Dodd-Frank Wall Street Reform and Consumer Protection Act

Financial Markets Alerts: Insights on the Changing Financing Landscape for Financial Institutions

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FINANCIAL MARKETS ALERT

JULY 16, 2010

Dodd-Frank Wall Street Reform and Consumer Protection Act: Securitization Provisions

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On July 15, 2010, the Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was passed by the House of Representatives on June 30th. The President has indicated that he will sign the bill that has now passed both of the Houses.

The legislation covers a wide variety of topics in an effort to address the causes of the recent turmoil in the financial markets. With respect to securitization, the legislation covers the following topics: (i) whether issuers or other parties should be required to retain a portion of the credit risk in securitizations; (ii) disclosure and reporting standards related to securitization transactions; (iii) representations and warranties required to be provided in securitization transactions and the mechanisms for enforcing such representations and warranties; and (iv) requirements regarding due diligence with respect to loans underlying securitization transactions.

As indicated below, many of the requirements to be imposed have been left by Congress to actions to be taken by the Federal banking agencies, the SEC and other regulatory authorities.

Credit Risk Retention

The Federal banking agencies (defined as the OCC, the Fed and the FDIC) and the SEC are required to jointly prescribe regulations to require "securitizers" to retain an economic interest in a portion of the credit risk of any securitized asset. In addition, the Federal banking agencies, the SEC, HUD and the Federal Housing Finance Agency (FHFA) are required to jointly prescribe similar regulations focused specifically on residential mortgage securitizations.

Securitizer is defined as (A) an issuer of an asset-backed security or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.

Originator is defined as a person who (A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security and (B) sells an asset directly or indirectly to a securitizer.

Amount of Risk to be Retained in Securitizations

- Securitizations that do not consist entirely of "qualified residential mortgages":
    - A securitizer will be required to retain a minimum 5% of the credit risk; provided that less than 5% will be required if the originator meets underwriting standards that the legislation requires to be prescribed by the Federal banking agencies.
    - With respect to securitizations of commercial mortgages, the risk retention requirement may be satisfied by retention of a first loss position by a third party

purchaser who meets the standards to be imposed by the Federal banking agencies and the SEC.

- Securitizations that exist entirely of "qualified residential mortgages":

  - If all of the securitized assets are "qualified residential mortgages", a securitizer will not be required to retain any credit risk for any of the assets in the securitization. See the discussion below for details regarding "qualified residential mortgages".

- The amount of risk required to be retained with respect to collateralized debt obligations and other resecuritizations will be determined by designated regulatory agencies.

Form and Duration of Risk Retention

- The form and duration of any required credit risk retention will be determined by designated regulatory agencies.

Hedging or Transfer of Risk

- Securitizers will be prohibited from hedging (directly or indirectly) or transferring the risk required to be retained.

Who Retains the Risk?

- The allocation of risk retention obligations between a securitizer and an originator that sells assets to the securitizer is to be determined jointly by the Federal banking agencies and the SEC by taking into account the following items:

  - Whether the assets sold to the securitizer have terms, conditions and characteristics that reflect low credit risk;

  - Whether the form or volume of transactions creates incentives for imprudent origination of the specific types of assets; and

  - The potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms.

- The percentage of the risk retention obligation imposed on the securitizer will be reduced by the percentage of the risk retention obligation imposed on the originator.

Underwriting Standards to Be Established

- The underwriting standards to be established (as referred to above) must be specific with regard to particular asset classes, including residential mortgages, commercial mortgages, commercial loans and auto loans.

- The underwriting standards must specify the terms, conditions and characteristics within the asset class that indicate a low credit risk for such specific class of loan.

"Qualified Residential Mortgages"

- As discussed above, securitizations existing solely of "qualified residential mortgages" will not be subject to the risk retention requirements. The definition of a "qualified residential mortgage" will be established by regulations to be issued jointly by the Federal banking agencies, the SEC, HUD and the FHFA, "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default", including documentation and verification of assets, front-end and back-end DTI, payment shock, PMI, prepayment penalties and other loan terms and product features.

- The term "qualified residential mortgage" shall be defined in such a way that is no broader than the definition of "qualified mortgage" under Section 129(C) of the Truth in Lending Act. Under the Truth in Lending Act, as amended by the Consumer Financial Protection Act of 2010, a "qualified mortgage" is defined generally as follows: (i) no negative amortization, (ii) no large balloon payment, (iii) VOI and VOA, (iv) DTI based on a fully-indexed rate, (v) compliance with

regulations established by the Fed with respect to back-end DTI, (vi) total points and fees not in excess of 3% of the loan amount and (vii) maximum term of 30 years.

Exemptions, Exceptions and Adjustments from Risk Retention Requirements

- The regulations to be prescribed will provide a total or partial exemption from the risk retention requirements for securitizations by federal, state and certain other entities, as follows:
  - "Any securitization as may be appropriate in the public interest and for the protection of investors".
  - Securitizations of assets issued or guaranteed by the U.S. or a federal agency (specifically excluding Fannie Mae or Freddie Mac).
  - Securitizations issued or guaranteed by any State, political subdivision or public instrumentality exempt from the registration requirements of the Securities Act of 1933 (the "'33 Act") pursuant to Section 3(a)(2) of the '33 Act, or qualified scholarship funding bonds under the Internal Revenue Code.
- Farm Credit System: Loans made, insured, guaranteed or purchased by any institution subject to Farm Credit Administration supervision are not subject to the risk retention provisions of the legislation.
- Other Federal Programs: Securitizations backed by residential, multifamily or health care facility loans insured or guaranteed by the U.S. or a federal agency (not including Fannie Mae or Freddie Mac or the Federal Home Loan Banks) are not subject to the risk retention provisions of the legislation.
- In addition to the above, the Federal banking agencies and the SEC are specifically empowered to jointly adopt exemptions, exceptions and adjustments to the risk retention rules required to be issued in order to assure high quality underwriting standards, encourage appropriate risk management practices, improve the access to credit, or otherwise be in the public interest and for the protection of investors.

Timing

- The regulations called for by the legislation are required to be prescribed not later than 270 days after enactment of the legislation.
- The legislation requires that the regulations prescribed shall become effective (i) for residential mortgage securitizations, one year after the date on which the final rules are published in the Federal Register, and (ii) for all other securitizations, two years after the date on which the final rules are published in the Federal Register.

Risk Retention Study and Report

- The Fed Board, in coordination and consultation with the OCC, the OTS, the FDIC and the SEC, is required by the legislation to conduct a study of the impact of the credit risk retention requirements and FAS 166 and 167 and to submit a report to Congress not later than 90 days after enactment of the legislation including recommendations for "eliminating any negative impacts on the continued viability of the asset-backed securitization markets and on the availability of credit for new lending" identified by the study.
- In addition, the Chairman of the newly created Financial Services Oversight Council is required by the legislation to carry out a study on the macroeconomic effects of the risk retention requirements imposed by the legislation "with emphasis placed on potential beneficial effects with respect to stabilizing the real estate market." A report to Congress containing any findings and determinations is required to be made no later than 180 days after enactment of the legislation.

Securitization Disclosure and Reporting

Disclosure

- Section 7 of the '33 Act sets forth the information required to be disclosed in registration statements filed under the '33 Act.

