, at least 90% of which are manufactured by an affiliate.6

The definition is replete with terms that call out for clarification in the rulemaking process. It seems to target entities with swaps activities at systemically significant levels, with lower thresholds for financial than for commercial entities. It will be difficult, however, to predict the scope of the provision with any confidence until the rulemaking process has progressed.

Regulatory Requirements for Swap Dealers and Major Swap Participants

Swap dealers and major swap participants will be subject to a range of new registration, recordkeeping, documentation, conflicts of interest management and other requirements. The debate during the legislative process focused on capital and margin requirements, new business conduct standards and special rules for dealings with special entities:

- **Capital and Margin Requirements.** These entities’ swaps activities will be subject to capital requirements and, with respect to non-cleared swaps, to initial and variation margin requirements. The requirements are to be set by the CFTC and SEC and, for swap dealers and major swap participants that are banks, by the applicable prudential regulator at levels that help ensure the safety and soundness of the entity and that are appropriate for the risk associated with non-cleared swaps. The use of non-cash collateral is to be permitted to the extent consistent with the financial integrity of the swap markets and preserving the stability of the U.S. financial system.

The rules on capital and margin were a major focus of the legislative debate because of their potential for increasing the cost to end users of establishing and maintaining hedges using derivatives. For reasons that are not entirely clear, an exemption in prior versions from margin requirements for commercial end users with respect to non-cleared swaps was not included in the final bill. The lack of such an exception prompted calls for a corrections bill to be passed before the Act’s margin provisions become effective. By letter of June 30, 2010, Senators Dodd and Lincoln sought to establish the legislative intent to protect commercial end users from burdensome margin requirements. The concern is heightened given that there is no express exemption for legacy positions, with the result that end users might be required to post margin under new rules on trades entered into before the new rules were enacted. These issues undoubtedly will be the focus of special attention during the rulemaking process.

- **Business Conduct Standards.** Rules to be adopted by the CFTC and SEC are to establish business conduct standards that may pose considerable compliance challenges. Among other things, the Act calls for the CFTC and SEC to establish duties for swap dealers and major swap participants to verify their counterparties’ status as eligible contract participants, to disclose material risks and characteristics of transactions, to disclose any “material incentives or conflicts of interest” they may have with respect to a transaction, and to communicate with their counterparties “in a fair and balanced manner based on principles of fair dealing and good faith.” In addition, the CFTC and SEC are given broad authority to enact additional rules relating to fraud, manipulation, abusive practices and other matters.

6 The exclusion for finance subsidiaries tracks the corresponding provision in the end-user exception from mandatory clearing, see note 3 above, and for similar reasons the exclusion applies only with respect to major swap participants, and not with respect to major security-based swap participants.
Duties With Respect to Special Entities. Heightened business conduct standards will apply in dealings with “special entities” (i.e., governmental entities, ERISA and governmental plans, and endowments).

- A swap dealer and major swap participant acting as an advisor to a special entity will have a duty to act in the best interests of the special entity and must use reasonable efforts to obtain information allowing for a reasonable determination that a recommended swap is in the special entity’s best interests.

- When acting as a counterparty to a special entity, swap dealers and major swap participants must give written disclosure of the capacity in which they are acting and comply with rules established by the CFTC or SEC with regard to the special entity having access to the advice of a qualifying “independent representative” with respect to the transaction. It is not clear whether these rules will apply with respect to all special entities and whether the rules will effectively require that an independent representative be used in all cases.

The heightened duties for dealings with special entities do not apply in transactions executed on an exchange or swap execution facility where the swap dealer or major swap participant does not know the identity of the counterparty.

Swaps “Pushout” Provision

The swaps “pushout” provision originally introduced by Senator Blanche Lincoln seeks to prohibit the use of “federal assistance” – including FDIC insurance and guarantees and certain Federal Reserve programs – in connection with the activities of swap dealers or major swap participants. Following last minute compromises, the final provision allows banking entities to maintain relevant swaps activities so long as they are placed into separate non-bank affiliates. In addition, there are exceptions for insured depository institutions to the extent they are major swap participants (and not swap dealers) and with respect to hedging and risk mitigation activities, for swaps activities involving assets that are permissible for investment by national banks (including interest rate and foreign exchange swaps, but not including many commodities transactions and swaps on equity securities), and for cleared credit defaults swaps. There is uncertainty, however, as to whether and how these exceptions will be applied with respect to uninsured branches and agencies of foreign banks.

Relevant banking entities will need to review the pushout provision in conjunction with the Volcker Rule on proprietary trading. Together these provisions could have a significant impact on these entities’ swaps activities.

Segregation of Collateral

Persons accepting collateral in connection with swaps transactions must be registered with the CFTC or SEC, either as futures commission merchants with respect to swaps or as a broker-dealer or security-based swap dealer with respect to security-based swaps. Collateral for cleared swaps must be treated as belonging to the customer and may not be commingled, except in accounts with bank or trust companies or with a clearing organization and in connection with the application for settlement or margining in the ordinary course.

With respect to non-cleared swaps, swaps dealers and major swap participants must notify their counterparties of the right to require segregation, and segregated collateral must be held with an independent third party custodian. If segregation is not required, the swap dealer or major swap...
participant must report on its back office procedures regarding margin and collateral on a quarterly basis.

Reporting of Swap Transactions and Pricing Data

In another significant change, the CFTC and SEC are called upon to promulgate rules requiring real-time public reporting – as soon as technologically practicable – of transaction data, including price and volume, for swaps that are required to be cleared or which are cleared on a voluntary basis. For transactions that are not cleared, real-time public reporting will be required in a manner that does not disclose the transactions and market positions of any person. Rulemaking is also to identify appropriate criteria for determining what constitutes a block trade, along with an appropriate time delays for their reporting to the public.

Position Limits and Large Trader Reporting

The Act calls upon the CFTC to establish limits on the amount of positions, excluding bona fide hedging transactions, with respect to physical commodities (other than excluded commodities) in order to prevent excessive speculation and manipulation, and to protect the availability of liquidity and the operation of the price discovery function of underlying markets. Position limits are to be aggregated across designated contract markets and foreign boards of trade providing access to participants in the United States. Similarly, in order to prevent fraud and manipulation, the SEC is to establish limits on security-based swap positions, which may be aggregated with positions in underlying securities or loans and other related instruments. Traders that exceed relevant limits must file reports with the CFTC or SEC.

Security-Based Swaps as Securities

The Act adds security-based swaps to the definition of “security” under both the Securities Act and the Exchange Act, thereby subjecting security-based swaps to the full range of the securities laws, in addition to the new requirements introduced by the Act itself. The implications are likely to become fully clear only with time. On some questions, the Act provides special rules:

- **Registration.** Security-based swaps may not be sold or offered to persons who are not eligible contract participants unless a registration statement with respect to the security-based swap is in effect, and such transactions may be effected only on a national securities exchange.\(^8\) The registration requirement applies notwithstanding the availability of an exemption under section 3 or section 4 of the Securities Act.

- **Beneficial Ownership.** For purposes of Exchange Act sections 13 and 16, a person will be deemed to have acquired beneficial ownership of an equity security based on the purchase or sale of a security-based swap only to the extent the SEC has determined that such purchase or sale provides incidents of ownership comparable to direct ownership.

- **Security-Based Swap Agreements.** The Act defines “security-based swap agreements” as swaps based on a broad-based group or index of securities. Security-based swaps agreements generally are swaps (and subject to CFTC regulation), but the Act also subjects them to antimanipulation, antifraud, and certain other rules under the securities laws.

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\(^8\) The Act also raises the requirements for qualification as an eligible contract participant. Governmental entities will be required to own or invest at least $50 million (up from the current requirement of $25 million) on a discretionary basis in order to qualify. Individuals must hold discretionary investments (rather than total assets) of $10 million (or $5 million for risk management transactions) in order to be eligible.
FERC, CFTC, and State Jurisdiction

The Act expressly preserves FERC and state regulatory authority over transactions subject to FERC or state approved tariff or rate schedules that are not executed or cleared on a registered entity or trading facility or that are executed or cleared on a registered entity or trading facility owned or operated by a regional transmission organization or independent system operator.

It also preserves the CFTC’s statutory authority over transactions entered into pursuant to FERC or state approved tariff or rate schedules, and preserves the CFTC’s jurisdiction over transactions that are executed or cleared on a registered entity or trading facility not owned or operated by a regional transmission organization or independent system operator. The CFTC may also exempt certain transactions from regulation where overlap occurs with FERC or state regulatory authorities, if the CFTC finds that such exemption would be in the public interest.

International Aspects

The Act provides that the provisions regarding swaps will not apply to activities outside the United States unless those activities have a direct and significant connection with activities in, or an effect on, U.S. commerce or contravene rules promulgated by the CFTC to prevent evasion. With respect to security-based swaps, the Act provides that it shall not apply with respect transactions outside U.S. jurisdiction, unless a transaction contravenes rules promulgated by the SEC to prevent evasion.

Overall, these general provisions leave many questions unanswered. For example, there is no provision similar to Exchange Act Rule 15a-6 regarding swap-related activities that foreign entities may undertake with respect to U.S. customers without registration in the U.S. as a swap dealer or major swap participant. This is another area where the CFTC and SEC likely will be pressed to provide guidance.

The Act calls upon the CFTC and SEC to conduct a joint study of the regulation of swaps and clearing agencies in the U.S., Asia and Europe and report to Congress in 18 months. If at any time the CFTC or SEC determines that the regulation of swaps in a foreign country undermines the stability of the U.S. financial system, it may, in consultation with the Treasury Secretary, prohibit entities domiciled in that country from participating in swaps-related activities in the United States.

Transitional Rules

The provisions of the Act generally are to become effective on the later of (i) 360 days after the date of enactment or (ii) to the extent a provision requires a rulemaking, not less than 60 days after publication of the final rule.

If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act subjects many financial institutions to an expanded framework of regulatory oversight that is likely to require those institutions to change the way that they operate. In particular, Section 619 of the Act imposes limitations on proprietary trading and fund sponsorship and investment activities by certain banking entities and nonbank financial companies. Section 619, which is based on proposals first advanced by Former Chairman of the Federal Reserve Paul Volcker, is commonly referred to as the “Volcker Rule.”

As described in more detail below, subject to certain exceptions, the Volcker Rule amends the Bank Holding Company Act of 1956 to prohibit banks and other banking entities from engaging in proprietary trading and from sponsoring or investing in private equity or hedge funds. The Volcker Rule also prohibits banks and other banking entities from extending credit to, or engaging in other covered transactions with, private equity or hedge funds that they advise, manage, sponsor, or organize. Any transactions between a banking entity and any such fund that are not prohibited must be entered into on arms-length market terms. Finally, the Volcker Rule tasks the Federal Reserve Board with imposing additional capital and quantitative limits on systemically important nonbank financial companies that engage in proprietary trading or that sponsor or invest in private equity or hedge funds.

The Volcker Rule does not take immediate effect. Rather, the new Financial Stability Oversight Council established by Section 111 of the Act (the FSOC) is directed first to complete a study of the Volcker Rule that includes recommendations for its implementation. The FSOC must complete the study within six months of the Act’s enactment. Within nine months of completion of the study, the appropriate federal banking agencies, the SEC, the CFTC, and the Federal Reserve Board are required to issue final rules implementing the Volcker Rule. The provisions of the Volcker Rule take effect on the earlier of (i) 12 months following the date final rules are issued, and (ii) two years after the Act’s enactment. Covered entities generally have two years to bring their activities and investments into compliance, subject to the availability of up to three one-year extensions or, in the case of certain investments in illiquid funds, one extension of up to five years.

Prohibition on Proprietary Trading

Subject to the exemptions described below under “Exemptions from Prohibitions on Proprietary Trading and Sponsoring or Investing in Private Equity or Hedge Funds,” the Act amends the Bank Holding Company Act to expressly prohibit proprietary trading by banks and other covered entities.

- **What Kind of Entities Are Subject to the Prohibition?**
  - Any “banking entity”, which is defined as any insured depository institution, any company that controls an insured depository institution or 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. Certain institutions that function solely in a trust or fiduciary capacity and
accept deposits on a limited basis are expressly exempted from the definition of “banking entity.”

- **What Is Proprietary Trading?**
  - With respect to a particular institution, engaging as a principal for the “trading account” of that institution in any transaction to purchase or sell, or otherwise acquire or dispose of, (i) any security, derivative, or contract of sale of a commodity for future delivery, (ii) any option on any of the foregoing, and (iii) any other security or financial instrument as the applicable regulators may determine.
  - The “trading account” of an institution is defined as (i) any account used to acquire or take positions in securities or financial instruments principally for the purpose of selling in the near-term or otherwise with the intent to resell in order to profit from short-term price movements, and (ii) any other account as the applicable regulators may determine.

**Prohibition on Sponsoring or Investing in Private Equity or Hedge Funds**

Subject to the exemptions described below under “Exemptions from Prohibitions on Proprietary Trading and Sponsoring or Investing in Private Equity or Hedge Funds,” the Act amends the Bank Holding Company Act to expressly prohibit banks and other covered entities from sponsoring, or from acquiring or retaining any equity, partnership, or other ownership interest in, a private equity or hedge fund.

- **What Kind of Entities Are Subject to the Prohibition?**
  - Any banking entity, as defined above with respect to the prohibition on proprietary trading.

- **What Is a “Hedge Fund* or “Private Equity Fund” for Purposes of the Prohibition?**
  - A “hedge fund” or “private equity fund” is (i) any issuer that would be an investment company but for the exemptions provided by section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, and (ii) any similar fund as the applicable regulators may determine.
  - Section 3(c)(1) of the Investment Company Act of 1940 is available to funds owned by 100 or fewer investors. Section 3(c)(7) is available to funds owned solely by “qualified purchasers.”
  - This definition is broad enough to pick up venture capital funds as well as more traditional private equity and hedge funds.

- **What Does it Mean to “Sponsor” a Private Equity or Hedge Fund?**
  - To “sponsor” a fund means:
    - serving as a general partner, managing member, or trustee of the fund;
    - in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of a fund; or
    - sharing with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

**Exemptions from Prohibitions on Proprietary Trading and Sponsoring or Investing in Private Equity or Hedge Funds**

- **Permitted Activities.** Subject to the blanket limitations described below and to any further limitations imposed by the applicable regulators, the following activities are expressly exempted
from the prohibitions on proprietary trading and sponsoring or investing in private equity or hedge funds.

- **Exemption for Sponsorship of and Investment in Funds Offered in Connection with an Investment Advisory Business.**
  - A banking entity is permitted to organize and offer a private equity or hedge fund, and may serve as sponsor to such a fund, if (i) the banking entity provides [*bona fide*](https://en.wikipedia.org/wiki/Bona_fide) trust, fiduciary, or investment advisory services as part of its business, (ii) the fund is organized and offered only in connection with such services and only to customers of such services, (iii) the banking entity does not guarantee or otherwise assume or insure the obligations or performance of the fund, (iv) the banking entity does not share the same name, or variation of the same name, with the fund, (v) no director or employee of the banking entity has an ownership interest in the fund unless he or she is directly engaged in providing services to the fund, and (vi) certain other conditions are met.
  - A banking entity may also make or retain an ownership interest in a private equity or hedge fund that it organizes and offers, provided that any such ownership interest is either (i) a seed capital investment made in order to establish the fund and attract unaffiliated investors, or (ii) a [*de minimis*](https://en.wikipedia.org/wiki/De_minimis) investment.
  - Within one year of establishing a fund, the banking entity’s ownership interest in the fund must represent no more than three percent of the fund’s total ownership. The banking entity must actively seek unaffiliated investors to dilute its investment in the fund to such level. The Federal Reserve Board may extend the one-year period for an additional two years under certain circumstances.
  - The banking entity’s investment in any private equity or hedge fund must be “immaterial” to the banking entity, as defined by the applicable regulators, and in any event the aggregate amount of all such investments may not exceed three percent of its Tier 1 capital.

- **Underwriting and Market-Making Activities.** Purchases, sales, acquisitions, or dispositions of securities and other instruments in connection with underwriting or market-making-related activities, to the extent such activities are designed not to exceed the reasonably-expected near-term demands of clients, customers, or counterparties are permitted.

- **Risk-Mitigating Hedging Activities.** Hedging activities that are designed to reduce specific risks to the banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings of such entity are permitted.

- **Customer-Driven Investments.** Purchases, sales, acquisitions, or dispositions of securities and other instruments on behalf of customers are permitted.

- **Activities Outside of the United States.**
  - Proprietary trading conducted solely outside of the United States by a banking entity pursuant to paragraph 9 or paragraph 13 of Section 4(c) of the Bank Holding Company Act is permitted, provided that the banking entity is not controlled directly or indirectly by a banking entity that is organized under the law of the United States or one or more States.\(^1\)

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\(^1\) Paragraph 9 of Section 4(c) is available to foreign companies the greater part of whose business is conducted outside of the United States, while paragraph 13 of Section 4(c) is available to foreign companies that do no business in the United States except as an incident to their international or foreign business.
The acquisition or retention of any equity, partnership, or other ownership interest in, or sponsorship of, a private equity or hedge fund by a banking entity solely outside of the United States pursuant to paragraph 9 or paragraph 13 of Section 4(c) of the Banking Holding Company Act is permitted, provided that (i) no ownership interest in such fund is offered for sale or sold to a resident of the United States, and (ii) the banking entity is not controlled directly or indirectly by a banking entity that is organized under the law of the United States or one or more States.