- The legislation empowers the SEC to adopt regulations under Section 7 to require securitization issuers to disclose information regarding the assets backing the securitization, including information in a format that would facilitate comparisons of data across securities in similar asset classes, and data necessary for investors to independently perform due diligence, such as data identifying loan brokers and originators, the nature and extent of broker or originator compensation and the amount of risk retention by the loan originator and securitizer.

Reporting and Suspension of Duty to File

- Generally, under Section 15 (d) of the Securities Exchange Act of 1934, issuers of securities registered under the '33 Act are required to file with the SEC certain supplementary and periodic information, documents, and reports with regard to the registered securities. The duty to file reports is automatically suspended as to any fiscal year, other than the fiscal year within which such registration statement became effective, if, at the beginning of such fiscal year, the securities of each class to which the registration statement relates are held of record by less than three hundred persons.

- The legislation amends the forgoing provision by eliminating the automatic suspension with respect to asset-backed securities and giving the SEC the ability to determine whether issuers of particular types of securitizations will be able to suspend or to terminate their duty to make the filings otherwise required.

Representations and Warranties and Enforcement Mechanisms

The legislation requires that the SEC prescribe regulations on the use of representations and warranties in securitizations. Such regulations, which are required to be prescribed no later than 180 days after enactment of the legislation, must include the following requirements.

Rating Agency Reports

- Rating agencies will be required to include in any report accompanying a credit rating on a securitization a description of the representations and warranties included in the transaction and the enforcement mechanisms available to investors, as well as how those provisions differ from such provisions in similar securitizations.

Securitization Disclosure

- Securitizers (as defined above) will be required to disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer "so that investors may identify asset originators with clear underwriting deficiencies".

Due Diligence ANALYSIS AND DISCLOSURE

- Section 7 of the '33 Act is further amended by the legislation that require the SEC to prescribe regulations, no later than 180 days after enactment of the legislation, that require securitization issuers to perform a review of the assets underlying their securitizations and to disclose the nature of the review.

CONFLICTS OF INTEREST

General Prohibition Against "Material Conflicts of Interest"

- The legislation requires the SEC to issue rules, no later than 270 days after enactment of the legislation, to require that no underwriter, placement agent, initial purchaser or sponsor (or any affiliate or subsidiary of any such entity) of any asset-backed security (including, for these purposes, any synthetic asset-backed security) shall engage in any transaction that would involve or result in any "material conflict of interest" with respect to any investor for a period of one year after the date of the first closing or sale.

Exceptions

- The prohibition will not apply to:
  - Risk-mitigating hedging activities specifically designed to reduce specific risks associated with positions or holdings arising out of the party's role in the securitization;
  - Purchases or sales made pursuant to and consistent with commitments to provide liquidity for the asset-backed security; and
  - Bona-fide market-making in the asset-backed security.

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Dodd-Frank Wall Street Reform and Consumer Protection Act: Credit Rating Agency Provisions

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The legislation covers a wide variety of topics in an effort to address the causes of the recent financial crisis. With regard to credit rating agencies, the legislation covers the following topics: increased accountability, internal controls to avoid conflicts of interest and to better ensure the accuracy of ratings, elimination of reliance on ratings by federal agencies, and public disclosure of the information on which ratings are based to allow investors and other users to evaluate accuracy and to compare the performance of different agencies.

As indicated below, many of the requirements to be imposed have been left by Congress to regulations to be prescribed by the SEC and many actions that had been proposed in Congress have been relegated to studies to be conducted over the next several years. Generally, the SEC is required to issue final regulations with regard to credit rating agencies within one year of the date the legislation is enacted

Accountability

Liability for Information Filed Section 15E of the Securities Exchange Act of 1934 (the ?34 Act) includes provisions relating to the registration of Nationally Recognized Statistical Rating Organizations ("NRSROs") with the SEC. In various parts of Section 15E, there had been references to information to be "furnished" to the Commission. NRSROs will now be required to "file" such information with the Commission, and will therefore be subject to liability under Section 18 of the ?34 Act in the event that any such filings contain false or misleading statements of material fact.

"Accuracy" The legislation also empowers the SEC to temporarily suspend or permanently revoke the registration of an NRSRO with respect to a particular class of securities if, among other things, the Commission finds that the NRSRO "has failed over a sustained period of time . . . to produce ratings that are accurate for that class or subclass of securities . . .."

"Expert" Liability Rule 436(g) under the Securities Act of 1933 (the ?33 Act), which provides that credit ratings assigned by an NRSRO are not considered part of a registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the ?33 Act, is nullified. Written consent of an NRSRO must thus be obtained by a registrant in order to include a credit rating in a registration statement, and NRSROs are therefore subject to liability under Section 11 of the ?33 Act for misstatements or omissions of material facts in connection with credit rating disclosure.

Internal Controls

Section 15E has also been amended to require NRSROs to "establish, maintain and enforce an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings".

Annual Report Requirement The SEC is required by the legislation to prescribe rules requiring NRSROs to submit to the SEC annual internal controls reports describing the responsibility of the NRSRO's management in establishing and maintaining internal controls, assessing the effectiveness of their internal control structures, and containing an attestation of the CEO.

Conflicts of Interest

Separation of Ratings from Sales and Marketing The SEC will also be required to issue rules to prevent sales and marketing considerations from influencing the production of ratings. The legislation mandates that exceptions to the rules be provided for small NRSROs where separation of sales and marketing is not practical.

Look-back Requirement NRSROs will be required to put in place procedures reasonably designed to ensure that, if any employee of an issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating had previously been employed by the NRSRO and participated in determining a credit rating of that entity during the one-year period before the rating action, the NRSRO will conduct reviews to determine whether conflicts of interest influenced the rating, and will revise the rating as appropriate. The SEC will be required to periodically review the look-back procedures and code of ethics policies of each NRSRO.

Employment Transitions NRSROs will be required to report to the SEC (and the SEC will be required to disclose to the public) when an individual who had been an employee of the NRSRO within the previous five years becomes employed by an obligor, issuer, underwriter, or sponsor of a security or money market instrument that was rated by the NRSRO during the twelve months before the employee transitioned to his or her new position, in cases where the employee was a senior officer of the NRSRO or participated in or supervised someone participating in rating the obligor, issuer, underwriter, or sponsor.

Rule to Prevent Conflicts of Interest The legislation sets forth the sense of Congress that the SEC should exercise its rulemaking authority to prevent improper conflicts of interest arising from NRSRO employees providing services to issuers, including consulting and advisory services, in addition to providing credit ratings to those issuers.

Corporate Governance

Independent Board Each NRSRO must have a board of directors, at least half but no fewer than two members of which are independent. To be independent, a board member may not, other than in the capacity of member of the board, accept a fee from the NRSRO, be associated with the NRSRO or any affiliated company, or be involved in determining a rating in which it has a financial interest. Some of the independent members must be users of NRSRO ratings.

Duties of Board The NRSRO board of directors will be required to oversee the establishment, maintenance, and enforcement of policies and procedures for determining credit ratings and addressing and dealing with conflicts of interest, the effectiveness of the internal control system, and compensation and promotion policies.

If the SEC determines that compliance with these provisions is an unreasonable burden for a small NRSRO, the SEC may permit such NRSRO to delegate these responsibilities to a committee which includes at least one person who is a user of NRSRO ratings.

Regulation of NRSROs

Office of Credit Ratings The SEC will be required to establish an Office of Credit Ratings within the SEC to administer rules regarding the practice of determining ratings, promoting rating accuracy, and ensuring that ratings are not influenced by conflicts of interest.

- Examinations The Office of Credit Ratings will be required to conduct examinations of NRSROs at least annually to review management of conflicts of interest, internal controls, governance, and implementation of its policies, procedures, and rating methodologies.

- Inspection Reports The SEC will make available to the public a summary of its findings with regard to material regulatory deficiencies, including whether the NRSRO has appropriately addressed recommendations of the SEC and any responses by the NRSRO.

- Penalties The SEC will be required to establish fines and other penalties applicable to NRSROs violating the provisions of Section 15E.

Private Right of Action

- Statements Made by Credit Rating Agencies Section 15E(m) of the ?34 Act is amended so that the penalty and enforcement provisions of the ?34 Act apply to statements made by a credit rating agency in the same manner and to the same extent as they apply to statements made by a registered public accounting firm or a securities analyst under the securities laws. These statements are not deemed to be forward-looking statements for purposes of the safe harbor pursuant to Section 21E of the ?34 Act. There is no longer a bar against private rights of action as there previously had been under Section 15E(m).

- State of Mind Section 21D(b)(2) of the ?34 Act is amended so that, with respect to private securities fraud actions for money damages against a rating agency or a controlling person, it is sufficient that a complaint state with particularity the facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk, or (ii) to obtain reasonable verification of such factual elements from other sources the credit rating agency considered competent, and that were independent of the issuer and underwriter.

Duty to Report Tips Alleging Material Violations of Law

Each NRSRO must report to the appropriate authority any credible information it receives alleging that an issuer of securities rated by the NRSRO has committed or is committing a material violation of law.

Disclosure of Credit Ratings

SEC Rule as to Disclosure The SEC must issue a rule requiring NRSROs to publicly disclose information on the initial credit rating given to each obligor, security, and money market instrument, and on any subsequent rating change.

Content and Type of Disclosure The disclosures made by each NRSRO must (i) be comparable so that users can compare credit ratings performance across NRSROs, (ii) be clear and informative, (iii) include performance information over a range of years and for a variety of types of credit ratings, including for withdrawn credit ratings, (iv) be freely available and easily accessible on its website, and (v) include an attestation that the rating is based solely on an independent evaluation of the risks and merits of the instruments being rated.

Form Accompanying Ratings The SEC will require each NRSRO to prescribe a form to accompany each publication of a credit rating which is easy to use, comparable across security type, and readily available to credit rating users.

- Qualitative Content: The form will be required to include disclosure of (i) the credit rating, (ii) the main assumptions and data used in making the rating determination, (iii) potential limitations of the credit rating, (iv) information on the reliability, accuracy, or quality of the data used in making a credit rating determination, (v) information as to limitations of essential data such as limits on the scope of historical data and limits on accessibility to certain documents, (vi) whether and to what extent third party due diligence services were used by the NRSRO, a description of the information that third party reviewed, and a description of the third party's conclusions, (vii) an assessment of the quality of information available in making the rating determination, and (viii) information as to conflicts of interest.

- Quantitative Content: The form will be required also to include disclosure of (i) factors that could lead to a change in the credit rating and the magnitude of change to be expected under various market conditions, (ii) information on the content of the rating, including the historical performance of the rating, and the expected probability of default and consequent loss, and (iii) information on the sensitivity of the rating to assumptions made in the rating process.

Third Party Due Diligence The issuer or underwriter of any asset-backed security will be required to make publicly available the findings and conclusions of any third party due diligence report it obtains. Any third party due diligence provider employed by an NRSRO, issuer, or underwriter must provide written certification to the NRSRO that it conducted a thorough review of the data

and documentation used by an NRSRO to make a rating determination in a form to be established by the SEC, and the NRSRO will be required to disclose the certification to the public.

Elimination of Regulation FD Exemption Under Regulation FD, if an issuer or any person acting on behalf of an issuer discloses material nonpublic information about the issuer or its securities to certain enumerated entities, the issuer must make such disclosure public. The current rule exempts disclosures made to credit rating agencies. The SEC is required to revise Regulation FD within 90 days of enactment of the legislation to remove the exemption for disclosures to credit rating agencies.

Methodologies and Procedures

SEC Rules as to Procedures and Methodologies The SEC must prescribe rules requiring NRSROs to:

- ensure that credit ratings are determined using procedures and methodologies that are approved by the board of the NRSRO and in accordance with the NRSRO's policies and procedures,

- ensure that material changes to credit rating procedures and methodologies are applied consistently to all credit ratings, as applicable, within a reasonable period of time, and that the reasons for the change are publicly disclosed, and

- notify credit rating users of the version of a procedure or methodology used to determine a particular rating, when a material change to a procedure is made, when an error is identified, and the likelihood that a material change in procedure will result in a rating change.

Use of Information from Outside Sources NRSROs must consider information about an issuer that it receives from a source other than the issuer or underwriter when producing a rating, if the NRSRO finds the information credible and potentially significant to the rating decision.

Qualifications for Credit Rating Analysts The SEC will be required to issue rules designed to ensure that persons employed by an NRSRO to perform credit ratings meet standards of training, experience, and competence necessary to produce accurate ratings and are tested for knowledge of the credit rating process.

Universal Rating Symbols The SEC must require NRSROs to establish, maintain, and enforce written policies and procedures that (i) assess the likelihood that an issuer of a security or money market instrument will default or fail to make payments in a timely manner in accordance with the terms of the instrument, (ii) clearly define the symbol used to denote the credit rating, and (iii) apply credit rating symbols in a consistent manner.

Removal of Statutory References to Credit Ratings

Removal of Statutory References Certain statutory references to credit ratings are required to be removed, effective two years after the date of enactment. Regulatory bodies will be required to develop their own standards of credit-worthiness to replace these references.

Feasibility Study The SEC will be required to undertake a study on the feasibility and desirability of standardizing credit rating terminology and meanings. The SEC must submit a report of its findings and recommendations to Congress within one year after enactment.

Review and Modification of Federal Agency Reliance on Ratings

Each federal agency is required to review and modify its regulations to remove references to credit ratings and substitute its own standard of credit-worthiness. Upon conclusion of the process, each federal agency must submit a report to Congress describing the modifications made.

Studies

NRSRO Independence The SEC must conduct a study of the independence of NRSROs and of how such independence affects the ratings issued. The SEC must evaluate management of conflicts of interest raised by an NRSRO providing services in addition to awarding ratings, and the potential impact of rules prohibiting an NRSRO from providing such other services to issuers it rates. A report on the results must be submitted to Congress within three years of enactment.

Alternative Business Models The GAO must conduct a study on alternative means for compensating NRSROs in order to create incentives for NRSROs to provide more accurate credit ratings. A report on the results must be submitted to Congress within 18 months of enactment.

Creation of Independent Professional Analyst Organization The GAO must conduct a study on the feasibility and merits of creating an independent professional organization for rating analysts employed by NRSROs that would be responsible for establishing independent standards for governing the profession and a code of ethical conduct, and for overseeing the profession. A report on the results must be submitted to Congress within one year of enactment.