Investments in Government and Government-Related Obligations. Permitted activities include purchases, sales, acquisitions, or dispositions of obligations issued by (i) the United States or any agency of the United States, (ii) Ginnie Mae, Fannie Mae, Freddie Mac, any Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or any Farm Credit System institution, or (iii) any State or political subdivision of a State.

Investments by Insurance Companies and Their Affiliates. Purchases, sales, acquisitions, or dispositions of securities and other instruments by a regulated insurance company, or any affiliate of a regulated insurance company, for the general account of such regulated insurance company are generally permitted, subject to certain conditions.

Public Policy Exemptions. Permitted activities include investments in small business investment companies (as defined in section 103 of the Small Business Investment Act of 1958), investments designed to promote the public welfare as provided in 12 U.S.C. § 24(11), and certain investments related to tax-qualified rehabilitated building or certified historic structure projects.

Blanket Limitations. None of the permitted activities described above are permitted if the activity:

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

Treatment of Certain Securitization Activities. The Act also specifically provides that nothing in the Volcker Rule should be construed as limiting or restricting the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law.

Limitations on Transactions and Other Relationships with Private Equity and Hedge Funds

The Act also imposes limitations on relationships and transactions between banks and other covered entities, on the one hand, and certain related private equity and hedge funds, on the other hand.

What Kind of Entities Are Subject to the Limitations?
- Any banking entity, as defined above with respect to the prohibition on proprietary trading.

What Is a “Hedge Fund” or “Private Equity Fund” for Purposes of the Limitations?
- “Hedge fund” and “private equity fund” are defined as described above with respect to the prohibition on sponsoring or investing in such funds.
What Are the Limitations?

- No banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a private equity or hedge fund, or that organizes and offers a private equity or hedge fund, and no affiliate of any such banking entity, may enter into a “covered transaction” with any such fund or with any private equity or hedge fund controlled by any such fund.

  - “Covered transaction” is defined by section 23A of the Federal Reserve Act and includes, among other things, (i) any loan or extension of credit to the fund, (ii) any purchase of or investment in securities issued by the fund, (iii) the issuance of a guarantee, acceptance, or letter of credit on behalf of the fund, and (iv) any derivatives transaction or transaction that involves the borrowing or lending of securities, in either case to the extent that the transaction causes the covered entity to have credit exposure to the fund.

  - The Federal Reserve Board may permit a banking entity to enter into prime brokerage transactions with a private equity or hedge fund in which a private equity or hedge fund managed, advised, or sponsored by such banking entity has taken an ownership interest, provided that the Federal Reserve Board concludes that such transactions are consistent with the safe and sound operation and condition of the banking entity and certain other conditions are met.

  - Any other transactions between a banking entity and any private equity or hedge fund for which it serves as investment manager, investment adviser, or sponsor, or that it has organized and offered, must be on arms’ length market terms, consistent with the requirements of section 23B of the Federal Reserve Act.

Propriety Trading and Sponsorship and Investment Limitations Applicable to Certain Nonbank Financial Companies

The Act amends the Federal Bank Holding Company Act to direct the Federal Reserve Board to impose additional capital and quantitative limits on systemically important nonbank financial companies that engage in proprietary trading or sponsor or invest in private equity or hedge funds.

What Kind of Entities and Activities are Subject to the Limitations?

- Nonbank financial companies that have been designated for prudential regulation by the Federal Reserve Board under Section 113 of the Act and that engage in proprietary trading or sponsor, or acquire or retain an equity, partnership, or other ownership interest in, any private equity or hedge fund, in each case as those concepts are applied to banking entities in the prohibitions described above.2

What Exemptions Apply?

- Nonbank financial companies are not subject to any additional capital or quantitative limits with respect to activities described above under “Exemptions from Prohibitions on Proprietary Trading and Sponsoring or Investing in Private Equity or Hedge Funds,” provided the activities comply with the blanket limitations described in that section.

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2 The Act authorizes the FSOC to subject nonbank financial companies that the FSOC determines are systemically important to regulation and supervision by the Federal Reserve Board. A nonbank financial company is generally defined as a company, other than a bank holding company, that is predominantly engaged in financial activities.
Anti-Evasion Provisions

- The Volcker Rule provides the applicable regulators with the authority to order a banking entity or a nonbank financial company to terminate any activity or dispose of any investment that the regulator has reasonable cause to believe functions as an evasion of the requirements of the Volcker Rule.

- The applicable regulators are also directed to issue rules requiring internal controls and recordkeeping to insure compliance with the provisions of the Volcker Rule.

Study, Rule-Making Process, and Effective Date

- **FSOC Study.** The FSOC is required to complete a study of the Volcker Rule within six months of the Act’s enactment. The study must include recommendations for implementing the Volcker Rule in order to achieve certain enumerated purposes. These purposes include, among other things, to protect taxpayers and consumers and enhance financial stability, limit the inappropriate transfer of federal subsidies to unregulated entities, reduce conflicts of interest, and limit activities that have previously caused undue risk or loss in banking entities and certain nonbank financial companies.

- **Rule-Making Process.** No later than nine months after the date that the FSOC completes its study, the appropriate federal banking agencies, the SEC, the CFTC, and the Federal Reserve Board must adopt rules carrying out the Volcker Rule. The regulators are required to consult and coordinate with one another to assure that the final rules are comparable and consistent. Rule-making authority is allocated among the regulators as follows:
  - with respect to insured depository institutions, jointly to the appropriate federal banking agencies;
  - with respect to any entity for which the CFTC is the primary financial regulator under the Act, to the CFTC;
  - with respect to any entity for which the SEC is the primary financial regulator under the Act, to the SEC; and
  - with respect to any other entity, to the Federal Reserve Board.

- **Effective Date.** The provisions of the Volcker Rule take effect on the earlier of (i) 12 months after the date of the issuance of final rules by the regulators, and (ii) two years after the Act’s enactment.

- **Transition Period.** A banking entity or nonbank financial company generally has two years from the date on which the Volcker Rule provisions take effect to bring its activities and investments into compliance. The regulators may impose additional capital and other requirements during the transition period.
  - **Generally-Available Extensions.** The Federal Reserve Board may, by rule or order, extend the two-year period for not more than one year at a time and up to an aggregate of three years if it determines that such an extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest.
  - **Extensions for Investments in Illiquid Funds.** The Federal Reserve Board may also extend the transition period to permit a banking entity to take or retain its equity, partnership, or other ownership interest in, or otherwise provide additional capital to, an “illiquid fund”, provided the extension is necessary in order for the banking entity to fulfill a contractual obligation that was in effect on May 1, 2010. Any such extension must be limited to no more than five years.
An “illiquid fund” is a hedge fund or private equity fund that (i) as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets such as portfolio companies, real estate investments, and venture capital investments, and (ii) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

**Rule-Making with Respect to Transition Periods.** The Act requires the Federal Reserve Board to issues rules implementing the transition-period provisions of the Volcker Rule no later than six months after the Act’s enactment.

If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act includes a number of provisions aimed at greater shareholder and regulatory oversight of executive compensation. Among other things, the Act gives shareholders of public companies a “say-on-pay” vote on the compensation of their companies’ executives and enhances the power of regulators to restrict executive compensation at a variety of financial firms. The Act also includes provisions that will affect corporate governance practices at many public companies.

Many of the changes described in this advisory will be implemented through SEC rulemaking and revisions to listing standards by national securities exchanges. Annex A provides a summary of the various rulemakings and applicable deadlines, if any, under the Act.

Key Executive Compensation and Corporate Governance Provisions

- Requires public companies to provide their shareholders a non-binding vote on the compensation of their executives and on “golden parachute” severance arrangements.
- Confirms SEC’s authority to adopt rules requiring public companies to include director nominees submitted by shareholders in the company’s proxy materials.
- Strengthens standards relating to independence of listed public companies’ compensation committees and advisers to such committees.
- Requires listed companies to adopt policies requiring recovery of compensation paid to executives when it is later shown that the compensation was based on erroneous financial results (“claw backs”).
- Mandates disclosure by public companies of median annual total compensation of all employees and CEO’s annual total compensation.
- Expands authority of federal regulators to regulate incentive-based compensation at a wide variety of financial firms.

Shareholder Votes on Executive Compensation

The Act requires public companies to provide their shareholders periodically with a non-binding vote (“say-on-pay”) on the compensation of their executives, as well as on “golden parachute” severance arrangements in connection with mergers and other similar transactions.

Periodic Vote on Overall Compensation of Executives

The Act gives shareholders of public companies an opportunity to express, in a non-binding vote, their views on the compensation paid to the company’s executives. Specifically, public companies will now be required to provide their shareholders, at least once every three years, with a non-binding
vote on the compensation of their executives at a meeting of shareholders for which the SEC’s proxy solicitation rules require the inclusion of compensation disclosure. The vote will be based on the compensation paid to the company’s “named executive officers” as disclosed under Item 402 of Regulation S-K, which includes the compensation committee report, compensation discussion and analysis, compensation tables and related disclosures. While it is expected that most companies will hold such votes as part of a regular annual meeting, the Act permits such votes to be held at special meetings for which compensation disclosures are required in the proxy materials.

The new advisory shareholder vote on executive compensation will first be required at the first shareholder meeting occurring after the six-month anniversary of the Act’s enactment, which likely means the new requirement will be in place for the 2011 spring proxy season. At that meeting, in addition to providing shareholders with an advisory vote on the compensation of executives, companies must also ask shareholders to cast a non-binding vote on whether the company should hold shareholder advisory votes on executive compensation every year or every two or three years. Subject to any direction the SEC may provide on this subject, companies could, in their soliciting material for such proposals, express a preference for an annual, biennial or triennial approach and explain their rationale for recommending that their shareholders vote for a particular approach. Companies with multi-year incentive compensation plans may be better positioned to recommend a biennial or triennial say-on-pay vote than those with only annual incentive plans.

The Act states that both of the shareholder votes, i.e., on executive compensation and on the frequency of its consideration by shareholders, are not binding on the company or its board of directors and may not be construed as overruling any decision of the company or its board of directors. Further, these shareholder votes may not be construed to create or imply any change to the fiduciary duties, or to create or imply any additional fiduciary duties, of the company or its board of directors. The legislation also states that the shareholder votes may not be construed to restrict or limit the ability of shareholders to make proposals related to executive compensation for inclusion in the company’s proxy materials.

The Act’s say-on-pay provisions are self-executing and do not, by their terms, require the SEC to adopt any implementing rules. It would not be surprising, however, for the SEC to adopt rules addressing this new requirement, especially in light of the SEC’s rules implementing the requirement under the Emergency Economic Stabilization Act of 2008 for recipients of financial assistance under the Troubled Asset Relief Program to provide their shareholders with a non-binding say-on-pay vote. Among other things, the SEC may wish to clarify, through rulemaking or interpretation, whether a company’s inclusion of a say-on-pay proposal triggers the need to file a preliminary proxy statement and any disclosure that should accompany such proposal. The Act also authorizes the SEC to exempt an issuer or class of issuers from the say-on-pay shareholder vote requirements, and specifically mentions the potentially disproportionate burden of the requirement on small companies.

1 The “named executive officers” are the company’s principal executive officer, principal financial officer, and the three other most highly paid executive officers during the most recent fiscal year. Although Rep. Barney Frank at one point suggested broadening the say-on-pay vote to cover compensation paid to a larger group of employees, this idea did not make it into the legislation. See Press Release, “Frank Announces Hearing on Compensation,” House Committee on Financial Services, Jan. 13, 2010.

2 Thereafter, shareholders must be asked at least once every six years whether they wish to have an annual, biennial or triennial advisory vote on executive compensation.

3 See Rel. No. 34-61335 (Jan. 12, 2010).
Vote on Golden Parachutes

Public companies will also be required, in connection with proxy or consent solicitations relating to merger, acquisition or similar transactions, to provide their shareholders with specific disclosures about, and a separate non-binding vote on, any “golden parachute” compensation arrangements. These include any agreements or understandings with any named executive officers of the company (or the acquiring company) concerning any type of compensation (whether present, deferred or contingent) that is based on or related to the merger or acquisition transaction. The disclosure regarding golden parachute arrangements will have to be provided in clear and simple form under rules to be promulgated by the SEC.

The new advisory shareholder vote on golden parachutes, as well as the new proxy disclosures regarding such arrangements, will first be required in connection with any shareholder meeting called to vote on a merger, acquisition or similar transaction occurring after the six-month anniversary of the Act’s enactment. The SEC must adopt rules specifying the required disclosures about golden parachutes within the same time frame.

If the company’s golden parachute arrangements have previously been subject to a vote of shareholders as part of the periodic shareholder vote on executive compensation as described above, no separate shareholder vote on the golden parachute arrangements is required in connection with a shareholder vote on the merger or acquisition transaction. Like the annual say-on-pay vote on executive compensation described above, the shareholder vote on golden parachute arrangements will not be binding on the company or its board of directors and may not be construed as overruling any decision of the company or its board of directors. In this regard, shareholder approval of a merger agreement should not be affected by a negative shareholder advisory vote on the golden parachute arrangements for the company’s executives at the same meeting.

Shareholder Access To the Proxy

The Act implements a number of new corporate governance-related provisions that will give shareholders the opportunity to have greater influence over their company’s affairs. Most significantly, the Act amends Section 14 of the Securities Exchange Act of 1934 (the Exchange Act) to make it clear that the SEC has authority to adopt rules requiring public companies to include board nominees submitted by shareholders in the company’s proxy materials. The Act also explicitly permits the SEC to exempt smaller public companies from any such shareholder access rules. The SEC, of course, already has a pending rule proposal to give shareholders the opportunity to nominate directors in their company’s proxy materials. Under the SEC’s proposal, a shareholder meeting specified ownership thresholds (1% for a large accelerated filer, 3% for an accelerated filer, 5% for all others) would be entitled to require the company to include its nominee(s) in the company’s proxy materials.

4 It should be noted that the Senate-approved financial regulatory reform bill would have called for even greater insertion by the federal government into the internal governance of corporations. The Senate bill would have required all listed companies to adopt a majority voting standard in uncontested elections of directors. This provision was dropped during the conference negotiations.

5 During the House-Senate conference process, a number of proposals were made by Senate conferees that would have required the SEC’s rules to limit the proxy access right to shareholders owning a specified amount of a company’s shares and/or for a specified period of time. After lengthy deliberations, these proposals were ultimately dropped. It will be interesting to see if this debate influences in any way the SEC’s current rulemaking in this area. See f.n. 6 below.

materials, as long as the shareholder has the right to nominate directors under applicable state law and the company’s governing documents. Such shareholders would be entitled to nominate the greater of one nominee or 25% of the number of board seats up for election.

Role of the Compensation Committee

The Act strengthens the independence and authority of Board compensation committees, presumably in an effort to enhance Board oversight of executive compensation. Specifically, companies with securities listed on national securities exchanges or national securities associations will be subject to new required listing standards that their compensation committees be comprised entirely of independent directors.7 In defining the term “independence” for purposes of these listing standards, the national securities exchanges must consider relevant factors, including (i) the source of compensation of a member of the board of directors, including any consulting, advisory, or other compensatory fee paid by the company to such director, and (ii) whether a director is affiliated with the company, a subsidiary, or an affiliate of a subsidiary.8 The securities exchanges would have the authority to exempt a particular relationship from the independence requirements, taking into account the size of a company and any other relevant factors.

The Act encourages compensation committees to use outside consultants and advisers that are independent, presumably on the basis that consultants will give better advice about compensating the company’s executives if they are not unduly beholden to the same executives as a result of providing other services to the company. Through the required new listing standards, the Act confirms that the compensation committee has the authority, in its sole discretion, to appoint, compensate and oversee the work of compensation consultants, independent legal counsel and other advisors. Although the Act does not mandate, per se, the use of independent consultants, compensation committees will be required to consider a number of specific factors, to be identified by the SEC through rulemaking, before selecting a compensation consultant, legal counsel, or other adviser to the committee. The factors to be identified by the SEC would be factors that might affect the independence of a compensation consultant, legal counsel or other adviser, including providing services to the company outside the mandate of the compensation committee.9

The new listing standards relating to compensation committees will not apply to “controlled companies,” which are listed companies of which more than 50 percent of the outstanding voting power is held by an individual, a group, or another issuer of securities. In addition, the Act provides authority for national securities exchanges to exempt a category of issuers from the requirements of the new listing standards, particularly taking into account the potential impact of such requirements on smaller reporting companies.

Although the Act makes clear that compensation committees have the authority to retain independent legal counsel, the Act does not specifically require that compensation committees use

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7 The New York Stock Exchange and the NASDAQ Stock Market already require that compensation committees of public companies be comprised entirely of directors who are independent under the respective independence criteria of these exchanges.

8 This is, effectively, a corollary to Section 10A of the Exchange Act, which sets independence requirements for members of audit committees of listed public companies and was added to the Exchange Act by the Sarbanes-Oxley Act of 2002.