Assigned Credit Ratings Study and Rulemaking

- Study The SEC must conduct a study of (i) the credit rating process for structured finance products and the conflicts of interest associated with issuer-pay and subscriber-pay models, (ii) the feasibility of establishing a system whereby NRSROs are assigned to determine credit ratings of structured finance products, including an assessment of potential ways to determine fees, appropriate methods for paying fees, and the extent to which such a system could be viewed as the creation of a moral hazard by the Federal Government, (iii) the range of metrics that could be used to determine the accuracy of credit ratings, and (iv) alternative compensation schemes that would incentivize more accurate credit ratings. A report on the results must be submitted to Congress within two years of enactment.

- Establishment of Assignment System After submission of the report, the SEC must, as it determines is necessary or appropriate, establish a system for the assignment of NRSROs to determine initial credit ratings of structured finance products, such that the issuer, sponsor, or underwriter of the structured finance product does not make the assignment.

Section 15E(w) of the ?34 Act, as that provision would have been added by section 939D of H.R. 4173 (111th Congress), as passed by the Senate on May 20, 2010, would have established a system pursuant to which a self-regulated Credit Rating Agency Board would assign NRSROs to determine initial credit ratings of structured finance products. The SEC will be required to implement the system described in Section 15E(w) unless the SEC determines that an alternative system would better serve the public interest and the protection of investors.

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FINANCIAL MARKETS ALERT

JULY 16, 2010

Summary of the Private Fund Investment Advisers Registration Act Provisions in the Dodd-Frank Act

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The United States Congress has passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and President Obama is expected shortly to sign it into law.[1] Title IV of the Dodd-Frank Act consists of the "Private Fund Investment Advisers Registration Act of 2010" (the "PF Act"). The PF Act amends the Investment Advisers Act of 1940 (the "Advisers Act") and eliminates an exemption from investment adviser registration that is often claimed by hedge fund and other private fund managers. In consequence, many of these managers will be required to register as investment advisers with the Securities and Exchange Commission (the "SEC") when the PF Act becomes effective.[2] The PF Act also imposes significant new recordkeeping and reporting requirements on private fund managers, transfers regulatory responsibility for certain mid-sized investment advisers from the SEC to the States and amends certain other sections of the Advisers Act. This Financial Markets Alert summarizes the principal provisions of the PF Act.

Investment Adviser Registration

The Advisers Act requires all "investment advisers" to register with the SEC unless an exemption from registration applies. At present, many managers of hedge funds, venture capital funds, private equity funds and similar funds rely upon the registration exemption provided by Section 203(b)(3) of the Advisers Act. Section 203(b)(3) exempts from registration any investment adviser having fewer than 15 clients in any 12- month period if it doesn't hold itself out generally to the public as an investment adviser and does not provide investment advice to registered investment companies or "business development companies" (as defined for purposes of the Investment Company Act of 1940 (the "Investment Company Act")). In applying the numerical limit in Section 203(b)(3), investment advisers generally are permitted to count as a single "client" any hedge fund or similar private fund that they advise; they are not required to count the individual investors in such funds as separate clients. Accordingly, private fund managers have been able to rely upon the "private advisers exemption" in Section 203(b)(3) and advise a substantial number of separate funds (not more than 14 in any 12-month period) without becoming subject to SEC registration.

The facts that (i) private fund managers typically have been exempt from registration under the Advisers Act, (ii) the managed funds typically have been exempt from Investment Company Act registration pursuant to the exemptions provided by Sections 3(c)(1) and 3(c)(7) of that Act (each of these sections exempts from investment company registration privately-placed investment funds if specified conditions are met) and (iii) the amount of money managed in private funds has grown significantly in recent years, led some to question whether the SEC had adequate regulatory authority over an important segment of the investment management industry. In the PF Act, Congress has addressed these concerns by eliminating the private advisers exemption in Section 203(b)(3) effective as of the first anniversary of the Enactment Date.

The elimination of the private advisers exemption will require many hedge fund and other private fund managers to register as investment advisers with the SEC. In particular, investment advisers to private funds that rely upon Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act (respectively, "private fund advisers" and "private funds"), should consider (if they are not already registered with the SEC) whether the PF Act will require them to register.

The PF Act does include certain exemptions from the registration requirement that will be available to certain private fund advisers (including, in particular, an exemption for private fund advisers with less than $150,000,000 of assets under management). At the same time, it disqualifies private fund advisers from claiming certain other existing exemptions in the Advisers Act. These new exemptions and disqualifications include the following:

A. Foreign Private Advisers.

The PF Act creates an exemption from registration for "foreign private advisers". A "foreign private adviser" is defined as an investment adviser who has no place of business in the United States, has, in total, fewer than 15 clients and investors in the United States in private funds advised by it, has less than $25 million in assets under management attributable to clients in the United States and investors in the United States in private funds advised by it (or such higher amount as the SEC may approve by rule), and doesn't hold itself out generally to the public in the United States as an investment adviser or act as an investment adviser to any registered investment company or as a business development company.

B. Venture Capital Fund Advisers.

The PF Act exempts from registration under the Advisers Act any investment adviser who provides investment advice solely to one or more venture capital funds. The PF Act does not define the term "venture capital fund", but instructs the SEC to issue final rules defining the term not later than the first anniversary of the Enactment Date. Although exempt from registration, advisers to venture capital funds will be required to maintain such records and provide to the SEC such annual or other reports as the SEC determines are necessary or appropriate in the public interest or for the protection of investors.

C. Smaller and Mid-Sized Private Fund Advisers.

The PF Act exempts from registration under the Advisers Act any investment adviser who (i) provides investment advice solely to private funds, and (ii) has assets under management in the United States of less than $150,000,000. Any such private fund advisers will still be required to maintain such records and provide to the SEC such annual or other reports as the SEC determines are necessary or appropriate in the public interest or for the protection of investors.

D. Narrowing of Intrastate Exemption.

Section 203(b)(1) of the Advisers Act currently exempts from registration any investment adviser all of whose clients are residents of the State in which the investment adviser maintains its principal office and place of business so long as the adviser does not furnish advice or issue analyses or reports with respect to any securities listed or admitted to unlisted trading privileges on any national securities exchange. The PF Act amends Section 203(b)(1) to make this exemption unavailable to private fund advisers that might otherwise qualify.

E. Revision of Exemption for Commodity Trading Advisors.

Section 203(b)(6) of the Advisers Act exempts from registration any investment adviser that is registered as a commodity trading advisor with the Commodity Futures Trading Commission (the "CFTC") if such adviser's business does not consist primarily of acting as an investment adviser and it does not provide advice to any registered investment company or business development company. The PF Act amends Section 203(b)(6) to require any private fund adviser who is registered with the CFTC as a commodity trading advisor to register with the SEC as an investment adviser if its business shall become predominately the provision of securities-related advice. The PF Act does not define "predominately" as used in this context.

F. Advisers to Small Business Investment Companies.

The PF Act creates an exemption from registration for any investment adviser (other than any entity regulated as a business development company under the Investment Company) whose only clients are small business investment companies licensed under the Small Business Investment Act of 1958 or certain similar or affiliated entities.

The PF Act requires the SEC to assess whether "mid-sized private funds" pose "systemic risk" after taking into account their size, governance and investment strategies and to "provide for registration and examination procedures with respect to the investment advisers of such funds which reflect the level of systemic risk" that such funds pose. The SEC therefore has been directed by Congress to develop specific registration and examination procedures for investment advisers to mid-sized private funds. However, the PF Act does not define the term "mid-sized private fund".

Recordkeeping, Reporting and Examination Requirements

The PF Act requires each registered investment adviser to maintain such records and file with the SEC such reports concerning each private fund it advises as the SEC shall specify by rule to promote investor protection or to permit the Financial Stability Oversight Council (the "Council") to assess systemic risk.[3] Without limitation to the foregoing, each private fund adviser will be required to maintain records and/or file reports describing the following matters in relation to each of its private fund clients: (i) the amount of assets under management and use of leverage, including off-balance sheet leverage, (ii) counterparty credit risk exposure, (iii) trading and investment positions, (iv) valuation policies and practices, (v) types of assets held, (vi) any side arrangements or side letters whereby certain private fund investors obtain more favorable rights than other investors, (vii) trading practices, and (viii) any other information that the SEC, in consultation with the Council, determines to be necessary and appropriate (in establishing any additional reporting requirements under this clause (viii), the SEC is authorized to establish different reporting requirements for different classes of fund advisers, based on the type or size of the private fund being advised). The SEC is to specify by rule the exact content of the required reports and the time periods for which private fund advisers must maintain the related records.

The PF Act requires the SEC to conduct periodic inspections (on such schedule as the SEC shall determine) of the records maintained by a registered private fund adviser for its private fund clients and authorizes the SEC to conduct such additional or special examinations as it deems appropriate. Each registered private fund adviser will also be obligated to provide to the SEC upon request any copies or extracts from such records that may be prepared without undue effort, expense or delay.

The PF Act requires the SEC to keep confidential any records, reports or other information supplied to it by a private fund adviser pursuant to the Act's recordkeeping and reporting requirements and such information will not be subject to compelled disclosure under the Freedom of Information Act; provided that the SEC is permitted to share all such information with the Council and (upon an agreement of confidentiality) with Congress and to comply with (i) information requests it receives from any other U.S. government department or agency or any self-regulatory organization acting within the scope of its jurisdiction, and (ii) disclosure orders issued by a United States court in an action brought by the United States or the SEC. Any other U.S. government department or agency or self-regulatory organization that receives any such information will be subject to the same confidentiality obligations. The PF Act further prohibits the SEC from publicly disclosing any "proprietary information" received from a private fund adviser (other than in a public hearing held by the SEC or pursuant to a court proceeding brought to enjoin a violation of the Advisers Act or in certain other specified situations). The term "proprietary information" is defined as "sensitive, non-public information" regarding (i) the adviser's investment or trading strategies, (ii) analytical or research methodologies, (iii) trading data, (iv) computer hardware or software containing intellectual property, and (v) any additional information that the SEC determines to be proprietary.

In part to implement the new recordkeeping and reporting requirements, one provision of the PF Act broadens the SEC's authority to require investment advisers to disclose client information to it. At present, Section 210(c) of the Advisers Act states that the SEC may not require any investment advisor engaged in providing investment supervisory services (i.e., the provision of continuous investment advice based on the client's individual needs) to disclose the identity, investments or affairs of any of its clients unless such disclosure is necessary in any investigation or proceeding directed toward the enforcement of the Advisers Act. The PF Act amends Section 210(c) so that the SEC may also require such disclosure as needed "for purposes of assessment of potential systemic risk." This amendment eliminates the conflict that could otherwise exist between Section 210(c) and the expanded reporting requirements.

The SEC will be required to report annually to Congress on how it has used the data collected from private fund advisers to monitor the securities markets to protect investors and the integrity of the market.

Enhanced State Authority

The Advisers Act bifurcates regulatory responsibility for investment advisers between the SEC and the State securities commissions such that advisers (unless otherwise exempt from registration) register with the SEC, or with the State commissions, but not with both. Specifically, Section 203A of the Advisers Act prohibits an investment adviser who is subject to regulation as an investment adviser in the State in which it maintains its principal office and place of business from registering as an investment adviser with the SEC unless it has at least $25,000,000 of assets under management (or such higher amount as the SEC may specify by rule) (the "Minimum Assets Amount") or certain exceptions apply.[4] Investment advisers that don't meet the threshold must register with the State securities commissions, rather than the SEC, unless they qualify for an exception permitting SEC registration or are exempt from State registration.[5] The States are prohibited from requiring the registration of any investment adviser registered with the SEC.[6] The PF Act amends Section 203A to prohibit from registering with the SEC any investment adviser (a "Covered Adviser") who (i) is required to be registered and is subject to examination as an investment adviser in the State in which it maintains its principal office and place of business, and (ii) has assets under management between the Minimum Assets Amount and $100,000,000 (or such higher amount as the SEC may specify by rule). The prohibition does not apply, however, to any Covered Adviser who is an adviser to a registered investment company or a business development company or who would (if not registered with the SEC) be required to register as an investment adviser with 15 or more States. The amendments to Section 203A will transfer authority over certain mid-sized investment advisers from the SEC to the States and are intended to make additional SEC resources available for the regulation of larger private fund advisers who will become subject to SEC registration pursuant to the PF Act.

Adjusting the Definitions of "Accredited Investor" and "Qualified Client"

Regulation D under the Securities Act establishes a "safe harbor" pursuant to which issuers may sell their securities without registering them under the Securities Act if specified conditions are satisfied. In particular, Rule 506 of Regulation D provides a safe harbor implementing the private placement exemption in Section 4(2) of the Securities Act. An issuer may sell its securities in a Rule 506 offering to "accredited investors" and not more than 35 non-accredited investors. Securities Act Rule 501(a) defines an "accredited investor" to include, among other categories of investors, any natural person who had an income in excess of $200,000 (or $300,000 with spouse) in each of the last two years and expects such income in the current year or who has a net worth (individually or with spouse) in excess of $1,000,000). The PF Act directs the SEC to amend its definition of "accredited investor" so that (i) the value of an investor's primary residence is excluded in calculating his or her net worth, and (ii) the minimum required net worth will remain $1,000,000 until the fourth anniversary of the Enactment Date and thereafter shall be such higher amount as the SEC shall from time to time determine. The SEC further is authorized (or, in the case of the "accredited investor" definition in Rule 215 under the Securities Act, required) to conduct a study to determine whether other changes should be made to the definition of "accredited investor" as it applies to natural persons. In addition, the Comptroller General is directed to conduct a study on the financial thresholds or other criteria that should be required to qualify for "accredited investor" status and eligibility to invest in private funds and to report the results of that study to Congress not later than the third anniversary of the Enactment Date.

Section 205(a)(1) of the Advisers Act generally prohibits registered investment advisers from charging fees to clients that are calculated as a share of the capital gains or capital appreciation in the client's account. The SEC by rule, however, has provided certain exceptions to this prohibition. In particular, the SEC permits investment advisers to charge such fees to "qualified clients". Among other persons, this term includes any client who has at least $750,000 of assets under management with the investment adviser or who has a net worth (individually or including assets held jointly with his or her spouse) of at least $1,500,000. The PF Act directs the SEC to adjust the dollar amounts used in the definition of "qualified client" for inflation not later than the first anniversary of the Enactment Date, and to readjust such amounts for inflation every five years thereafter. Any adjustments to such dollar amounts must be made in multiples of $100,000.

Possible SRO

The Comptroller General is directed to conduct a study of the feasibility of forming a self-regulatory organization to oversee private funds and to report the results of that study to Congress not later than the first anniversary of the Enactment Date.