9 The Act states that the factors to be promulgated by the SEC must be competitively neutral among categories of consultants, legal counsel and other advisers and must preserve the ability of compensation committees to retain the services of members of any such category.
only independent legal counsel. However, the committee’s decision to retain legal counsel must be considered in light of the “independence” factors identified by the SEC, which in turn will, undoubtedly, create a strong presumption that counsel retained by the compensation committee should be independent. Whether a particular relationship or the provision of particular services to the company precludes legal counsel from being deemed independent for purposes of serving the compensation committee will raise a range of challenging issues for the SEC to sort out in the implementing rules. Finally, nothing in the Act appears to prohibit the compensation committee from receiving advice from counsel retained by the company if it so chooses.

Recovery of Erroneously Awarded Compensation

Although many public companies have already voluntarily implemented so-called “claw back” policies addressing the recovery of compensation when it is later shown that the compensation was based on erroneous financial results, the Act will require all listed companies to adopt such a policy. Specifically, companies with securities listed on national securities exchanges or national securities associations will be subject to required new listing standards requiring them to implement “claw back” policies.

Under this requirement, the company’s claw back policy must provide that, if the company is required to restate its financial statements due to the company’s material noncompliance with any financial reporting requirement, the company will recover from any current or former executive officer who received incentive-based compensation during the three-year period preceding the date of the restatement, based on the erroneous data, in excess of what would have been paid to the officer under the restatement. Companies must also disclose their policy on incentive-based compensation that is based on financial performance required to be reported under the securities laws.

The scope of the claw back policy required to be adopted by listed companies is broader than the scope of the SEC’s recovery authority under Section 304 of the Sarbanes-Oxley Act of 2002. In that sense, the claw back provisions of the Act represent an effort to encourage companies to police themselves and thereby augment the SEC’s efforts. Section 304 of Sarbanes-Oxley, for instance, only permits the recovery of compensation in circumstances where there has been “misconduct” (versus “material noncompliance” in the Act), which has limited the utility of Section 304. Further, Section 304 of Sarbanes-Oxley may only be used to recover compensation from a company’s chief executive officer or chief financial officer, whereas the Act’s claw back provision would permit recovery from any current or former executive officer.

New Required Compensation and Governance Disclosures

The Act includes a number of new compensation and governance disclosure requirements.

Comparison of Employee Median Compensation and CEO Compensation

The Act requires the SEC to adopt a rule requiring companies to disclose, in a variety of filings with the SEC, (i) the median of annual total compensation of all employees of the company other than the CEO, (ii) the CEO’s annual total compensation, and (iii) the ratio of the amounts shown in clauses (i) and (ii). According to the Act, this information would be required to be shown in registration statements filed under the Securities Act of 1933 or Exchange Act, annual and other (quarterly)
reports under Sections 13 and 15(d) of the Exchange Act, going-private transaction statements, tender offer statements and proxy and information statements.

**Relationship Between Compensation and Performance**

The Act requires public companies to provide in their annual proxy statements, in accordance with rules to be adopted by the SEC, a clear description of any compensation required to be disclosed under Item 402 of Regulation S-K, including information showing the relationship between compensation paid and the company’s financial performance, taking into account any change in the value of the company’s stock and dividends and distributions. The information called for by this provision may be included by means of a graphic representation. This new statutory requirement arguably already has been addressed by the SEC through, for example, the Compensation Discussion and Analysis disclosure requirement and the various tabular disclosures called for by Item 402 of Regulation S-K. The one new area of disclosure that likely will flow from this provision will involve the relationship of executive pay to financial performance, almost certainly to be the subject of a detailed, and perhaps controversial, SEC rulemaking.

**Additional Disclosures About Use of Compensation Consultants**

Companies will be required to disclose in their annual proxy statements (beginning one year after the date of the Act’s adoption) whether the compensation committee retained or obtained the advice of a compensation consultant, and whether the consultant’s work has raised any conflict of interest. If any such conflict of interest arose, the company must disclose the nature of the conflict and how it is being addressed. This disclosure requirement will be implemented through rules to be adopted by the SEC within one year of the enactment of the Act.

**Disclosure of Institutional Investment Managers’ Say-on-Pay Votes**

The Act requires institutional investment managers subject to Section 13(f) of the Exchange Act to report, at least annually, how they voted on any shareholder votes on executive compensation or golden parachute arrangements. This new disclosure requirement goes beyond the very limited information currently required to be disclosed by institutional investment managers regarding the securities they hold. The practical effect of this new requirement is likely to be somewhat muted by virtue of the new reports presumably being required to be filed sometime after a shareholder meeting, not beforehand.

**Chairman and CEO Leadership Structures**

The Act requires the SEC to adopt rules requiring public companies to disclose in their annual proxy statements the reasons why the company has chosen either (i) the same person to serve as chairman of the board of directors and chief executive officer, or (ii) different individuals to serve in those positions. The SEC recently adopted a rule calling for substantially the same disclosure, so it will be interesting to see if this provision of the Act prompts further requirements in this area.12

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11 Section 13(f) of the Exchange Act applies to institutional investment managers that exercise investment discretion with respect to accounts holding equity securities registered under Section 12 of the Exchange Act having an aggregate fair market value of at least $100 million. These institutional investment managers must file quarterly reports on Form 13F with the SEC to report basic data about the securities they hold.

12 See Item 407(h) of Regulation S-K.
Disclosure of Employee and Director Hedging

The Act requires public companies to disclose in their annual proxy statements, in accordance with rules to be adopted by the SEC, whether employees or directors are permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) designed to hedge or offset any decrease in the market value of the company’s equity securities, whether such securities are granted to the employee or director as part of such person’s compensation or held by such employee or director. Although some companies have already addressed this issue in a company policy, at least with respect to executives and directors, all public companies will need to follow subsequent SEC rulemaking to assess adopting new or amending current policies to address the issue.

Broker Voting

The Act requires national securities exchanges to amend their rules to prohibit members of the exchange (i.e., brokers) from granting a proxy to vote shares on specified proposals unless the beneficial owner of the shares has given the broker instructions on how to vote. The proposals covered by this prohibition include elections of directors, executive compensation proposals (presumably including any say-on-pay vote on the company’s executive compensation), or any other “significant matter” as determined by the SEC through rulemaking. This provision of the Act will make it harder for management proposals on executive compensation (and other “significant matters” as determined by the SEC) to prevail, since brokers will not be able to vote shares held in street name unless the beneficial owner has given the broker instructions on how to vote.13

New Powers to Regulate Compensation at Many Financial Firms

The Act contains two separate provisions giving federal banking regulators and the SEC new powers to regulate compensation arrangements at a wide variety of financial firms.

Regulation of Incentive-Based Compensation Arrangements

Section 956 of the Act gives new authority to federal banking regulators and the SEC to examine, and impose restrictions on, incentive-based compensation arrangements at a range of financial firms. Under this provision, a “covered financial institution” will be required to disclose to the appropriate regulator the structures of all incentive-based compensation arrangements to enable the regulator to determine whether such structures (i) provide any executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits, or (ii) could lead to material financial loss to the institution.

More significantly, the Act requires the federal regulators jointly to issue rules or guidelines prohibiting any such incentive-based arrangement, or any feature of such arrangement, that the regulators determine encourage inappropriate risks by covered financial institutions by providing any executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits, or that could lead to material financial loss to the institution. It is important to note that this authority is not limited to compensation arrangements for executives, which has historically been the focus of the SEC’s disclosure rules. Rather, this new authority covers incentive-based arrangements that extend to all employees, as well as incentive-based arrangements with principal shareholders.

13 In 2009, the NYSE’s Rule 452 was amended to eliminate broker discretionary voting in elections of directors (except for registered investment companies).
This authority to examine and restrict incentive-based compensation applies to any “covered financial institution,” a term which includes banks, thrifts and their holding companies, as well as credit unions, registered broker-dealers, investment advisers (including those not registered with the SEC), Fannie Mae, Freddie Mac and “any other financial institution” that the federal regulators jointly determine should be treated as such. However, any institution with assets below $1 billion is excluded.

In determining whether incentive-based compensation arrangements encourage inappropriate risks, the federal regulators are instructed to follow standards comparable to the standards established under the Federal Deposit Insurance Act for insured depository institutions. These standards deem compensation to be excessive if the amounts paid are unreasonable or disproportionate to the services performed, in light of a number of specific factors including, among other things, the combined value of all cash and non-cash benefits provided, the compensation history of the individual and other individuals with comparable expertise at the institution, the financial condition of the institution, and comparable compensation practices at comparable institutions.

Compensation Schemes of Brokers, Dealers and Investment Advisers

Section 913 of the Act authorizes the SEC to examine, and where appropriate, issue rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the SEC deems contrary to the public interest and the protection of investors. On its face, this broad language seems to give authority to the SEC to regulate both the arrangements by which clients compensate their brokers, dealers and investment advisers, as well as the internal compensation arrangements for such entities’ executives and/or employees. While the impetus for this provision might have been a concern about full disclosure of fees charged to retail brokerage clients, the broad sweep of the language would potentially allow the SEC to impose restrictions on contractual arrangements by which private equity and hedge fund managers are compensated in their roles as investment advisers.

Key Issues for Rulemaking Phase

The Act leaves many important issues to be fleshed out in rulemaking proceedings at the SEC and listing standard modification proceedings by national securities exchanges. Among the key issues for the rulemaking phase are the following:

- The further evolution of the SEC’s pending rule proposal addressing shareholder access to the proxy.
- Procedural and/or disclosure requirements pertaining to the new say-on-pay requirements, including the content of new disclosures regarding golden parachute arrangements.
- Factors relating to the independence of compensation consultants, legal counsel and other advisers to compensation committees, which factors are to be considered by the compensation committee before retaining such advisers.
- The scope of additional disclosure requirements showing the relationship between compensation paid and the company’s financial performance, as well as regarding the CEO’s compensation as it relates to median compensation for all employees.
The scope of any other “significant matters” as to which brokers may not vote shares held in street name without instructions from the beneficial owners of such shares and how this change may affect other proxy system enhancements the SEC may initiate.14

The scope of any SEC rules restricting compensation arrangements at brokers, dealers and investment advisers.

What You Can Do

Public companies potentially affected by the Act may want to consider taking a number of steps, including:

- Keeping abreast of key developments in the rulemaking phase in the ensuing months so that they can fully understand the implications of proposed rules for their businesses and evaluate what efforts, if any, are being made by other firms/industry groups to participate in, and possibly shape, the rulemaking process.

- Developing realistic strategies to respond to the proposed rules — and ensuring that such strategies are effectively implemented. This would include considering how most effectively to communicate firm and industry views on proposed rules to SEC commissioners, the federal banking regulators and their respective staffs (for example, individually, through ad hoc groups or through trade associations).

- Separately, developing compliance action plans for expected new rules, including internal training and education, and, where appropriate, briefing of senior officers and relevant board members.

- Mapping out possible amendments to the charters of the Board’s compensation and/or nominating committees to address new requirements under the Act and impending SEC rules.

If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

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14 The SEC voted on July 14, 2010 to issue a concept release on the mechanics of proxy voting and related issues, sometimes referred to as the “proxy plumbing” project. See Rel. No. 34-62495 (Jul. 14, 2010).
### Agency Rulemakings

**Executive Compensation and Corporate Governance**

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act imposes new restrictions and an expanded framework of regulatory oversight for many financial institutions, not just banks.

The Act will subject advisers to private equity and hedge funds to new regulation and oversight. This advisory describes new SEC registration and reporting requirements for private fund advisers. Because of their potential relevance, the advisory also addresses the possibility of Federal Reserve supervision of private funds, new restrictions on banks’ ability to invest in and sponsor hedge funds and private equity funds, the ability of federal regulators to restrict certain compensation arrangements at a wide variety of financial firms, and the potential new requirement for annual stress tests.

The new SEC registration and reporting requirements described below will be effective one year after the date of the Act’s enactment.

Key Highlights of the Act for Advisers to Private Investment Funds

- Creates a new category of investment fund called a private fund — any fund that would be required to register under the Investment Company Act of 1940 but for the exemptions provided by Sections 3(c)(1) or 3(c)(7) thereof.
- Subjects registered advisers to private funds to a variety of new recordkeeping and reporting requirements regarding the funds they manage.
- Eliminates exemption from registration under the Investment Advisers Act of 1940 for advisers with fewer than 15 clients, and raises dollar threshold for SEC registration from $25 million of assets under management to $100 million, subject to various exceptions. As a result, advisers to most hedge funds and private equity funds will be required to register with the SEC.
- Exempts advisers to venture capital funds (to be defined by SEC) and advisers to private funds with less than $150 million in assets under management from SEC registration, but these advisers will be subject to new reporting and recordkeeping requirements.
- Permits new Financial Stability Oversight Council created by the Act to designate private funds for systemic risk regulation by the Federal Reserve.
- Imposes new restrictions on the ability of banks and related entities to sponsor or invest in private equity funds and hedge funds.
- Expands authority of federal regulators to regulate incentive-based compensation at a wide variety of financial firms, including investment advisers.
New SEC Registration and Reporting Requirements

The Act creates a new category of investment fund called a “private fund,” which is any fund that would be an “investment company” under the Investment Company Act of 1940 (the Investment Company Act) but for the exemptions provided by Section 3(c)(1) (i.e., funds owned by 100 or fewer investors) or Section 3(c)(7) (i.e., funds owned solely by “qualified purchasers”). Advisers to private funds generally will be required to register under the Investment Advisers Act of 1940 (the Advisers Act), although there are several exceptions, including for advisers to venture capital funds and smaller private funds. In addition, registered private fund advisers will have to comply with new recordkeeping and reporting rules.

Effective Date and SEC Rulemaking

The new registration, reporting and other requirements described below will be effective one year after the date of the Act’s enactment, which means that investment advisers not currently registered with the SEC but which are required to register as a result of the Act must do so within one year. In addition, the SEC will be required to adopt rules to implement the new recordkeeping and reporting requirements for advisers to private funds, as well as to define the term “venture capital fund.” This rulemaking must be completed within one year of the Act’s enactment.

SEC Registration

The law amends the Advisers Act in a number of respects, with the result that many advisers to private investment funds will, for the first time, be required to register with the SEC. Most importantly, the current exemption from registration under the Advisers Act for advisers with fewer than 15 clients has been eliminated. Because a typical “blind pool” fund is treated as a single client (regardless of how many investors invest through the fund), fund managers that manage 14 or fewer funds have generally been exempt, under current law, from registration under the Advisers Act.

In addition, the dollar threshold that triggers the requirement to register under the Advisers Act has been raised from $25 million (the current statutory threshold) to $100 million of assets under management. Although the Act adds a number of exemptions from the registration requirement (including, as described below, an exemption for advisers solely to private funds with less than $150 million of assets under management), generally speaking an adviser to any fund with at least $100 million of assets under management will be required to register with the SEC under the Advisers Act.

The Act will increase administrative/compliance burdens and expenses for a large class of previously unregistered investment advisers, i.e., those that have been exempt from registration under the “fewer than 15 clients” exemption under the Advisers Act. The registration process itself, while not unduly cumbersome or time-consuming, subjects the adviser to a number of requirements. These include: (i) a requirement to file Form ADV with the SEC, as well as annual updates to such form, (ii) the need to provide a written brochure to the adviser’s clients, (iii) certain restrictions on performance-based client fees charged by the adviser, (iv) restrictions on fees that can be paid to third party solicitors of clients, (v) the need to maintain specified books and records, and (vi) a requirement to adopt a compliance system to govern the adviser’s operations, including policies and

1 Advisers required to register with the SEC may do so voluntarily before the one-year registration deadline.

2 The new law will also mandate registration with the SEC, even where assets under management is below the new $100 million threshold, if the investment adviser is not registered with or subject to examination by a state regulator in its home state. Further, advisers that manage less than $100 million of assets may voluntarily register with the SEC if they would be required to register with 15 or more states.
procedures designed to prevent violations of the securities laws and the designation of a chief compliance officer to administer these policies.

Exemptions from SEC Registration

The Act adds a number of important new exemptions from the registration requirements, as described below. Notably, however, during the House-Senate conference process, the conferees agreed to eliminate an exemption for advisers to private equity funds which had been included in the version of the legislation passed by the Senate.

The following categories of investment advisers will not be required to register with the SEC:

- **Venture capital fund advisers** - any adviser that acts as an investment adviser solely to one or more “venture capital funds,” with such term to be defined by the SEC through a rulemaking process.\(^3\) However, while not required to register with the SEC under the Advisers Act, advisers to venture capital funds would be subject to annual report and other reporting and recordkeeping requirements to be specified by SEC.

- **Advisers to smaller private funds** - any adviser acting solely as an adviser to private funds with assets under management in the United States of less than $150 million. However, as with venture capital fund advisers, advisers to these smaller private funds would be subject to annual report and other reporting and recordkeeping requirements to be specified by SEC.