Other Required Studies

The PF Act requires the Comptroller General and the SEC to undertake other specified studies, including a study by the Comptroller General of the compliance costs associated with the rules requiring registered investment advisers to hold client funds and securities through a "qualified custodian" and a study by the SEC's Division of Risk, Strategy and Financial Innovation on the state of short selling on national securities exchanges and in the over-the-counter markets and on the feasibility, benefits

and costs of certain proposed changes in trade reporting procedures. Although included in the PF Act the latter study is not directly connected to investment adviser regulation.

Effective Date

The PF Act will become effective on the first anniversary of the Enactment Date. Prior to that date, private fund advisers may voluntarily register with the SEC, subject to applicable SEC rules

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1 The House of Representatives passed the Dodd-Frank Act on June 30, 2010 and the Senate on July 15, 2010.

2 As discussed herein, the PF Act will become effective on the first anniversary of its date of enactment (the "Enactment Date"). Assuming that President Obama signs the Dodd-Frank Act later this month, the PF Act will become effective in July 2011.

3 The Council will be established pursuant to the Dodd-Frank Act and will be comprised of one representative from each of the principal federal financial regulators and certain other persons. Among other responsibilities, the Council has been charged with identifying and responding to emerging threats to the stability of the United States financial system.

4 Among other exceptions, investment advisers with less than $25,000,000 of assets under management still may register with the SEC if they would otherwise be subject to registration in more than 30 States or if they are affiliated with, and have the same principal office and place of business as, an investment adviser registered with the SEC. In addition, advisers to registered investment companies must register with the SEC regardless of the amount of assets under management.

5 Most States exempt from registration investment advisers who have no place of business in the State and whose only clients are specified categories of institutional investors. In addition, Section 222(d) of the Advisers Act prohibits the States from requiring the registration of any investment adviser who has no place of business in the State and during the preceding 12 months has had fewer than six clients who are residents of the State.

6 The States may nonetheless require the registration of certain employees of SEC-registered investment advisers ("investment adviser representatives") who advise natural persons and maintain a place of business in the State.

ORRICK

FINANCIAL MARKETS ALERT **JULY 21, 2010**

Wall Street Transparency and Accountability Act of 2010

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On July 15th, the U.S. Senate passed the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Financial Reform"), which was passed by the U.S. House of Representatives on June 30th and was signed by the President today. The legislation covers a wide variety of topics in an effort to address the causes of the recent turmoil in the financial markets. Title VII of the Financial Reform is titled the "Wall Street Transparency and Accountability Act of 2010" (the "Act"). The Act is the culmination of numerous Administration and legislative proposals for derivatives regulation that have been considered since the beginning of the 2008 financial crisis, including the collapse of Lehman Brothers and the meltdown of AIG, both of which thrust the $615 trillion over-the-counter (OTC) derivatives market(1) into the media and legislative spotlight. As expected, the Act makes sweeping changes to the regulation of OTC derivatives markets.

The primary goals of derivatives reform were clearly delineated from the beginning of the regulatory overhaul effort: increasing pricing transparency and reducing bilateral credit risk. The Act pursues these goals by encouraging and, in some cases, requiring derivatives to be traded on registered exchanges and cleared through registered central counterparties and by imposing margin and capital requirements on derivatives.

Regulated Entities and Regulated Transaction Types

Generally, the Act divides regulatory authority over derivatives between the Commodity Futures Trading Commission (CFTC), generally covering "swaps" (described below), and the Securities and Exchange Commission (SEC), generally covering "security-based swaps" (described below). However, a regulated entity's "prudential regulator"(2) is also relevant for certain purposes, including for establishing capital and margin requirements. The Act generally provides for the regulation of two types of transactions (swaps and security-based swaps) and four types of market participants (swap dealers, security-based swap dealers, major swap participants and major security-based swap participants).

"Swaps" are defined very broadly to include, inter alia, interest rate swaps, caps and floors, credit default, swaps,(3) total return swaps, weather swaps, energy swaps, equity swaps, equity index swaps, agricultural swaps, commodity swaps and any "agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap".(4) Foreign exchange swaps and forwards (other than retail transactions) constitute swaps unless the Secretary of the Treasury makes a written determination that they should not be subject to regulation and they are not structured to evade the Act in violation of any CFTC rule.(5) "Security-based swaps" are defined to include, inter alia, swaps based on either (i) a narrow-based security index, including any interest therein or on the value thereof, (ii) a single security or loan, including any interest therein or on the value thereof or (iii) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrowbased security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.(6)

A "swap dealer" is defined as any person who (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. (A "security-based swap dealer" is defined in substantially the same manner, but with respect to security-based swaps.) However, an insured depository institution will not be considered a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer. To qualify as a swap dealer, a person must enter into swaps for such person's own account, either individually or in a fiduciary capacity, as part of a regular business.(7) A person may be designated as a swap dealer for one or more types or classes of swaps but not others.

A "major swap participant" is defined as any person who is not a swap dealer and (i) maintains a "substantial position" in swaps for any of the major swap categories (excluding positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan), (ii) whose outstanding swaps create "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets or (iii) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency and maintains a substantial position in outstanding swaps in any major swap category.(8) (A "major security-based swap participant" is defined in substantially the same manner, but with respect to security-based swaps.) A person may be designated as a major swap participant for one or more categories of swaps without being classified as a major swap participant for all classes of swaps.(9)

The ultimate scope of the definition of major swap participant will be largely determined by the CFTC definition of "substantial position", which is to be set at the threshold that the CFTC determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the U.S.(10)

Each swap dealer (irrespective of whether it is registered as a depository institution or a security-based swap dealer) and major swap participant must register with the CFTC by filing a registration application and, by doing so, becomes subject to continuing reporting requirements pertaining to its business. Similarly, each security-based swap dealer (irrespective of whether it is registered as a swap dealer) and major security-based swap participant must register with the SEC by filing a registration application and, by doing so, becomes subject to continuing reporting requirements pertaining to its business.

Federal Assistance

The most controversial proposal under discussion during the reconciliation of the U.S. House of Representatives and U.S. Senate regulatory proposals that ultimately merged to become the Act came to be known as the "push-out" provision. This proposal was intended to prohibit future bailouts of banks using taxpayer funds. As drafted in the earlier U.S. Senate proposal, this provision would have effectively required commercial banks that are protected by federal deposit insurance or that have access to the Federal Reserve discount window (generally, financial institutions that are allowed to raise money at lower costs) to spin off into separate entities (and separately capitalize) their trading desks that provide derivatives products to customers in the regular course of banking relationships.

The prohibition against certain entities receiving federal assistance remained in the Act, but it was tempered significantly.(11) Specifically, under the Act, beginning two years after the effectiveness of the Act, no "federal assistance"(12) may be provided to a "swaps entity" with respect to any swap, security-based swap or other activity of the swaps entity.

A "swaps entity" is defined to include any swap dealer or major swap participant, but, significantly, excludes major swap participants (but not swap dealers) that are insured depository institutions. Further, the financial assistance prohibition does not apply to insured depository institutions that limit their swap activities to: (i) hedging and other similar risk mitigating activities directly related to their own activities and (ii) swaps involving rates or reference assets that are permissible for investment by a national bank under specified law. This exception effectively permits banks to continue to act as counterparties in many common derivatives transactions, including interest rate swaps and foreign exchange transactions (which together comprise approximately 80% of the current OTC derivatives market), as well as bullion transactions. However, the Act also makes clear that credit default swaps (including such swaps referencing the credit risk of asset-backed securities) are not to be considered permissible activities of a bank unless they are centrally cleared.