- **Foreign private advisers** - any adviser who: (i) has no place of business in the United States, (ii) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the adviser, (iii) has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the adviser of less than $25 million, and (iv) doesn’t hold itself out to the public in the United States as an investment adviser or act as an investment adviser to a registered investment company or business development company.\(^4\)

- **Advisers to small business investment companies** - any adviser who solely advises: (i) small business investment companies (SBIC) licensed under the Small Business Investment Act of 1954, (ii) entities that have been notified by the Small Business Administration that they may proceed to qualify for a license as a SBIC, or (iii) applicants for a SBIC license that are affiliated with another licensed SBIC.

Recordkeeping and Reporting Requirements for Private Fund Advisers

Advisers to private funds that are required to register with the SEC will be subject to special recordkeeping and reporting rules. More specifically, the Act gives the SEC authority to require registered investment advisers to maintain such records, and file such reports, regarding private funds advised by the adviser as are necessary and appropriate in the public interest and for the

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\(^3\) Given the overlap between venture capital investment, on the one hand, and growth equity and other similar areas of private equity investment, on the other, the SEC will face challenges in defining what constitutes a “venture capital fund.”

\(^4\) The foreign private adviser exception is a narrow one and may require further clarification by the SEC, particularly with regard to the circumstances under which assets are attributable to clients in the United States. The narrow scope of the exception has the effect of expanding the extra-territorial reach of the SEC’s authority to regulate investment advisers.
protection of investors or, notably, for the assessment of systemic risk by the Financial Stability Oversight Council. 5

The Act specifies several categories of information that must be included in the records and reports required to be maintained by registered advisers that are subject to inspection by the SEC and that may also be required to be included in reports filed with the SEC. These categories of information are, for each private fund:

- the amount of assets under management and use of leverage (including off balance sheet leverage);
- counterparty credit risk exposure;
- trading and investment positions;
- valuation policies and practices of the fund;
- types of assets held;
- side arrangements or side letters giving some investors in a fund more favorable rights or entitlements than other investors;
- trading practices; and
- such other information as the SEC determines is necessary and appropriate.

The Act requires the SEC to share with the Financial Stability Oversight Council copies of all reports, documents, records, and other information filed with it or provided to it by advisers to private funds, so that the Council may assess the systemic risk posed by private funds. However, reports and other information provided to the SEC, the Financial Stability Oversight Council or any other governmental agency or any self-regulatory organization will be excluded from the scope of Freedom of Information Act requests. Further, “proprietary information” of an investment adviser (including information regarding investment or trading strategies and analytical or research methodologies) ascertained by the SEC from any report filed with the SEC by a registered investment adviser will be kept confidential to the same extent as facts ascertained during an examination of the adviser as provided by Section 210(b) of the Advisers Act.

In establishing these recordkeeping and reporting requirements, the Act directs the SEC to consider the special circumstances of “mid-sized” private funds. 6 In its rulemaking, the SEC must take into account such funds’ size, governance, and investment strategy to determine whether such funds pose systemic risk. Further, the registration and examination procedures for advisers to mid-sized funds must reflect the level of systemic risk posed by such funds. 7

Finally, although the version of legislation originally adopted by the House would have authorized the SEC to establish rules requiring registered advisers to private funds to make disclosures to investors, prospective investors, counterparties, and creditors, the House-Senate conference committee eliminated this provision. Conferees were persuaded that investors in private funds are generally sophisticated and do not need the protection of additional disclosure rules.

5 The Act also permits the SEC to require registered investment advisers to provide such information or reports directly to the Financial Stability Oversight Council.

6 The Act does not specify what constitutes a mid-sized private fund.

7 This provision is noteworthy because it vests responsibility for considering systemic risk in the SEC, as opposed to the Financial Stability Oversight Council.
Other Items of Interest

The Act includes other items of interest for advisers to private investment funds:

- The term “investment adviser” has been amended to exclude a “family office,” which term will be further defined by the SEC through rulemaking, but in a manner consistent with the SEC’s previous exemptive orders for family offices.

- The SEC is directed to modify the “accredited investor” standard in its rules under the Securities Act of 1933, so that the “net worth” element of such standard excludes the value of a person’s primary residence. In addition, the SEC is authorized to review and make periodic adjustments to the accredited investor standard, as it relates to natural persons, including in light of the economy.

- Any SEC rules that define the term “qualified client” for purposes of the Advisers Act by reference to a dollar amount test will be required to be adjusted for the effects of inflation every five years.

- The General Accounting Office is directed to study the feasibility of forming a self-regulatory organization to oversee private funds.

Potential Regulation of Systemically Important Private Funds by Federal Reserve

Under the Act, a new Financial Stability Oversight Council will have the authority to designate any U.S. or foreign nonbank financial company as systemically important such that the company will be subject to systemic risk regulation by the Federal Reserve. The term “nonbank financial company” generally means a company, other than a bank holding company, that is predominantly engaged in financial activities. It would appear that the principal activities of private equity funds, hedge funds, and other private funds, as well as those of their advisers, fall within the realm of “financial activities.” This broad authority would, therefore, permit the Financial Stability Oversight Council to designate private investment funds and/or their advisers as systemically significant enough to warrant supervision by the Federal Reserve.

In determining whether a particular company warrants such designation, the Council is to take into account the threat posed to the financial stability of the United States by “material financial distress” at the company or by the nature, scope, size, scale, concentration, interconnectedness, or mix of the company’s activities. In making any such determination, the Council must consider a variety of factors that touch on systemic risk, such as the company’s leverage, off-balance sheet exposures, and inter-connectedness with other significant financial entities. The Act also requires the Federal Reserve to issue rules setting forth criteria for exempting certain types or classes of companies from systemic risk regulation by the Federal Reserve.

Any private investment fund designated for systemic risk regulation by the Federal Reserve will be subject to prudential standards which would include, among other things, the following:

- minimum leverage capital and risk-based capital requirements;

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8 A company is deemed to be predominantly engaged in financial activities if (i) its annual gross revenues from activities that are “financial in nature” (as defined in Section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, from the ownership or control of insured depository institutions, represents 85% or more of its consolidated annual gross revenues, or (ii) its consolidated assets related to activities that are financial in nature and, if applicable, related to the ownership or control of insured depository institutions, represents 85% or more of its consolidated assets. Under Section 4(k) of the Bank Holding Company Act, among other things the business of investing for others and providing investment advisory services are considered activities that are financial in nature.
- limits on leverage;
- a prohibition on merging with or acquiring a company if the total consolidated liabilities of the resulting company would exceed 10% of the aggregated consolidated liabilities of all financial companies;
- treatment as a bank holding company for certain purposes, including (i) needing prior approval by the Federal Reserve for certain acquisitions of interests in banks and (ii) prohibiting in certain circumstances interlocking directorships or senior management;
- required reporting of the company’s credit exposure to other systemically important firms and such other firms’ exposure to the company;
- for public companies, required establishment of a risk committee;
- required periodic stress tests;
- imposition of escalating remediation requirements if the company experiences increasing financial distress; and
- potential assessment for the new orderly resolution fund to cover the cost of resolving systemically important firms.

Volcker Rule Restrictions

The Act imposes limitations on fund sponsorship and investment activities by banks, bank holding companies, and certain nonbank financial companies based on proposals first advanced by former Chairman of the Federal Reserve Paul Volcker. These provisions will have a number of consequences for banking entities, which may be required to divest or substantially reduce their interests in hedge funds and private equity funds, as well as for the affected funds and potential acquirors of such funds.

Specifically, subject to certain exceptions, the Act amends the Bank Holding Company Act to prohibit specified banking entities\(^9\) from sponsoring or investing in private equity or hedge funds,\(^10\) as well as from engaging in proprietary trading. The Act also prohibits banking entities from extending credit to, or engaging in certain other specified transactions with, private equity and hedge funds for which they act as investment manager, adviser, or sponsor, or that they organize and offer. Any transactions between a banking entity and any such fund that are not specifically prohibited must be entered into on arms-length market terms. Finally, the Act gives authority to the Federal Reserve Board to impose additional capital and quantitative limits on certain nonbank financial companies\(^11\)—i.e., those designated by the Financial Stability Oversight Council as being systemically important—that sponsor or invest in private equity or hedge funds or engage in proprietary trading.

There are important exceptions to the prohibition on sponsoring and investing in private equity or hedge funds. Under one of the most significant of those exceptions, banking entities will be permitted to organize and offer a private equity or hedge fund if (i) the banking entity provides \textit{bona fide}...
trust, fiduciary, or investment advisory services as part of its business, (ii) the fund is organized and offered only in connection with such services and only to customers of such services, (iii) the banking entity does not guarantee or otherwise assume or insure the obligations or performance of the fund, (iv) no director or employee of the banking entity has an ownership interest in the fund unless he or she is directly engaged in providing services to the fund, and (v) certain other conditions are met.

Further, a banking entity may acquire or retain an ownership interest in a private equity or hedge fund that it organizes and offers, provided that its ownership interest is either a seed capital investment made in order to establish the fund and attract unaffiliated investors, or a de minimis investment. Within one year of establishing a fund, a banking entity’s ownership interest in the fund must represent no more than three percent of the total ownership interests of such fund. The banking entity must actively seek unaffiliated investors to dilute its investment in the fund. In addition, a banking entity’s investment in any private equity or hedge fund must be “immaterial” to the banking entity, as defined by the appropriate regulators, and in any event the aggregate amount of all such investments may not exceed three percent of the banking entity’s Tier 1 capital. The exemption described above is not available if it would result in a material conflict of interest (as defined by the regulators) between the banking entity and its customers or counterparties, would result in material exposure to high-risk assets or high-risk trading strategies (as defined by the regulators), or would pose a threat to U.S. financial stability or the safety or soundness of the banking entity.

Under this part of the Act, the terms “hedge fund” and “private equity fund” mean any issuer that is exempt from registration as an investment company pursuant to Section 3(c)(1) or 3(c)(7) of the Investment Company Act, as well as any similar fund as may be determined through rulemaking by the appropriate regulators. This title’s approach to defining these terms is so broad that it picks up not only hedge funds and private equity funds, but also venture capital funds and other private funds that rely on the Section 3(c)(1) or Section 3(c)(7) exemptions under the Investment Company Act.

The appropriate regulators must adopt regulations implementing the Volcker rule provisions within nine months after the Financial Stability Oversight Council completes a study of those provisions. The Financial Stability Oversight Council’s study must be completed within six months of the Act’s enactment. The restrictions imposed by the Volcker rule take effect on the earlier of (i) 12 months after the completion of the aforementioned rulemaking, and (ii) two years after the Act’s enactment. Banking entities will generally have two years from the date the restrictions take effect to bring themselves into compliance, subject to the availability of up to three one-year extensions. Banking entities may also be able to avail themselves of a five-year extension for divestitures of certain funds principally invested in illiquid assets, such as portfolio companies and real estate or venture capital investments.

These restrictions will have a number of consequences for banking entities and their affiliate funds. For example, bank holding companies with units that own, invest in, or sponsor hedge funds or private equity funds will have to dispose of or significantly reduce such investments, whether through redemptions, sales to third parties, or restructurings such as a spin-off to existing management. Sales or redemptions of fund interests by banks or their affiliates could trigger contractual rights by other investors in the funds, and could also raise fiduciary duty issues for the fund’s general partner. Divesting banks may seek to provide financing for a management-led buyout, although this would not be possible where the bank will act as investment manager or adviser to the fund after its divestment. Finally, in any transaction designed to ensure compliance with these new restrictions, the interests of the divesting banks are likely to diverge from those of the fund itself and the other investors in the fund.
New Powers to Regulate Compensation at Many Financial Firms

The Act contains two separate provisions giving federal banking regulators and the SEC new powers to regulate compensation arrangements at a wide variety of financial firms, including investment advisers.

Regulation of Incentive-Based Compensation Arrangements

Section 956 of the Act gives new authority to federal banking regulators and the SEC to examine, and impose restrictions on, incentive-based compensation arrangements at a range of financial firms. Under this provision, a “covered financial institution” will be required to disclose to the appropriate regulator the structures of all incentive-based compensation arrangements to enable the regulator to determine whether such structures (i) provide any executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits, or (ii) could lead to material financial loss to the institution.

More significantly, the Act requires the federal regulators jointly to issue rules or guidelines prohibiting any such incentive-based arrangement, or any feature of such arrangement, that the regulators determine encourage inappropriate risks by covered financial institutions by providing any executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits, or that could lead to material financial loss to the institution. It is important to note that this authority is not limited to compensation arrangements for executives, which has historically been the focus of the SEC’s disclosure rules. Rather, this new authority covers incentive-based arrangements that extend to all employees, as well as incentive-based arrangements with principal shareholders.

This authority to examine and restrict incentive-based compensation applies to any “covered financial institution,” a term which includes banks, thrifts, and their holding companies, as well as credit unions, registered broker-dealers, investment advisers (including those not registered with the SEC), Fannie Mae, Freddie Mac and “any other financial institution” that the federal regulators jointly determine should be treated as such. However, any institution with assets below $1 billion is excluded.

In determining whether incentive-based compensation arrangements encourage inappropriate risks, the federal regulators are instructed to follow standards comparable to the standards established under the Federal Deposit Insurance Act for insured depository institutions. These standards deem compensation to be excessive if the amounts paid are unreasonable or disproportionate to the services performed, in light of a number of specific factors including, among other things, the combined value of all cash and non-cash benefits provided, the compensation history of the individual and other individuals with comparable expertise at the institution, the financial condition of the institution, and comparable compensation practices at comparable institutions.

Compensation Schemes of Brokers, Dealers and Investment Advisers

Section 913 of the Act authorizes the SEC to examine, and where appropriate, issue rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the SEC deems contrary to the public interest and the protection of investors. On its face, this broad language seems to give authority to the SEC to regulate both the arrangements by which clients compensate their brokers, dealers, and investment advisers, as well as the internal compensation arrangements for such entities’ executives and/or employees. While the impetus for this provision might have been a concern about full disclosure of fees charged to retail brokerage clients, the broad sweep of the language would potentially allow the
SEC to impose restrictions on contractual arrangements by which private equity and hedge fund managers are compensated in their roles as investment advisers.

Annual Stress Test

The Act requires all financial companies that have total consolidated assets over $10 billion and are regulated by specified federal financial regulators (generally, the federal banking regulators, the SEC, and the Commodity Futures Trading Commission) to conduct an annual stress test. For this purpose, the Act does not define the term “financial companies.” However, based on the Act’s definition of the term “nonbank financial company,” the term “financial companies” likely means any company predominantly engaged in financial activities.\(^\text{12}\) This term, together with the Act’s definition of “primary financial regulatory agencies,” suggests that the annual stress test requirement will apply to, among others, investment advisers registered under the Advisers Act, broker-dealers registered under the Exchange Act, and investment companies registered under the Investment Company Act, in each case if they have total consolidated assets over $10 billion.\(^\text{13}\)

The SEC and other applicable federal financial regulators are required to issue rules implementing the annual stress test requirement. Each agency’s rules must, for entities regulated by it, define the term “stress test,” establish methodologies for conducting the stress test that include at least three sets of conditions (including baseline, adverse, and severely adverse), and establish the form and content of a report regarding the stress test which must be submitted to the Federal Reserve Board and to the entity’s primary federal financial regulator (e.g., the SEC in the case of registered broker-dealers, investment advisers, and investment companies). Companies required to conduct an annual stress test will also be required to publish a summary of the results.

Key Issues for Rulemaking Phase

The Act leaves many critical issues to be fleshed out in rulemaking proceedings at the SEC and other agencies. Among the key issues for the rulemaking phase are the following:

SEC Rulemaking

- Defining the term “venture capital fund” (advisers to which are exempt from registration under the Advisers Act).
- The precise scope and frequency of the information that will be required to be provided to the SEC and/or the Council by registered advisers to private funds, and the extent of any exceptions to such requirements for advisers to “mid-sized” private funds.
- Whether the SEC will vary the recordkeeping and reporting requirements for advisers to private funds according to the nature of the fund’s business or the type of fund or other criteria.
- The scope of the SEC’s rules regarding compensation arrangements at brokers, dealers, and investment advisers.
- The scope of the SEC’s rules with respect to the annual stress test requirement for registered broker-dealers, investment advisers, and investment companies.

\(^\text{12}\) See f.n. 8 above. Also, the Act’s title on the new orderly liquidation authority defines the term “financial company” in a manner consistent with this approach.

\(^\text{13}\) The Act also calls for semi-annual stress tests by nonbank financial companies designated for systemic risk regulation by the Financial Stability Oversight Council.
Rulemaking by Federal Banking Regulators

- Content and scope of rules setting forth criteria for exempting certain types or classes of companies from systemic risk regulation by the Federal Reserve.
- Elaboration of the specific factors or criteria that the Council will consider in determining whether a private fund should be designated as systemically important.
- Whether the Council and/or the Federal Reserve will issue any guidance identifying specific criteria or factors that would operate as a “safe harbor” from designation as systemically important.
- Defining the terms “private equity fund” and “hedge fund” for purposes of the Volcker rule restrictions.
- Clarifying the scope of the exemptions from the provisions of the Volcker rule, particularly the exemption for seed capital and de minimis investments in private equity and hedge funds organized and offered by a banking entity.