The federal assistance provision provides for a transition period of up to 24 months (which may be extended for up to one additional year by the appropriate federal banking agency, after consultation with the CFTC and the SEC and upon taking into

account several specified factors) for insured depository institutions that would qualify as swaps entities to divest themselves of the swaps or cease the activities that require them to register as swaps entities.

Special Entities

Legislators have struggled to find an appropriate balance between protecting "special" counterparties to derivatives, such as governmental entities, pension funds and endowments, and shutting them out of the market entirely.(13) In fact, the U.S. Senate bill prior to reconciliation with the U.S. House of Representatives bill proposed an approach that would have imposed fiduciary duties on dealers that propose or advise on, or serve as counterparties under, derivatives transactions with state and local governments or pension funds. This, of course, would have stood in marked contrast to existing general market practice that parties enter into derivatives transactions at "arms'-length" and that each party understands the risks of any transaction entered into, has not relied on the advice of the other party and has made its own investment decision, engaging such experts as it deems appropriate. The market feared that this approach would leave municipal entities largely unable to hedge interest rate risk related to floating rate debt issuances and leave pension funds unable to hedge risk and diversify portfolios through the use of derivatives transactions.

However, the Act takes a more balanced approach. In particular, the Act requires that each swap dealer or major swap participant that enters into or offers to enter into a swap with a "special entity" comply with the following requirements: (i) have a reasonable basis to believe that the special entity has an independent representative that has sufficient knowledge to evaluate each transaction and its risks, is not subject to a statutory disqualification, is independent of the swap dealer or major swap participant, undertakes a duty to act in the best interest of the special entity, provides written representations to the special entity regarding fair pricing and the appropriateness of each transaction and, in the case of an employee benefit plan subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA), is a fiduciary of the special entity and (ii) before the initiation of any transaction, disclose to the special entity in writing the capacity in which the swap dealer or major swap participant is acting. A "special entity" is defined to include federal agencies; States, State agencies, cities, counties, municipalities or other political subdivisions of a State; employee benefit plans under ERISA; governmental plans under ERISA; and endowments (including organizations described in section 501(c)(3) of the Internal Revenue Code of 1986, as amended).

A swap dealer that acts as an advisor to a special entity has a duty to act in the best interest of the entity and must make reasonable efforts to obtain such information as is necessary to make a reasonable determination that a swap it recommends is in the best interests of such entity, including information relating to the entity's financial status, tax status and investment (or financing) objectives. Moreover, a swap dealer or major swap participant advising a special entity on swaps may not employ schemes or engage in transactions that operate to defraud that entity or engage in any act that is fraudulent, deceptive or manipulative.

Business Conduct Standards

The Act requires the CFTC to adopt business conduct requirements that, *inter alia*, (i) establish a duty for swap dealers and major swap participants to verify that a counterparty meets the eligibility standards of an "eligible contract participant" and (ii) require swap dealers and major swap participants to (a) disclose information about the material risks and characteristics of a swap, any material incentives or conflicts of interest they have in connection with a swap and (b) provide counterparties with daily marks for swaps (which, for cleared transactions are to be made upon request and may derive from the appropriate derivatives clearing organization (DCO)). Swap dealers and major swap participants also must communicate in a fair and balanced manner based on principles of fair dealing and good faith.

Clearing

The Act makes it unlawful for any person to engage in a swap that the CFTC determines should be required to be cleared unless that person submits the swap for clearing to a registered or exempt DCO. The CFTC, on an ongoing basis, must review each type of swap to determine, following a 30-day public comment period, whether it should be required to be cleared. Moreover, DCOs are to submit for approval to the CFTC any type of swap they seek to accept for clearing and the CFTC is to take final action within 90 days of any such submission. The CFTC's determinations on what types of swaps should be required to be cleared are to be based on factors such as the existence of significant outstanding notional exposures, trading illiquidity and adequate pricing data, and the effect such clearing will have on systemic risk and competition. If the CFTC finds that certain swaps would otherwise be subject to mandatory clearing but no DCO accepts them for clearing, then the CFTC is to investigate and issue a public report on the matter; in this regard, the CFTC may take such actions as necessary and in the public interest, which may include applying margin and capital requirements to such swaps (although it appears that the CFTC may not mandate that a DCO accept a certain swap for clearing).

An important exemption to the clearing requirement of the Act (commonly referred to as the "commercial end-user exemption") exists if one counterparty to a swap (i) is not a financial entity,(14) (ii) is using the swap to hedge or mitigate "commercial risk" (as such term will be defined by the CFTC) and (iii) notifies the CFTC how it generally meets its financial obligations associated with uncleared swaps. Notwithstanding this exemption, such a party that satisfies these requirements and enters into a swap with a swap dealer or major swap participant may elect to require clearing of the swap and, in any such case, will have the sole right to select the DCO at which the swap will be cleared.

If one party to a swap that requires clearing is a swap dealer or major swap participant and the other party is not (including a party that is not using the swap to hedge or mitigate commercial risk), then the party that is not a swap dealer or major swap participant may select the DCO through which to clear that swap. DCOs are required to offset all swaps within the organization having the same terms and conditions and provide for the clearing of swaps executed either bilaterally or on an unaffiliated market on a non-discriminatory basis. Moreover, DCOs are subject to numerous core principles relating to financial resources, reporting and recordkeeping, risk management, settlement procedures, information sharing, governance fitness standards, conflicts of interest, and legal risks.

Swaps entered into before the date of enactment of the Act (or before the application of the clearing requirements under the Act) are exempt from the clearing requirements of the Act, so long as they are reported to a swap data repository(15) or the CFTC, as appropriate, within specified periods.

Exchange Trading

Generally, parties subject to the clearing requirement for a swap must execute that swap on a board of trade designated as a "contract market" or on a registered or exempt swap execution facility (SEF),(16) unless no board of trade or SEF makes the swap available for trading. It is important to note that swaps need not be executed on such a contract market or SEF if they are exempt from the clearing requirement under the commercial end-user exemption or otherwise. Each SEF must comply with numerous core principles, including that it (i) may permit trading only in swaps that are not readily susceptible to manipulation, (ii) must make public timely information on price, trading volume and other swap trading data, as prescribed by the CFTC, (iii) must monitor trading in swaps to prevent manipulation, price distortion and settlement disruptions and (iv) must adopt for each contract position limitations or position accountability for speculators.

Capital and Margin Requirements

Registered swap dealers and major swap participants for which there is a prudential regulator must meet minimum capital and margin (both initial and variation) requirements prescribed by that regulator; swap dealers and major swap participants for which there is no prudential regulator must meet minimum capital and margin (both initial and variation) requirements prescribed by the CFTC. In setting capital requirements for a swap dealer or major swap participant for a single type (or class or category) of swaps, the prudential regulator or the CFTC, as applicable, is to take into account the risks associated with other types (or classes or categories) of swaps engaged in and other activities conducted by that person that are not otherwise subject to regulation by virtue of that person's status as a swap dealer or major swap participant. In prescribing margin requirements, the prudential regulator or the CFTC, as the case may be, is instructed to permit the use of non-cash collateral, as it determines to be consistent with preserving the financial integrity of markets trading swaps and preserving the stability of the U.S. financial system. The capital and margin requirements imposed in connection with uncleared swaps are to reflect the greater risk to the swap dealer or major swap participant and the financial system arising from such swaps.