What You Can Do

We believe that investment funds potentially affected by the Act will want to consider a number of steps relating to the upcoming rulemaking phase, including

- Keeping abreast of key developments in the rulemaking phase in the ensuing months so that they can (i) fully understand the implications of proposed rules for their businesses and (ii) evaluate what efforts, if any, are being made by other firms/industry groups to participate in, and possibly shape, the rulemaking process. Many firms have designated (or are considering designating) one senior-level person within their organization (often the general counsel or other senior manager) to be their “point person” for this monitoring process.
- Reaching out to peer firms and other affected businesses to explore opportunities for a collective response to proposed rules (and to share the costs of such collective response).
- Developing realistic strategies to respond to the proposed rules — and ensuring that such strategies are effectively implemented. This would include considering how most effectively to communicate firm and industry views on proposed rules to SEC commissioners, the federal banking regulators, and their respective staffs (for example, individually, through ad hoc groups or through trade associations).
- Consulting with legal advisors on ways to structure existing business lines to satisfy requirements under the new rules, and developing compliance action plans for expected new rules, including internal training and education, and, where appropriate, briefing of senior officers and relevant board members.

Our firm has been deeply involved in many aspects of the U.S. Government’s response to the economic crisis over the last two years. With decades of experience in assisting clients with critical regulatory and legislative issues in Washington and with our particular expertise in regulatory and legislative affairs touching the financial services industry, our firm is well-suited to assist clients in connection with the new requirements for advisers to private investment funds.
If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). A central intent of the Act is to improve investor protection in the financial regulatory framework and make other related enhancements to securities regulation. This advisory describes a number of those provisions.

Many of the changes described in this advisory will be implemented through rulemaking by the Securities and Exchange Commission (SEC) and certain other agencies. Annex A provides a summary of the various rulemakings and applicable deadlines, if any, under the Act.

- Provides for the payment of bounties to whistleblowers in connection with certain securities enforcement actions and greater protection from retaliatory actions by employers in response to whistleblower tips and participation.
- Augments investor protection administrative functions at the SEC.
- Expands the bases for finding aiding and abetting violations in securities enforcement actions.
- Directs the SEC to:
  - establish rules disqualifying “bad actors” from relying on the private placement exemption under Rule 506 of Regulation D; and
  - narrow the definition of the term “accredited investor.”
- Exempts non-accelerated filers from compliance with the auditor attestation requirements in Section 404(b) of the Sarbanes-Oxley Act.
- Directs the SEC to conduct a study to evaluate the effectiveness of the existing standards of care for broker-dealers and investment advisers for providing personalized investment advice regarding securities to retail customers.
- Subjects credit rating agencies to increased regulation, as well as heightened standards of liability.
- Subjects municipal advisors to registration with the SEC and regulation by the MSRB. Also, imposes a fiduciary duty on municipal advisors providing advice to municipal entities.

**Whistleblower Incentives and Protections**

**Whistleblower Bounty Program**

Section 922 of the Act provides for the payment of bounties to whistleblowers who voluntarily provide to the SEC original information about a securities law violation that leads to a securities
enforcement action resulting in more than $1 million in monetary sanctions.¹ The award to a whistleblower in the SEC’s discretion must be no less than 10 percent and no more than 30 percent of the monetary sanctions actually collected by the SEC in connection with the action. Awards will be paid out of a fund established in the U.S. Treasury and funded by the monetary sanctions collected by the SEC. Information that could reasonably be expected to reveal the identity of the whistleblower must be kept confidential.

Greater Protections Against Retaliation

In addition to creating, through the payment of bounties, an incentive for whistleblowers to report violations, Section 922 also provides protections to those individuals against retaliation by their employers. In particular, the Act prohibits an employer from directly or indirectly discriminating against a whistleblower in any manner (including by threatening, demoting or discharging such individual) in response to the following whistleblower actions:

- providing to the SEC information regarding securities law violations in accordance with the Act;
- participating in a judicial or administrative action brought by the SEC in connection with such information; or
- making disclosures that are protected under certain federal laws, including the Securities Exchange Act of 1934 (the Exchange Act), the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) and other laws and regulations within the SEC’s jurisdiction.

A whistleblower who alleges such retaliatory action may bring an action against the offending employer in federal court within six years from the date of the violation or within three years from the date when material facts regarding the right of action reasonably should have been known to the whistleblower. Under no circumstances may a whistleblower bring such an action more than 10 years from the date of the violation.

These measures are significant because they are separate and apart from the existing whistleblower protections under the Sarbanes-Oxley Act, which, in Section 806, protects whistleblowers from employer retaliation in connection with similar kinds of protected activities to those described above. The Sarbanes-Oxley Act provisions, however, have more restrictive procedural hurdles than the new protections under the Act. For instance, whereas under the Act, whistleblowers can bring retaliation claims directly in federal court, under the Sarbanes-Oxley Act, the whistleblower must file a complaint first with the Department of Labor. Additionally, the Sarbanes-Oxley Act has a much shorter statute of limitations than under the Act—180 days (as extended by the Act—see below) versus up to 10 years (described above). Consequently, the Act provides whistleblowers with a different and potentially surer path to being heard with respect to retaliation claims than under the Sarbanes-Oxley Act protection scheme.

Changes to Whistleblower Provisions under the Sarbanes-Oxley Act

The Act also makes certain changes to the whistleblower provisions in Section 806 of the Sarbanes-Oxley Act. Most importantly, Section 922(c) doubles the statute of limitations period for reporting retaliations claims from 90 to 180 days. It also provides for jury trials and prohibits waiver of rights and predispute arbitration agreements.

¹ Under Section 922, “original information” is (i) derived from the independent knowledge or analysis of the whistleblower, (ii) not known to the SEC from any other source, and (iii) not exclusively derived from allegations made in judicial or administrative hearings, governmental reports, hearings, audits, or investigations, or from the news media.
New Investor Protection Administration at SEC

The Act augments the administrative functions surrounding investor protection at the SEC in a number of respects. This will require a new and permanent allocation of SEC staff to support the activities of the new functions, staff that will be redeployed from other areas of the agency.

- **Office of the Investor Advocate.** Section 915 of the Act amends Section 4 of the Exchange Act to establish the Office of the Investor Advocate. The Investor Advocate (the head of this office who is appointed by the SEC Chairman) is, among other things, charged with (i) assisting retail investors in resolving significant problems with the SEC or self-regulatory organizations (SROs), (ii) identifying areas in which investors would benefit from changes in SEC regulations or SRO rules, (iii) identifying problems that investors have with financial service providers and investment products, and (iv) analyzing the potential impact on investors of proposed regulations of the SEC and rules of SROs.

- **Ombudsman.** Under Section 919D of the Act, the Investor Advocate will appoint an Ombudsman who will (i) act as a liaison between the SEC and retail investors in resolving the problems described above, (ii) review and make recommendations regarding policies and procedures to encourage individuals to utilize the Investor Advocate as a resource regarding securities law compliance questions, and (iii) establish safeguards to maintain the confidentiality of investor communications with the Ombudsman.

- **Investor Advisory Committee.** Section 911 of the Act establishes on a permanent basis the Investor Advisory Committee comprised of, among others, the Investor Advocate, a representative of State securities commissions, a representative of senior citizen interests and representatives of individual debt and equity investor interests. In general, the committee will advise and consult with the SEC on (i) regulatory priorities, (ii) issues relating to the regulation of securities products, trading strategies, fee structures, and the effectiveness of disclosure, and (iii) initiatives to protect investor interest and to promote investor confidence and the integrity of the securities markets.

Expansion and Clarification of Aiding and Abetting Liability

Currently, the SEC can bring enforcement actions against aiders and abettors under the Exchange Act and Investment Advisers Act of 1940 (the Advisers Act). Section 929M of the Act expands this authority, providing that the SEC can bring such actions under the Securities Act of 1933 (the Securities Act) and the Investment Company Act of 1940. In addition, Section 929O of the Act expands the bases for liability by imposing liability on persons who “recklessly” provide substantial assistance to someone who violates the Exchange Act. Finally, Section 929N of the Act permits the SEC to pursue monetary penalties against aiders and abettors in actions brought under the Section 209(e) of the Advisers Act.

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2 In June 2009, the SEC established an Investor Advisory Committee with a charter that provides for termination of such committee in June 2011.

3 The House and Senate conferees considered including in the Act a provision essentially overruling *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) and *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008) and establishing a private right of action against aiders and abettors for violations of the securities laws. Ultimately, however, they opted against including such a measure, although Section 929Z of the Act does direct the General Accounting Office to study whether private plaintiffs should be permitted to bring actions against aiders and abettors.
Standards of Care for Broker-Dealers and Investment Advisers

One of the most widely discussed aspects of the Act with respect to investor protection has been how it might harmonize the standards of care applicable to and employed by broker-dealers and investment advisers. Under the Advisers Act, registered investment advisers are subject to implicit fiduciary duties. By contrast, broker-dealers owe their customers more limited duties of suitability and are subject to general anti-fraud prohibitions under the Exchange Act and other standards imposed by the Financial Industry Regulatory Authority. Consequently, significant debate has concerned whether substantive distinctions exist between the activities of broker-dealers and investment advisers to justify fragmented standards of care.

In the end, the Act takes only limited steps towards addressing this issue. Under Section 913(b) of the Act, the SEC must conduct a six-month study to evaluate the effectiveness of the existing standards of care for broker-dealers and investment advisers (and their associated persons) for providing personalized investment advice regarding securities to “retail customers.” In addition, such study must evaluate whether there exist legal or regulatory gaps, shortcomings, or overlaps with respect to such standards of care that should be addressed by rule or statute, taking into consideration a number of enumerated factors.

Following the conclusion of the study and submission of a report to Congress, the SEC is authorized (but not directed) under Section 913(f) of the Act to establish rules to address the standards of care for broker-dealers and investment advisers providing personalized investment advice to retail customers. To this end, Section 913(g) of the Act modifies Section 15 of the Exchange Act to provide that the SEC may adopt rules providing that broker-dealers that provide personalized advice to retail customers are subject to the same standard of care applicable to investment advisers under Section 211 of the Advisers Act. In parallel, the Act modifies Section 211 of the Advisers Act to provide that the SEC may establish rules to provide that the standard of care applicable to broker-dealers and investment advisers when providing such advice is to act in “the best interest of such customer without regard to the financial or other interest” of the intermediary in providing the advice. Such rules must be no less stringent than the anti-fraud provisions contained in Sections 206(1) and 206(2) of the Advisers Act.

Exemptions from Registration under the Securities Act

The Act directs the SEC to narrow exemptions from registration under the Securities Act in two respects.
Disqualification of Bad Actors

Pursuant to Section 926 of the Act, the SEC must establish within one year of the Act’s enactment rules that disqualify persons from relying on Rule 506 of Regulation D who have been shown to have committed certain improper acts. The disqualifications must operate to bar persons based on provisions similar to those already applicable to limited offerings under Rule 505 of Regulation, as well as securities law felons and violators of various State laws.

Adjustment to Accredited Investor Test for Natural Persons

Section 413 of the Act directs the SEC to change the definition of “accredited investor” for purposes of the SEC’s rules under the Securities Act. The changes will have the effect of raising the financial threshold for natural persons to qualify as accredited investors in exemptions from registration for issuers. Specifically, starting at the fourth anniversary of the Act’s enactment, the SEC must adjust the net worth threshold required for a natural person to qualify for accredited investor status to more than $1 million (the current level), as such amount may be adjusted periodically by SEC rules. Until such time, this threshold must remain at $1 million. Importantly, however, the net worth threshold must now (and on a going-forward basis) exclude the value of such person’s primary residence. Additionally, such section of the Act directs the SEC to review every four years the definition of an accredited investor, as it applies to natural persons, to determine whether such definition should be adjusted or modified for the protection of investors, in the public interest and in light of the economy.

Sarbanes-Oxley Exemption for Small Companies

In an effort to lessen a perceived compliance burden on small companies, Section 989G of the Act exempts non-accelerated filers (i.e., companies with less than $75 million in public float) from compliance with Section 404(b) of the Sarbanes-Oxley Act, which requires an issuer’s auditor to attest to, and report on, management’s assessment of the effectiveness of the issuer’s internal control structure and procedures for financial reporting. In addition, Section 989G directs the SEC to conduct a study to determine how it can reduce the burden of complying with Section 404(b) for smaller companies whose market capitalization is between $75 million and $250 million without jeopardizing the investor protections for such companies.

Credit Rating Agencies

The Act contains a number of provisions designed to increase the oversight and accountability of credit rating agencies in recognition of Congress’ finding that these organizations play a critical “gate-keeper” function in the debt market that is similar to that of securities analysts and auditors. Provisions of the Act that are applicable to credit rating agencies are described below.

Repeal of Rule 436(g) under the Securities Act

Section 939G of the Act repeals Rule 436(g) under the Securities Act, which exempted credit ratings provided by nationally recognized statistical rating organizations (NRSROs) from being considered a part of a registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the Securities Act. Rule 436(g) thus shielded an NRSRO from liability under Section 11.

Repeal of Rule 436(g) requires issuers that refer to an NRSRO or an NRSRO’s credit rating in a registration statement or prospectus filed under the Securities Act to file the NRSRO’s consent as an exhibit to the registration statement. NRSROs that provide such a consent potentially will be subject

7 Credit rating agencies registered as such with the SEC are known as “nationally recognized statistical rating organizations.” There are ten firms currently registered as NRSROs.
to liability as “experts” under Section 11 of the Securities Act. The repeal of Rule 436(g), thus, removes a liability shield and places NRSROs in the same position as unregistered credit rating agencies and other entities deemed experts with respect to potential Section 11 liability.

Consequently, this provision may lead to significant changes in the practices surrounding public issuances of rated debt. In the short term, it is possible that NRSROs will respond to this provision by refusing to consent to references to their names or ratings in a registration statement and that issuers would therefore not voluntarily disclose such information in their registration statements or prospectuses (as was generally the case prior to the Act’s adoption). However, repeal of Rule 436(g) may have more widespread consequences if the SEC adopts a rule it has proposed that would require issuers to disclose information about a credit rating in a registration statement if a credit rating is “used” in connection with a registered offering, as such disclosure will now require an NRSRO’s consent.

Private Actions Against Credit Rating Agencies

Section 933 of the Act provides that statements by credit rating agencies (not just NRSROs) will be subject to the enforcement and penalty provisions of the Exchange Act in the same manner as statements made by registered public accounting firms and securities analysts and that such statements will not be deemed to be forward-looking statements under Section 21E of the Exchange Act. Section 933 of the Act also establishes a pleading standard for a civil action brought against a credit rating agency or a controlling person thereof. Under this provision, it would be sufficient for the complaint to state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to (i) conduct a reasonable investigation or obtain reasonable verification regarding the factual elements relied on by its own methodology for evaluating credit risk or (ii) obtain reasonable verification of such factual elements from other sources that the credit agency considers to be competent and that were independent of the issuer and underwriter.

In addition to these provisions, Section 932 of the Act provides that certain reports NRSROs currently “furnish” to the SEC must now be “filed,” thereby exposing NRSROs to claims under Section 18 of the Exchange Act. Section 932 of the Act also replaces Section 15E(m) of the Act, which explicitly protected NRSROs from private rights of action in connection with such reports and any other disclosures required of such entities.

Study Regarding Credit Rating Agency Assignment System

Section 939F of the Act requires that the SEC carry out a two-year study (beginning no later than 90 days following enactment of the applicable subtitle of the Act) of the credit rating process for “structured financial products” with a focus on the feasibility of establishing a system in which a public or private utility or an SRO would assign a particular NRSRO to determine the initial credit rating for each structured financial product.8 Following the study, the Act directs the SEC to implement rules, as necessary or appropriate, to establish a system for the assignment of NRSROs to determine initial credit ratings for structured financial products. In particular, the SEC must give thorough consideration to a system such as that described in Section 939D of the Senate bill, which would have established a Credit Rating Agency Board to assign an NRSRO to determine the initial credit ratings for any structured financial product.

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8 A “structured financial product” is an asset-backed security or another structured product based on such a security.
Registration and Regulation of Municipal Securities Advisors

The Act also seeks to protect investors by bolstering the regulatory oversight of the municipal securities market by creating a new class of regulated intermediaries, “municipal advisors,” as described below.

SEC Registration

In particular, Section 975 of the Act, requires “municipal advisors” to register with the SEC in order to (i) provide advice to or on behalf of a “municipal entity” or “obligated person” with respect to municipal financial products (i.e., municipal derivatives, guaranteed investment contracts, and investment strategies), the issuance of municipal securities or (ii) solicit a municipal entity or obligated person. The Act defines the term “municipal advisor” to include a person (who is not a municipal entity or an employee of such entity) who (i) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities or (ii) solicits a municipal entity, other than other regulated advisors (such as broker-dealers, investment advisers, and municipal securities dealers), attorneys and engineers.

MSRB Regulation

Section 975(b) of the Act charges the Municipal Securities Rulemaking Board (MSRB) with establishing a wide variety of rules regulating the conduct and practices of municipal advisors, including with respect to qualification standards, examinations and recordkeeping. The scope of such rulemaking authority is comparable to that with respect to municipal securities dealers. To promote independence, Section 975(b) requires that the MSRB be composed of a majority of members who are unaffiliated with any broker-dealer, municipal securities dealer, or municipal advisor.

Municipal Advisor Fiduciary Duty

In addition, Section 975(c) of the Act amends Section 15B(c) of the Exchange Act to impose a fiduciary duty on municipal advisors. In particular, a municipal advisor owes a fiduciary duty to any municipal entity for whom it acts as a municipal advisor. Municipal advisors are prohibited from engaging in practices that are inconsistent with such fiduciary duty. The Act does not specify the precise scope or substance of such duty (i.e., whether it mirrors the implicit fiduciary duties owed by investment advisers in connection with providing investment advice to their clients).

Key Issues for Rulemaking Phase

The Act leaves many critical issues to be fleshed out in rulemaking proceedings at the SEC and other agencies. Among the key issues for the rulemaking and implementation phase are the following:

- The procedures regarding whistleblower information submitted to the SEC and any additional factors to be considered by the SEC in determining the amounts of whistleblower awards.

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9 Under Section 975 of the Act, a “municipal entity” is a State (or political subdivision or municipal corporate instrumentality thereof), including state agencies or authorities, any plans, program, or pool of assets sponsored or established by a State (e.g., a municipal pension plan) and any other municipal securities issuer. Under the same section, an “obligated person” is a person who is generally committed pay all or part of the obligations on the municipal securities to be sold in an offering of such securities.
The actual role that will be carved out for the Office of the Investor Advocate and how the SEC will manage the Investor Advisory Committee.

Whether the SEC will adopt a broker-dealer fiduciary duty and, if so, how that duty will be articulated.

Any additional texture to the rules disqualifying bad actors from relying on Rule 506 of Regulation D.

Any applicable adjustments to the net worth requirements in connection with determining accredited investor status.

Whether the SEC adopts final rules requiring the disclosure of information regarding credit ratings in a registration statement in connection with a registered offering.

The precise substance of any qualification standards for municipal advisors established by the MSRB pursuant to its rulemaking authority.

What You Can Do

We believe that public companies and other persons potentially affected by the Act will want to consider a number of steps relating to the upcoming rulemaking phase, including:

- Keeping abreast of key developments in the rulemaking phase in the ensuing months so that they can fully understand the implications of proposed rules for their businesses and evaluate what efforts, if any, are being made by other firms/industry groups to participate in, and possibly shape, the rulemaking process.

- Developing realistic strategies to respond to the proposed rules – and ensuring that such strategies are effectively implemented. This would include considering how most effectively to communicate firm and industry views on proposed rules to SEC commissioners, the federal banking regulators, and their respective staffs (for example, individually, through ad hoc groups or through trade associations).

- Separately, developing compliance action plans for expected new rules, including internal training and education, and, where appropriate, briefing of senior officers and relevant board members.

- Reviewing compliance policies and procedures relating to employee complaints in response to new whistleblower regulations.

If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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### Agency Rulemakings –
Enhanced Protection of Investors and Other Changes to Securities Regulations

<table>
<thead>
<tr>
<th>Section of Act</th>
<th>Subject of Rulemaking</th>
<th>Deadline</th>
</tr>
</thead>
<tbody>
<tr>
<td>413</td>
<td>Rules adjusting the accredited investor test for natural persons</td>
<td>Four years after enactment of Act (and, at least, once every four years thereafter), SEC must review accredited investor test and may adjust accordingly</td>
</tr>
<tr>
<td>913</td>
<td>Rules to address the standards of care for broker-dealers and investment advisers (or their associated persons) providing personalized investment advice to retail customers</td>
<td>No deadline – As necessary and appropriate following conclusion of six-month SEC study</td>
</tr>
<tr>
<td>922</td>
<td>Rules to implement provisions relating to whistleblower incentives and protections</td>
<td>No deadline – As necessary or appropriate to implement such provisions</td>
</tr>
<tr>
<td>924</td>
<td>Final regulations to implement provisions relating to whistleblower incentives and protections</td>
<td>270 days after enactment of Act</td>
</tr>
<tr>
<td>926</td>
<td>Rules disqualifying bad actors from Regulation D offerings</td>
<td>One year after enactment of Act</td>
</tr>
<tr>
<td>939F</td>
<td>Rules establishing system of assigning NRSROs to determine initial credit ratings of structured financial products</td>
<td>No deadline – As necessary or appropriate following conclusion of two-year SEC study</td>
</tr>
<tr>
<td>975</td>
<td>MSRB directed to issue several rules applicable to municipal advisors, including those to prevent acts that are inconsistent with such advisors’ fiduciary duties</td>
<td>No deadlines specified. The amendments to the Exchange Act related to municipal advisors take effect on October 1, 2010</td>
</tr>
</tbody>
</table>
ADVISORY | Dodd-Frank Act

July 29, 2010

ENHANCED PROTECTION FOR WHISTLEBLOWERS AGAINST EMPLOYER RETALIATION

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act). Amid the Act’s hundreds of pages is a section, Section 922, that significantly enhances the protections available to whistleblowers. Not only will Section 922 fortify existing protections available to whistleblowers under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), but also, and perhaps more importantly, it will create an entirely new retaliation-protection regime. Although much attention has been paid to the bounty provisions of the Dodd-Frank Act, less has been focused on the retaliation provisions, which could potentially impact relations between companies and their employees in significant ways.

Historical Significance of Sarbanes-Oxley Act Protections

The Sarbanes-Oxley Act for the first time provided specific whistleblower protection against employer retaliation based on the reporting of securities-related violations and various federal fraud crimes.1 Through July 2010, more than 600 whistleblower complaints alleging retaliation have been adjudicated within the Department of Labor in accordance with the administrative framework established by the Sarbanes-Oxley Act.2 The vast majority of these cases were voluntarily withdrawn by the whistleblowers or summarily decided or dismissed by the administrative law judges tasked with handling them. Of the small percentage of cases actually decided by the administrative law judges on the merits, only a handful of the decisions were favorable to the whistleblowers. It is, of course, impossible to know how many whistleblower retaliation cases have settled in the shadow of these administrative proceedings.

Impact of Dodd-Frank Act

The Dodd-Frank Act establishes an entirely new category of whistleblowers—those who give the SEC “original information” (as defined in the Act) and thereby qualify for a newly-enacted whistleblower bounty program. Under this program, whistleblowers are eligible to receive cash awards of 10% to 30% of the sanctions collected by the SEC. The precise requirements and parameters of the new bounty program are outside the scope of this advisory, which focuses on whistleblower retaliation claims.

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2 Information on whistleblower retaliation cases brought under the Sarbanes-Oxley Act is available on the Department of Labor’s website. See http://www.oalj.dol.gov/libwhist.htm (last visited July 28, 2010).
The Dodd-Frank Act also establishes a new retaliation-protection regime for such claims. The Act does not completely usurp the administrative adjudication process provided for under the Sarbanes-Oxley Act but, instead, creates a separate enforcement mechanism that parallels the existing regime. The Sarbanes-Oxley Act protects whistleblowers who provide information about certain violations of federal securities laws or various forms of fraud, including fraud against shareholders. The Dodd-Frank Act, in contrast, covers reports required or protected by the Sarbanes-Oxley Act, reports about violations of other laws subject to the SEC’s jurisdiction, and reports to law enforcement officers about the commission of federal offenses.

Protection for Whistleblowers Under the Sarbanes-Oxley Act and the Dodd-Frank Act

The following table contains a comparison of the main provisions of the Sarbanes-Oxley Act and the Dodd-Frank Act. In some cases, the Sarbanes-Oxley Act’s protections have been amended by the passage of the Dodd-Frank Act.

<table>
<thead>
<tr>
<th>Scope of Protected Reporting</th>
<th>Sarbanes-Oxley Act (as amended to date)</th>
<th>Dodd-Frank Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>Whistleblowers are protected from retaliation for reporting violations of:</td>
<td>Whistleblowers are protected from retaliation for making disclosures that are required or protected under:</td>
<td></td>
</tr>
<tr>
<td>o any rule or regulation of the SEC;</td>
<td>o the Sarbanes-Oxley Act;</td>
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<tr>
<td>o federal criminal provisions relating to securities, bank, mail, or wire fraud; or</td>
<td>o the Securities Exchange Act of 1934 (Exchange Act), including Section 10A(m), which requires each public company audit committee to establish procedures for receiving and handling complaints regarding accounting or auditing matters and confidential, anonymous submissions by employees regarding questionable accounting or auditing matters;</td>
<td></td>
</tr>
<tr>
<td>o any federal law relating to fraud against shareholders.</td>
<td>o 18 U.S.C. § 1513(e), which prohibits retaliation, including in connection with employment, against individuals for providing information to a law enforcement officer about the possible commission of a federal offense; and</td>
<td></td>
</tr>
<tr>
<td>Whistleblowers are protected from retaliation if they have provided such information to:</td>
<td>o any other law, rule, or regulation subject to the SEC’s jurisdiction.</td>
<td></td>
</tr>
<tr>
<td>o a federal regulatory or law enforcement agency;</td>
<td>Whistleblowers are also protected for making disclosures to the SEC</td>
<td></td>
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<tr>
<td>o a member or committee of Congress; or</td>
<td></td>
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<tr>
<td>o a person with supervisory authority over the whistleblower.</td>
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</tr>
</tbody>
</table>

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3 This section summarizes the relevant provisions of the Dodd-Frank Act, as signed into law on July 21, 2010. It should be noted, however, that the SEC is required by the Act to promulgate additional regulations implementing the whistleblower provisions of the Act within 270 days of its passage. Moreover, the Office of the Inspector General of the SEC is directed to issue a report on the efficacy of the Act’s whistleblower incentive provisions within 30 months of the Act’s passage.
pursuant to the new Dodd-Frank whistleblower bounty program.4

| Statute of Limitations | 180 days after the date of the violation or after the employee became aware of the violation.5 | No more than  
| | | ○ six years after the violation; or  
| | | ○ three years after facts material to the right of action are known or reasonably should have been known by the employee.  
| | | In any event, no action may be brought more than 10 years after the date of the violation. |

| Jurisdiction over Complaints | Whistleblowers must file an initial complaint with the Occupational Safety and Health Administration (OSHA) within the Department of Labor. If the Secretary of Labor fails to issue a final decision with respect to the complaint within 180 days, the whistleblower may bring an action in federal district court. | Whistleblowers may file an initial complaint in federal district court. There is no preliminary OSHA adjudication of these complaints. |

| Remedies | Reinstatement with equivalent seniority and back pay with interest. Reasonable attorneys’ fees and related costs are also recoverable. | Reinstatement with equivalent seniority and two-times back pay with interest. Reasonable attorneys’ fees and related costs are also recoverable. |

| Amendments to Sarbanes-Oxley Act by Dodd-Frank Act | The Dodd-Frank Act amended the Sarbanes-Oxley Act as follows:  
| | ○ increases statute of limitations from 90 to 180 days, as described above (see note 5);  
| | ○ eliminates an employer’s ability to enforce waivers of whistleblowers’ rights or remedies, or to require arbitration of claims of retaliation through pre-dispute agreements;  
| | ○ grants parties to retaliation cases in federal district court a right to trial by jury; and | N/A |

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4 The Dodd-Frank Act also contains provisions protecting whistleblowers from retaliation for, among other things, providing information to the Commodities Futures Trading Commission or the Bureau of Consumer Financial Protection. See Dodd-Frank Act §§ 748 and 1057. These provisions are outside the scope of this advisory.

5 The Sarbanes-Oxley Act originally contained a statute of limitations of 90 days. The Dodd-Frank Act increased this 90-day period to 180 days and extended the formulation to include the time period “after the date on which the employee became aware of the violation.”
clarifies that the Sarbanes-Oxley Act’s retaliation provisions cover employees of subsidiaries and affiliates of public companies whose financial information is included in the consolidated financial statements of such public company.

Comparison of Provisions and Implications

Scope of Protected Reporting Significantly Expanded

The scope of the protected disclosures underlying the retaliation cause of action in the Dodd-Frank Act is significantly broader than the scope of the protected disclosures set forth in the Sarbanes-Oxley Act. The Dodd-Frank Act’s cause of action covers retaliation due to any disclosures “required or protected” under the Sarbanes-Oxley Act, the Exchange Act, 18 U.S.C. § 1513(e), and any other law, rule, or regulation subject to SEC regulation. Thus, any claim of retaliation that could have been brought by a whistleblower under the Sarbanes-Oxley Act can still be brought—under either the Sarbanes-Oxley Act or the Dodd-Frank Act. Moreover, various claims of retaliation which could not have previously been brought (because they fall outside the scope of the Sarbanes-Oxley Act’s protections) can now be brought under the Dodd-Frank Act.

A few examples illustrate the point. Suppose a whistleblower disclosed to his or her supervisor a potential violation of the securities laws and was later terminated for this disclosure. This set of facts could give rise to a claim of retaliation under the Sarbanes-Oxley Act. It could also give rise to a claim of retaliation under the Dodd-Frank Act.

Suppose, instead, a whistleblower provided information to an FBI agent about a conspiracy hatched by his or her employer to create a monopoly in violation of the Sherman Antitrust Act and was later terminated for this disclosure. This could give rise to a claim of retaliation under the Dodd-Frank Act (because the disclosure was protected by 18 U.S.C. § 1513(e)), but could not be the basis for a retaliation claim under the Sarbanes-Oxley Act. Whereas the Sarbanes-Oxley Act focuses on protecting whistleblowers making disclosures of violations of the securities and various fraud laws, the Dodd-Frank Act significantly expands that focus to encompass a host of disclosures required or protected by additional federal statutes.

Finally, the Sarbanes-Oxley Act’s provisions apply to public companies (i.e., companies with a class of securities registered under Section 12 of the Exchange Act or required to file reports with the SEC under Section 15(d) of the Exchange Act) and, as clarified in the Dodd-Frank Act, the subsidiaries and affiliates whose financial information is included in the public companies’ consolidated financial statements. The Dodd-Frank Act’s provisions, on the other hand, apply to all companies. This means, for example, that an employee of a small, non-public company who reports to the SEC that individuals at the company are engaging in wire fraud and suffers an adverse employment action at the hands of his or her employer could bring a claim of whistleblower retaliation in violation of the Dodd-Frank Act in federal district court. This sort of lawsuit could come as quite a shock to the company, given that it was not otherwise subject to the SEC’s oversight.
**Statute of Limitations Extended**

The time period during which a whistleblower may bring a complaint alleging retaliation has been increased from 180 days under the Sarbanes-Oxley Act (as amended by the Dodd-Frank Act) to as long as 10 years under the Dodd-Frank Act. This lengthy statute of limitations may bring with it a host of issues.

For example, there is a greatly increased possibility that whistleblowers bringing these claims no longer work for the employer alleged to have engaged in retaliation. Moreover, other personnel with knowledge of the alleged retaliation may no longer be employees, and the employer may no longer have the relevant employment and other records, making it difficult to determine whether the alleged retaliation actually occurred.

Imagine a retaliation case brought by a former employee, five years after the employee left the company, and eight years after the allegedly retaliatory employment action. If, for example, the allegedly retaliatory action involved a denied promotion, it may be extremely difficult to find the records, and personnel with sufficient recollection of events, to establish why the former employee was not promoted eight years before.

**Jurisdiction Removed From OSHA**

Whereas OSHA serves as a gatekeeper for complaints under the Sarbanes-Oxley Act’s retaliation-protection regime, whistleblowers now have the opportunity to go straight into district court with their allegations under the Dodd-Frank Act. The implications of this change for companies could be significant. The rules of civil litigation in federal district court allow for extensive discovery and motion practice. This could result, among other things, in higher litigation costs, greater risk of confidential information being publicly disclosed, and an increased possibility of spin-off securities and other litigation.

**Remedies Increased**

Under the Sarbanes-Oxley Act, a whistleblower who succeeds in his or her claim of retaliation is entitled, among other remedies, to back pay with interest. Under the Dodd-Frank Act, a successful claimant can obtain up to two-times back pay with interest. This increase, coupled with the longer statute of limitations during which whistleblowers may bring claims (i.e., up to 10 years instead of up to 180 days), may result in much higher awards of back pay for successful claimants. Successful claimants also remain entitled to reimbursement of reasonable attorneys’ fees and other costs of litigation. These attorneys’ fees and related costs will likely be higher due to the federal court venue and the higher back-pay awards (upon which attorneys’ fees may be based). Finally, reinstatement is a remedy under both the Sarbanes-Oxley Act and the Dodd-Frank Act. The much longer statute of limitations provided by the Dodd-Frank Act may make the prospect of reinstatement, already difficult for employers, even more difficult given the longer passage of time.

**Whistleblower Claims Increased**

The Dodd-Frank Act’s new whistleblower bounty program—providing for the payment of cash awards to whistleblowers—will likely increase the number of whistleblowers and, therefore, the number of employees who could claim that they were retaliated against for their whistleblowing activities.
Key Takeaways

The Dodd-Frank Act enhances the retaliation protections available to whistleblowers for reporting violations of federal securities, fraud, and other laws. It enhances certain parts of the Sarbanes-Oxley whistleblower regime, while creating a wholly independent, parallel enforcement mechanism. Some key takeaways for employers regarding these changes are:

- The whistleblower-protection provisions of the Dodd-Frank Act apply to all employers, not just public companies. Therefore, all companies (including subsidiaries of public companies) should ensure a “compliance culture” with robust processes in place to handle whistleblower grievances.

- A whistleblower alleging retaliation for reports that fall within the protections of the Dodd-Frank Act may bring an action in federal district court without first filing a complaint with OSHA. Therefore, companies should maintain procedures whereby whistleblowers who believe they have been retaliated against can complain internally, thereby reducing the likelihood they will take their retaliation claims directly to federal court.

- The procedures established by public company audit committees for handling accounting and related complaints pursuant to Section 10A(m) of the Exchange Act should be evaluated and perhaps broadened to pick up the kinds of reports protected by the Dodd-Frank Act.

- The new SEC bounty program creates a powerful financial incentive for whistleblowers to provide “original information” directly to the SEC. In response, companies should consider establishing (or bolstering) mechanisms that encourage and reward employees who internally report potential problems early, thereby preventing small problems from growing and minimizing the SEC’s interest in enforcement actions down the road. Of some comfort for employers dealing with whistleblowers who, despite these mechanisms, go straight to the SEC with information is that until the whistleblower’s identity is revealed, the employer cannot be said to have engaged in retaliatory conduct.

Attorneys in Covington’s White Collar, Employment, Corporate, and Securities Litigation practice groups advise a range of clients on legislative and regulatory developments. You may contact any member of these practice groups or the undersigned, should you have any questions.

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DODD-FRANK BEEFS UP SEC AND CFTC ENFORCEMENT

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act institutes the most wide-ranging changes to the banking, securities, derivatives, and financial services industries since the 1930s. This advisory briefly summarizes the new law’s key provisions affecting SEC and CFTC enforcement that will soon take effect.

New SEC Causes of Action

Aiding and Abetting

The Act empowers the SEC to bring more aiding-and-abetting claims, which will now also be much easier to prove. It gives the SEC the right to bring aiding-and-abetting claims for violations of the Securities Act of 1933 and the Investment Company Act of 1940. In addition, the Act gives the SEC the authority to seek monetary penalties for aiding and abetting violations of the Investment Advisers Act of 1940. Several federal district courts had held that the SEC had no right to bring aiding-and-abetting claims under the Securities Act and the Investment Company Act, and no right to pursue monetary penalties for such claims under the Investment Advisers Act. The SEC has now obtained through the Act the express right to bring aiding-and-abetting claims under all of the federal securities statutes.

The Act also lowers the state of mind required for the SEC to prove aiding and abetting. The SEC no longer needs to prove “actual knowledge” in every case. Recklessness now suffices. The Private Securities Litigation Reform Act of 1995, which gave the SEC (but not private litigants) the right to sue for aiding and abetting a violation of the 1934 Act, stated that aiding and abetting required “knowing” misconduct. Federal court decisions held that Congress meant what it said — that the SEC must prove actual knowledge, and not mere recklessness, to prevail on an aiding-and-abetting charge. The SEC has effectively nullified those decisions by obtaining from Congress the state-of-mind requirement that it wanted.

Control-Person Liability

The Act expressly authorizes the SEC to bring cases based on “control person” liability under Section 20 of the 1934 Act. Under the control-person theory, a person who directly or indirectly controls another person who commits a securities violation is responsible for that violation unless that person can show that he/she acted in good faith and did not directly or indirectly induce the violation. Control-person liability is a staple of private securities actions, but the SEC has rarely asserted control-person claims as there long were questions about whether it had the authority to bring them. Those questions have now been resolved in the SEC’s favor.

This change creates significant new exposure for a company’s officers and directors. If a low- or mid-level employee violates the federal securities laws, it potentially opens up the officers and directors
to a control-person claim from the SEC, shifting the burden to the officer or director to show good faith and that he/she did not directly or indirectly induce the violation by the lower-level person. Thus, the SEC has a potent new tool to go after directors and senior management.

Other New SEC Powers

Broader Penalty Authority in Administrative Proceedings

Under the Act, the SEC now has the right to seek monetary penalties against any person in an administrative cease-and-desist proceeding before an SEC Administrative Law Judge. Previously, the SEC’s right to seek penalties in this forum was limited to SEC-regulated entities such as broker-dealers, investment advisers, mutual funds, and their associated persons. Now, the SEC can seek this remedy from an administrative law judge against a public company and/or its current or former officers, directors, or employees, or against any individual alleged to have violated the federal securities laws.

Depending on how extensively the SEC makes use of this new power, it could radically affect the rights of companies and individuals outside the securities industry who become subject to SEC enforcement action. Previously, the SEC could seek a penalty against such defendants only by suing them before an independent Article III judge in a U.S. District Court, where they would enjoy the right to extensive discovery and a jury trial. Now, the SEC can impose a potentially substantial penalty against any person or company through an administrative proceeding with quite limited discovery and no right to a jury trial, before an administrative law judge employed by the SEC itself.

Collateral Bars

Previously, the SEC could seek to bar an associated person of a regulated entity only from the type of business the person was in when the violation occurred. Thus, a person working for an investment advisor could be barred from the investment advisory business or a person working for a broker-dealer could be barred from the brokerage business. Federal appellate courts, however, have held that the SEC could not bar a person wholesale from the securities industry — that is, a violation committed while in the investment advisory business could not be the basis for barring a person from the brokerage business, and vice-versa. The Act now provides that the SEC can seek a collateral bar that bars a person from any part of the securities business.

International Jurisdiction

The Act also codifies that the SEC’s jurisdiction extends to enforcement actions with extraterritorial dimensions. First, the SEC has enforcement jurisdiction over conduct that constitutes “significant steps in furtherance of a violation” even if that violation occurred outside the United States. Second, the SEC has enforcement jurisdiction over conduct that occurred outside the United States if that conduct has a “foreseeable substantial effect” in the United States. In this regard, the Act clears up any uncertainty over the territorial scope of the SEC’s enforcement jurisdiction.

Nationwide Service of Trial Subpoenas

Previously, the SEC had nationwide service of process only in administrative proceedings. By contrast, in federal court cases, given the national or international scope of many SEC enforcement actions, most of the SEC’s trial testimony was given by videotaped depositions, which are generally less compelling than live testimony. Now, the SEC will be able to force its trial witnesses to testify in person, no matter how far they live from the courthouse where the case is being tried.
Whistleblowers

The Act provides a hefty monetary incentive for those aware of wrongdoing to report it to the SEC. It directs the SEC to pay whistleblowers who provide “original information” relating to a securities law violation an amount of no less than 10%, and no more than 30%, of the monetary sanctions actually collected by the SEC in connection with a successful enforcement action against the violator if the sanctions exceed $1 million. Previously, the SEC had the discretion to pay bounties only in insider trading cases, but rarely did so.

The Act also provides strong protection to whistleblowers. In particular, the Act permits whistleblowers to bring actions in federal court against their employers for retaliation. They may bring such claims within six years from the date of the violation or within three years from the date when material facts regarding the right of action reasonably should have been known to the whistleblower. The remedies include not just reinstatement, but also double back pay and litigation costs.

SEC Funding

The SEC has complained for decades that it lacked adequate resources to conduct examinations and investigations, given the number, size, complexity, and sophistication of the entities and persons it regulates. The SEC sought self-funding through the fees it collects from registrants. Congress refused to provide for self-funding, but the Act did provide for major funding increases, including establishing a $100 million reserve. It also prohibits the President from changing the SEC’s budget request before it is transmitted to Congress.

New CFTC Enforcement Powers

The Act significantly expands the range of liability available for malfeasance in derivatives trading. The CFTC is charged with enforcement of the new liability provisions associated with the trading of over-the-counter derivatives.

First, the Act amends Section 4b of the Commodity Exchange Act (“CEA”) to add a fraud liability provision mirroring Section 10(b) of the Securities Exchange Act. Now, just as Section 10(b) and Rule 10b-5 operate with respect to securities, Section 4b of the CEA will prohibit fraudulent activity and material misrepresentations in connection with commodity futures contracts and swaps. Section 4b now prohibits a wider range of fraudulent activity, and brings derivatives enforcement rules in line with those already in place for securities.

In a second and related provision, the Act expands liability for “manipulation” under the CEA both by broadening the scope of manipulative conduct and by including swaps within the proscriptive ambit of the statute. The Act also broadens liability for providing false or misleading information to the CFTC, by eliminating the requirement that such information had to be provided in a registration statement or report filed with the CFTC.

Finally, the Act proscribes a variety of additional practices, including forms of insider trading, newly defined “disruptive practices,” and fraudulent activity where a swap dealer is acting as an advisor. The CFTC is also given authority to establish “business conduct requirements” for swap dealers, which will include duties to disclose material information to transaction counterparties.

According to the Act, the CFTC’s enforcement authority includes nationwide subpoena power, and the ability to seek sanctions including industry bars, civil monetary penalties, and restitution.
Conclusion

Dodd-Frank has ramped up the enforcement mandates of the SEC and CFTC more than at any time since the agencies were created. Their jurisdictional reach is broader, the causes of action they can bring have increased, and their remedies have expanded. Public companies, regulated entities, and hedge funds, as well as their officers, directors, and employees, should brace themselves and prepare for a significant increase in enforcement activity by both the SEC and the CFTC.

If you would like to discuss the Act and our capabilities to assist you in SEC and CFTC enforcement matters, please contact the following members of our firm:

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act has received broad publicity for its signature provisions relating to financial services regulatory reform. Predictably, however, the Act also is a vehicle for an odd assortment of unrelated measures. One such area relates to extractive industries, for which the Act creates new disclosure obligations for (1) companies engaged in the commercial development of oil, natural gas and other minerals, (2) operators of coal and other mines and (3) persons that use certain minerals originating in the Democratic Republic of the Congo or its adjoining countries. This advisory briefly summarizes these provisions.

Two of the provisions described in this advisory will require, and the other will need, SEC rulemaking. Annex A provides a summary of the SEC rulemakings and applicable deadlines under the Act for these provisions.

DISCLOSURE OF PAYMENTS BY RESOURCE EXTRACTION ISSUERS

Section 1504 of the Act creates new disclosure requirements for “resource extraction issuers.” A resource extraction issuer is defined as any issuer required to file an annual report with the SEC that engages in the commercial development of oil, natural gas or minerals. The Act goes on to state that commercial development of such resources includes exploration, extraction, processing, export and other “significant” actions relating to such resources, or the acquisition of a license for any such activity, all as may be determined by the SEC.

Under the Act, by April 17, 2011 (270 days after the Act’s enactment), the SEC must issue final rules requiring each resource extraction issuer to include in its annual report information relating to any payment, other than de minimis payments, made by the issuer (or by a subsidiary or controlled entity of the issuer) to a foreign government or to the federal government for the purpose of the commercial development of oil, natural gas, or minerals. For this purpose, the Act specifies that “payments” include taxes, royalties, fees (including license fees), production entitlements, bonuses, and other “material benefits,” to the extent the SEC determines such payments are part of the “commonly recognized revenue stream” for the commercial development of oil, natural gas, or minerals.

The required annual disclosure of such payments must include the type and total amount of such payments made for each of the company’s projects, as well as the type and total amount of such payments made to each government. Further, the SEC’s rules regarding the annual disclosure of such information must require the information to be submitted to the SEC in an interactive data format.

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1 In making such determination, to the extent practicable, the SEC is to take account of the guidelines of the Extractive Industries Transparency Initiative, a coalition of governments (largely comprised of African and Asian countries rich in extractive resources), companies, investors, and other organizations with a goal of improving transparency regarding payments made to governments by companies in the extractives sector.
format, and the SEC’s rules must establish an interactive data standard to be used for this information.²

The new disclosure requirements for resource extraction issuers will first be required in the annual report covering the fiscal year ending at least one year after the date the SEC adopts final rules implementing this requirement.

**MINE SAFETY DISCLOSURES**

Section 1503 of the Act requires a public company that operates (or has a subsidiary that operates) a “coal or other mine”³ to include in each periodic report filed with the SEC specified disclosures regarding the company’s history of mine safety. This new disclosure obligation takes effect on August 20, 2010. Thus, for public companies with fiscal years ending on December 31, the first report required to include this new disclosure will be the quarterly report on Form 10-Q for the quarter ending September 30, 2010.⁴

Specifically, and subject to any conditioning that might be added by SEC rulemaking, a public company covered by this provision must disclose, for each coal or other mine operated by it or any subsidiary:

- the total number of violations of mandatory health or safety standards that could significantly and substantially contribute to a mine safety or health hazard for which the operator received a citation from the Mine Safety and Health Administration (MSHA);
- orders issued under section 104(b) of the Mine Act resulting from failure to abate a violation of health or safety standards;
- citations and orders for unwarrantable failure to comply with mandatory health or safety standards under section 104(d) of the Mine Act;
- flagrant violations under section 110(b)(2) of the Mine Act;
- imminent danger orders issued under section 107(a) of the Mine Act;
- the total dollar value of proposed assessments from the MSHA; and
- the total number of mining-related fatalities.

In its periodic reports, the company must also disclose a list of any mine operated by it or a subsidiary that receives written notice from the MSHA of a pattern or potential pattern of violations of mandatory health or safety standards that could significantly and substantially contribute to a

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² The Act lists a series of specific electronic data tags that must be included in the interactive data standard for this information, including non-financial data.

³ The Act defines “coal or other mines” with reference to section 3 of the Federal Mine Safety and Health Act of 1977 (the Mine Act) which includes, among other things, coal mines and any other type of mine from which minerals are extracted, including metals (such as iron, copper, zinc, gold, and silver), nonmetals (such as clay, shale and potash), and stone (such as marble, slate and granite).

⁴ Although this section of the Act is self-effectuating, the SEC is authorized to issue rules or regulations that are necessary or appropriate to protect investors and carry out the purposes of this section of the Act. It seems likely that, at a minimum, the SEC should provide guidance before August 20, 2010, and perhaps even issue proposed rules to implement this section of the Act. It is also possible that the SEC could adopt final implementing rules by August 20, 2010 if it “for good cause finds ... that notice and public procedure are impracticable, unnecessary, or contrary to the public interest.” See 5 U.S.C. §553(b).
mine safety or health hazard under the Mine Act, and any pending legal actions before the Federal Mine Safety and Health Review Commission.

In addition to these periodic reporting disclosures, the Act requires a company covered by this section to file a Current Report on Form 8-K upon the receipt of an imminent danger order issued under section 107(a) of the Mine Act or a written notice from the MSHA of a pattern or potential pattern of violations of mandatory health or safety standards that could significantly and substantially contribute to a mine safety or health hazard under the Mine Act.5

This section of the Act lays out a detailed disclosure schedule for technical information about mine safety issues that are well outside the SEC’s expertise and unbounded by traditional concepts of materiality. While this part of the Act is self-effectuating, its broad grant of authority to the SEC to adopt rules necessary or appropriate to protect investors will hopefully permit the agency to seek input from all constituents in the mine safety area, including the MSHA, and to tailor its disclosure rules in a sensible manner.

DISCLOSURES ABOUT CONFLICT MINERALS

Section 1502 of the Act imposes new disclosure requirements, subject to SEC rulemaking, for persons6 whose products make use of certain minerals (the “conflict minerals”) originating in the Democratic Republic of the Congo or its adjoining countries. The conflict minerals are “columbium-tantalum (coltan), cassiterite, gold, wolframite, or their derivatives” and other minerals that may be determined by the Secretary of State following a one year notice in the Federal Register.

Under the Act, the SEC has until April 17, 2011 to promulgate rules requiring annual reports by persons for which the use of conflict minerals is “necessary to the functionality or production of a product” manufactured by such person. Specifically, any such person must disclose whether conflict minerals it uses originated in the Democratic Republic of the Congo or an adjoining country.7

Where the conflict minerals did originate in any such country, there must be a report to the SEC that includes a description of the measures taken by the reporting person to exercise due diligence on the “source and chain of custody of such minerals,” which measures must include an independent private sector audit, “submitted through the [SEC]” and certified by the person submitting the report.8 The report must also include a description of the products manufactured or contracted to be

5 Until the SEC amends Form 8-K, this information could, presumably, be reported under either Item 7.01 (Regulation FD Disclosure) or Item 8.01 (Other Events), although information reported under Item 7.01 has the benefit of not being deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934. The deadline for filing a Form 8-K triggered by this provision of the Act will presumably be four days after the event giving rise to the obligation to file the report.

6 This new obligation was added to Section 13 of the Securities Exchange Act of 1934. Curiously, the provision covers “persons.” SEC rulemaking must bring clarity here, but it would be unusual for the agency to extend its reporting and disclosure regime far afield from public companies or securities transactions.

7 It is not completely clear from the Act’s language whether this annual report is meant to be included in a periodic report filed with the SEC, such as a Form 10-K, or in some other submission to the SEC that is not publicly filed. The SEC will surely clarify this in its rulemaking.

8 Whether the SEC will treat the provider of this audit as an “expert” for securities offering purposes under the Securities Act of 1933 will have to be addressed in the agency’s rulemaking.
manufactured that are not “DRC conflict free,” the entity that conducted the audit, the facilities used to process the conflict minerals, the country of origin of the conflict minerals, and the efforts to determine the mine or location of origin with the greatest possible specificity. Information provided to the SEC must also be made available to the public on the disclosing person’s website.

These new requirements will terminate on the date that the President determines and certifies that “no armed groups continue to be directly involved and benefiting from commercial activity involving conflict minerals.” The Act also requires the Secretary of State, the Comptroller General and the Secretary of Commerce to submit certain reports and information relating to the conflict in the Democratic Republic of the Congo and the effectiveness of the new disclosure requirements to the appropriate Congressional committees.

None of these sections of the Act is well drafted; each represents an unfortunate use of the federal securities laws for purposes unrelated to securities transactions and disclosures. This likely will result in special purpose information in SEC filings that is untethered from traditional principles of securities disclosure and may lack significance to the average investor. In all events, it will be interesting to see how the SEC tackles the twin challenges of intuiting Congressional intent and implementing measures that address policies well outside of its traditional expertise.

If you would like to discuss these provisions of the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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9 Products that are “DRC conflict free” do not contain minerals that “directly or indirectly finance or benefit armed groups in the Democratic Republic of the Congo or an adjoining country.”

10 This date may not, however, be sooner than July 21, 2015. Also, at the President’s direction based on national security considerations, the SEC must revise or temporarily waive the new requirements.

Under the Act, the CFPB is tasked with implementing and enforcing Federal consumer financial law to ensure that consumers have access to markets for consumer financial products and services, and that such markets are “fair, transparent, and competitive.”

Statutory Authority of the CFPB

The Act establishes the CFPB within the Federal Reserve System as an independent bureau, headed by an independent director appointed by the President for a 5-year term. Generally, the CFPB would have authority to regulate the offering and provision of “consumer financial products or services” under Federal consumer financial laws.

- Under the Act, the CFPB is given broad regulatory, supervisory, and enforcement authority over “covered persons” and “service providers” with respect to both new consumer financial protection provisions and an array of existing Federal consumer financial protection laws and provisions that are to be transferred to the CFPB from existing Federal banking agencies.

- Consumer financial protection responsibilities transferred to the CFPB from Federal banking agencies include authority under:
  - The Electronic Funds Transfer Act
  - The Equal Credit Opportunity Act
  - The Fair Credit Reporting Act
  - The Fair Debt Collection Practices Act
  - The Home Mortgage Disclosure Act
  - The Real Estate Settlement Procedures Act
  - The Secure and Fair Enforcement for Mortgage Licensing Act
  - The Truth in Lending Act
  - The Truth in Savings Act

Scope of CFPB Authority

Entities and Activities Subject to CFPB Jurisdiction

- The CFPB has authority to regulate any person who engages in offering or providing a “consumer financial product or service,” or any affiliate service provider of such a person.
Consumer financial products or services include:

- Financial products or services that are “offered or provided for use by consumers primarily for personal, family, or household purposes.”
- Certain financial products or services that are delivered, offered, or provided in connection with a consumer financial product—specifically, those related to extending credit and loan servicing, real estate settlement services, consumer reporting, and debt collection.

“Consumers” include both individuals and agents, trustees, or representatives acting on behalf of individuals.

Financial products or services subject to CFPB jurisdiction include:

- Extending credit and servicing loans (broadly defined to include acquiring, purchasing, selling, brokering, and certain other extensions of credit).
- Deposit-taking.
- Acting as a custodian of funds or any financial instrument for use by or on behalf of a consumer.
- Leasing real or personal property on a non-operating basis.
- Providing real estate settlement services.
- Selling, providing, or issuing stored value or payment instruments.
- Providing check cashing, check collection, or check guaranty services.
- Providing payments or financial data processing products or services to any consumer by “any technological means,” including payments made through an online banking system or mobile telecommunications network.
- Providing financial advisory services to consumers on individual financial matters or relating to proprietary financial products or services, including credit counseling, debt management, and avoiding foreclosure.
- Collecting, analyzing, maintaining, or providing consumer financial report information or other account information, including credit history, for certain purposes related to consumer financial products and services.
- Collecting debt related to a consumer financial product or service.
- Other financial products or services “defined by the Bureau by regulation,” if the product or service is either (1) “entered into or conducted as a subterfuge” or “to evade any Federal consumer financial law,” or (2) is permissible for a bank or financial holding company to offer and will likely have a “material impact” on consumers.

Limitations on CFPB Jurisdiction

- Excluded from CFPB jurisdiction are the following entities and activities:
  - The business of insurance.
  - Electronic conduit services, including electronic data transmission, routing, intermediate or transient storage, or connections to a telecommunications system or network.
  - Persons regulated by state insurance regulators, but only to the extent those persons are acting in a regulated capacity.
Persons registered with or regulated by the SEC or by a state securities commission, but only to the extent those persons are acting in a regulated capacity.

Persons registered with or regulated by the CFTC, but only to the extent those persons are acting in a regulated capacity.

- Both the SEC and CFTC must consult and coordinate with the CFPB on the passage of consumer protection rules regarding a “product or service that is the same type of product as, or that competes directly with, a consumer financial product or service” subject to CFPB jurisdiction.

Accountants performing “customary and usual” accounting activities, tax preparers, and licensed attorneys.

Employee benefit and compensation plans, except to the extent that the Secretary of the Treasury and Secretary of Labor request the CFPB, or approve a request by CFPB, to exercise rulemaking or to enforce a rule.

Merchants, retailers, and sellers of non-financial products; real estate license holders; and retailers of manufactured or modular homes.

- This exclusion does not apply to any credit transaction or collection of debt by a merchant, retailer, or seller, when such person is “engaged significantly” in offering or providing consumer financial products or services, and (1) the consumer debt is assigned, sold, or conveyed to another person, (2) the credit extended significantly exceeds the market value of the non-financial good or service, or (3) the credit is subject to a finance charge and the merchant regularly extends such credit to consumers.

- Notwithstanding the limitations on this exclusion, certain “small businesses” with annual receipts or number of employees below certain thresholds are excluded from CFPB jurisdiction.

Persons regulated by the Farm Credit Administration.

Activities related to charitable contributions, including the solicitation or making of a voluntary contribution to a tax-exempt organization.

Auto dealers with respect to the sale, servicing, and leasing of motor vehicles.

- The auto dealer exclusion does not apply to dealers who (1) provide financial services related to residential or commercial mortgages, (2) operate a business to extend credit or leases involving motor vehicles in which the extension of credit is offered directly to consumers and is not routinely assigned to an unaffiliated third party, or (3) offer a financial product or service unrelated to the auto dealer business.

The Act does not confer authority on the CFPB to impose a usury limit applicable to an extension of credit by a covered person to a consumer.

Specific Powers of the CFPB: Rulemaking, Enforcement, and Examination

CFPB Authority Over “Very Large” Banks, Savings Associations, Credit Unions, and Their Respective Affiliates

The CFPB has primary enforcement authority over “very large” insured depository institutions or insured credit unions, having total assets of more than $10 billion, and their affiliates. Any Federal agency authorized to enforce a consumer financial protection law with respect to a “very large” institution is given backup enforcement authority.
The CFPB has exclusive supervision authority, including examination authority, over these institutions and their affiliates to assess compliance with Federal consumer financial laws, obtain information about the institutions’ activities and compliance systems and procedures, and to detect and assess risks to consumers and markets.

Affiliates of a “very large” insured institution would be subject to CFPB enforcement and supervision to the same extent as the “very large” insured institution itself.

A service provider to a “very large” insured depository institution (or an affiliate) is subject to the authority of the CFPB to the same extent as if the activities being performed by the service provider for such institution (or an affiliate) were performed by the depository institution (or its affiliate) itself.

CFPB Authority Over Other Banks, Savings Associations, and Credit Unions

The CFPB is authorized to require reports from “other” insured depository institutions and insured credit unions with total assets equal to or less than $10 billion. Such reports may be required as necessary to support the CFPB in implementing Federal consumer financial laws, supporting examination activities, and assessing and detecting risks to consumers and financial markets.

The CFPB has limited examination authority with respect to these “other” institutions. Specifically, a CFPB examiner may be included on a sampling basis in the examinations performed by the institution’s prudential regulator; the CFPB examiner’s role is limited to assessing compliance with Federal consumer financial law.

The prudential regulator has exclusive authority to enforce Federal consumer financial laws with respect to these “other” institutions, and unlike the affiliates of “very large” institutions, affiliates of these “other” institutions are not expressly subject to CFPB enforcement.

A service provider that provides services to substantial numbers of “other” insured depository institutions is subject to the authority of the CFPB to the same extent as if the activities being performed by the service provider for such institutions were being performed by the institutions themselves.

CFPB Authority Over Non-Depository Institutions

The Act authorizes the CFPB to supervise certain non-depository institutions, including:

- Any covered person who offers or provides (a) origination, brokerage, or servicing of certain loans secured by real estate, or (b) loan modification or foreclosure relief services in connection with such loans.
- Any covered person who is a “larger participant” of a market for other consumer financial products or services (to be defined by CFPB regulation after consultation with the FTC).
- Any covered person whom the CFPB has reasonable cause to determine is engaging or has engaged in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services.
- Any covered person who offers or provides any private education loan or any payday loan.

The CFPB’s authority over non-depository institutions includes the ability to require reports and conduct periodic examinations, but the extent of this supervision authority is made dependent on the CFPB’s assessment of the risks posed to consumers by the non-depository institution, taking

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1 The Act generally refers to “any person that engages in offering or providing a consumer financial product or service,” and any affiliate service providers of such persons, as “covered persons.”
into consideration the assets of the institution, volumes of transactions involving consumer financial products or services, the risks to consumers created by the institution’s provision of consumer financial products or services, the extent of State oversight, and any other factors determined to be relevant by the CFPB.

- The CFPB must coordinate this supervision authority with prudential regulators and State bank regulators to minimize the burden on non-depository institutions.

- The CFPB generally is given exclusive authority to enforce Federal consumer financial protection law with respect to covered non-depository institutions, but must “coordinate” its efforts with the FTC through an agreement to be negotiated between the CFPB and the FTC.

- The CFPB is given exclusive rulemaking and examination authority over covered non-depository institutions for purposes of assuring compliance with Federal consumer financial protection law and any regulations thereunder.

- A service provider to a covered non-depository institution is subject to CFPB authority to the same extent as if the activities being performed by the service provider for such non-depository institution were being performed by the non-depository institution itself.

**Rulemaking Authority**

- The CFPB is given broad authority to prescribe rules and issue orders and guidance, in consultation with the appropriate prudential regulatory or other Federal agency, to carry out the CFPB’s regulatory responsibilities. In exercising its rulemaking authority, the CFPB is required to consider the benefits and costs of rules on covered persons and consumers, and the impact of proposed rules on covered persons and consumers in rural areas.

- In the event the CFPB and another agency are both authorized to issue regulations under a provision of Federal consumer financial protection law, the CFPB is given exclusive authority to prescribe rules. In addition, a court must afford deference to the CFPB regarding the meaning or interpretation of such Federal consumer financial protection laws, as if the CFPB were the only agency authorized to apply, enforce, interpret, or administer such laws.

- The CFPB is given authority to promulgate specific new rules:
  
  - Identifying any unlawful “unfair, deceptive, or abusive acts or practices” in connection with consumer transactions for consumer financial products or services. Under this authority, the CFPB may identify an act or practice as “unfair” only if it has a reasonable basis to conclude that (1) the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers and (2) such injury is not outweighed by countervailing benefits to consumers or to competition. Likewise, the CFPB may only identify an act or practice as “abusive” if it (1) materially interferes with the ability of a consumer to understand a consumer financial product, or (2) takes unreasonable advantage of the consumer’s lack of understanding, inability to protect the consumer’s own interests in selecting or using the product or service, or the consumer’s reasonable reliance on a covered person under the Act to act in the consumer’s interest.
  
  - 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 order to permit consumers to understand the “costs, benefits, and risks” associated with the product or service.
  
  - Prohibiting or imposing conditions on the use of any agreement between covered persons and consumers providing for the arbitration of any future disputes.
Identifying unlawful, unfair, deceptive, or abusive acts or practices in connection with reverse mortgage transactions or the offering of reverse mortgages.

Regulations promulgated by the CFPB may be appealed by a Federal banking agency to the Financial Stability Oversight Council. The Council, upon a 2/3 vote, may issue a stay (postponing the effective date of a regulation) or a set aside (rendering the regulation unenforceable), if it finds that the regulation or provision would put the safety and soundness of the United States banking system or the stability of the financial system at risk.

Monitoring and Registration of Certain Covered Persons

The CFPB is authorized to monitor the offering or provision of consumer financial products or services, including market developments, for risks to consumers. To facilitate this monitoring, the CFPB may require covered persons (other than an insured depository institution, insured credit union, or related person2) to register with the CFPB.

Funding of the CFPB

The CFPB is to be funded by an annual transfer from the Federal Reserve in an amount the CFPB Director determines is reasonably necessary to carry out the authorities of the Bureau. The Act does not provide assessments as a source of funding for the CFPB.

The annual transfer to the CFPB is subject to a cap based on a percentage of the Federal Reserve System budget as reported in its 2009 Annual Report to the Board of Governors, adjusted annually based on the employment cost index for State and local government workers published by the Federal Government. This cap is set at 10% for 2011, 11% for 2012, and 12% for 2013 and thereafter.

The CFPB budget is not subject to review by the Appropriations Committees of the House or Senate, but the budget is subject to annual audit by the Government Accountability Office.

Any civil money penalties collected by the CFPB are transferred to a separate “Consumer Financial Civil Penalty Fund,” which may be used to compensate victims of the activities for which the penalties were imposed, or in some cases for consumer education and financial literacy programs.

In the event the CFPB Director determines that the funding of the CFPB will be insufficient to carry out the Bureau’s responsibilities, additional funding appropriations up to $200 million may be authorized for each of the fiscal years 2010 through 2014.

Funds received from the CFPB through the annual transfer from the Federal Reserve are not subject to apportionment, but any additional amounts transferred pursuant to the appropriations process are subject to apportionment.

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2 For this purpose, “related persons” include: any director, officer, or employee charged with managerial responsibility for, or controlling shareholder of, or agent for a covered person; any shareholder, consultant, joint venture partner, or other person who materially participates in the conduct of the covered person’s affairs; and any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in any violation of any provision of law or regulation, or any breach of a fiduciary duty.
National Bank Act (NBA) and Home Owners’ Loan Act (HOLA) Preemption and OCC Visitorial Powers

Scope of NBA and HOLA Preemption

- The Act restricts NBA and HOLA preemption of all state consumer financial laws to instances where one of the following requirements is met:
  - Application of a state law would have a “discriminatory effect” on federally-chartered institutions in comparison to state-chartered institutions.
    - This preemption determination may be made by a court. Such a determination may also be made by regulation or order of the Comptroller, on a case-by-case basis. The case-by-case determination must be made by the Comptroller based on “substantial evidence.”
    - A court reviewing a decision by the Comptroller is to assess the validity of the Comptroller’s ruling based on “the thoroughness evident in the consideration of the agency, the validity of the reasoning of the agency, the consistency with other valid determinations made by the agency, and other factors which the court finds persuasive and relevant.”
  - A Federal law other than the NBA or HOLA preempts the state law.

Elimination of Preemption for Operating Subsidiaries of Federally-Chartered Institutions

- The Act overturns the Supreme Court’s *Watters* decision by eliminating NBA and HOLA preemption for national bank and Federal thrift operating subsidiaries.

Authority for State Attorneys General to Enforce Applicable Laws

- The Act codifies the Supreme Court’s *Cuomo* decision; State Attorneys General may enforce “an applicable law” against federally-chartered depository institutions. State Attorneys General also are authorized to bring civil actions against federally-chartered institutions to enforce regulations prescribed by the CFPB or to secure other remedies.

Implementation Timeline

Creation of the Agency

- The CFPB is established on the Act’s date of enactment.

Transfer of Consumer Protection Authority to the CFPB

- Consumer financial protection functions will be transferred from various existing Federal financial regulatory agencies to the CFPB on the “designated transfer date.” The transferred consumer financial protection functions include significant rulemaking and examination authority previously allocated to a number of these other Federal regulatory agencies (transferor agencies).
- The “designated transfer date” is to be prescribed by the Secretary of the Treasury and shall be 180 days to 12 months after the Act’s date of enactment, unless the Secretary extends the
designated transfer date, in which case the date may not be later than 18 months after the date of enactment.

Promulgation of Rules

- The CFPB, in consultation with the FTC, must define non-depository institutions subject to the authority of the CFPB as “covered persons” under the Act not later than one year after the designated transfer date.

- As discussed above, the Act gives the CFPB, effective on the date of enactment, specific rulemaking authority that includes CFPB authority (i) to identify certain acts or practices in connection with transactions in or offerings of consumer financial products as unlawful, unfair, deceptive, or abusive, and (ii) to prescribe rules ensuring that the features of consumer financial products and services are fully, accurately, and effectively disclosed to consumers.

  - As also discussed above, the CFPB is given additional rulemaking authority under transferred “consumer financial protection functions,” previously exercised by transferor agencies, effective on the “designated transfer date.”

  - Rulings, orders, determinations, agreements, and resolutions relating to consumer financial protection, in effect before the “designated transfer date,” will remain in effect after such date. Only certain previously-enacted rules and orders identified by the CFPB will be enforced by the CFPB.

If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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