A person who accepts any money, securities or property from or on behalf of a swap customer to margin, guarantee or secure a swap cleared by or through a DCO must register with the CFTC as a futures commission merchant (FCM).(17) An FCM must treat and deal with all monies, security and property of any such swaps customer as belonging to the swaps customer and such margin and collateral (with certain exceptions) must be segregated from the funds of the FCM and cannot be used to margin, secure or guarantee any trade or contract of any person other than such swaps customer. Money received as margin from a swaps customer may be invested in obligations of the United States, in general obligations of any State or any political subdivision of a State and in obligations fully guaranteed as to principal and interest by the United States, or in any other instrument that the CFTC may prescribe. A swap dealer or major swap participant must notify its counterparty at the beginning of any uncleared swap that the counterparty has the right to require segregation of the property used as initial margin (as opposed to variation margin) to margin, guarantee or secure its obligations. At the request of such counterparty, the swap dealer or major swap participant must (i) segregate such property for the benefit of the counterparty, and (ii) maintain such property in a segregated account at an independent third party custodian, separate from the assets of the swap dealer or major swap participant.

Reporting and Recordkeeping

Swaps entered into before the date of enactment of the Act must be reported to a swap data repository or the CFTC no later than 180 days after such enactment. Swaps entered into on or after enactment of the Act must be reported to a swap data repository or the CFTC not later than the later of 90 days after the date of enactment or such other time period after such swaps were entered into, as the CFTC may prescribe.

In addition, outstanding uncleared swaps entered into before the date of enactment of the Act must be reported to a swap data repository or the CFTC no later than 30 days after issuance of the interim final rule (to be promulgated by the CFTC within 90 days of the date of enactment of the Act) providing for the reporting of such swaps or such other period as the CFTC determines to be appropriate. Such swaps must be reported by the following counterparty: (i) for swaps where only one counterparty is a swap dealer or major swap participant, that counterparty, (ii) for swaps where one counterparty is a swap dealer and the other is a major swap participant, the swap dealer and (iii) for any other swaps, as selected by the counterparties.

Each swap dealer and major swap participant must make reports and maintain books and records, as required by the CFTC. Among other things, such entities must maintain daily trading records of their swaps and all related records and recorded communications (including electronic mail, instant messages and recordings of telephone conversations) and must maintain a complete audit trail for conducting comprehensive and accurate trade reconstructions.

Real-Time Public Reporting

The CFTC must promulgate rules to subject swaps and pricing data to "real-time public reporting"[18] for purposes of enhancing price discovery. With respect to cleared swaps, the CFTC rules for real-time public reporting of swaps must contain provisions to (i) ensure that the information provided does not identify the participants, (ii) specify the criteria for determining what constitutes a large notional swap transaction (i.e., block trade) for particular markets and contracts, (iii) specify the appropriate time delay for reporting block trades to the public and (iv) take into account whether public disclosure will materially reduce market liquidity. With respect to uncleared swaps that are reported to a swap data repository, the CFTC is instructed to require reporting in a manner that does not disclose the business transactions and market positions of any person.

Large Swap Trader Reporting

Under the Act, it is unlawful for any person to enter into a swap that the CFTC determines performs a significant price discovery function with respect to registered entities if the person directly or indirectly enters into (or obtains a position in) the swap during any one day in an amount equal to or in excess of a threshold amount established periodically by the CFTC. However, this prohibition does not apply to persons who file with the CFTC appropriate reports regarding such transactions and positions and maintain books and records (open at all times for regulator inspection) of all such transactions and positions.

Abusive Swaps

The CFTC may by rule or order collect information as may be necessary concerning the markets for any type of swap and issue a report with respect to any type of swap that it determines to be detrimental to either the stability of a financial market or to participants in a financial market.

Exclusion of Certain Derivatives Contracts From Section 1256

As noted above, many derivatives transactions currently traded OTC will be required (or encouraged) to be traded on regulated exchanges. Under current law, section 1256 of the Internal Revenue Code of 1986, as amended (the "Tax Code"), requires that certain contracts traded on exchanges be marked to market annually for tax purposes and, for individuals, the gain or loss of such contracts is to be treated as 40% short-term capital gain or loss and 60% long-term capital gain or loss. As a result, individuals may benefit from a partial rate reduction. In contrast, marking to market transactions under section 475 of the Tax Code results in ordinary income treatment.

During the drafting of the Financial Reform, concerns were raised that swaps (as described in the Act) would constitute section 1256 contracts and, as a result, would be subject to the 40/60 characterization. In response to these concerns, Title XVI of the Financial Reform excludes the following derivatives transactions from section 1256: (i) any securities futures contract or option on such a contract, unless such contract or option is a dealer securities futures contract and (ii) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or

similar agreement. The legislative history states that the purpose of this exclusion was to address the re-characterization of income as a result of increased exchange-trading of derivatives contracts. Interestingly, Title XVI uses the term "swap," instead of "notional principal contract," which is the standard tax terminology used for derivatives transactions. Regulations will likely clarify that, in this context, swaps refer to notional principal contracts; however, the term "swap" would include more contracts than those included in the definition of notional principal contracts. Included within the mix of contracts excluded from section 1256 treatment are credit default swaps; this, together with the provision precluding the treatment of those contracts as insurance for state law purposes, suggests that credit default swaps will be characterized as notional principal contracts for U.S. federal income tax purposes. Finally, while mark-to-market treatment under section 1256 will not apply to excluded contracts, many taxpayers will remain subject to mark-to-market treatment under section 475, which is applicable to dealers and traders in securities, but under which gain and loss is subject to ordinary income treatment.

Title XVI of the Financial Reform is effective for tax years beginning after the date of enactment, which was July 21, 2010.

Effectiveness

The Act becomes effective upon the later of 360 days after its enactment or, to the extent a provision requires a rulemaking, not less than 60 days after publication of a final rule or regulation implementing such provision.

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1 Bank of International Settlements, Semiannual OTC derivatives statistics at end-December 2009 (December 2009). For a summary of this report, please visit www.orrick.com/fileupload/2644.htm.

2 "Prudential regulator" means, inter alia, (i) the Board of Governors of the Federal Reserve System (the "Federal Reserve") (in the case of a regulated entity that this is a State-chartered bank that is a member of the Federal Reserve System, a State-charted branch or agency of a foreign bank, a foreign bank which does not operate an insured branch, a bank holding company or a savings and loan holding company); (ii) the Office of the Comptroller of the Currency (in the case of a regulated entity that is a national bank, a federally chartered branch or agency of a foreign bank or a federal savings association); (iii) the Federal Deposit Insurance Corporation (FDIC) (in the case of a regulated entity that is a State-chartered bank that is not a member of the Federal Reserve Bank or a State savings association); (iv) the Farm Credit Administration (in the case of a regulated entity that is an institution chartered under the Farm Credit Act of 1971, as amended); or (v) the Federal Housing Finance Agency (in the case of a regulated entity that is a regulated entity under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended).

3 Note that the Act explicitly provides that swaps are not to be considered insurance and are not to be regulated as insurance contracts under any State law. This provision is likely in response to proposals by certain State insurance regulators to regulate as insurance credit default swaps where the buyer of protection also owns the underlying obligation on which protection is written. See Client Alert.

4 Note, however, that the definition of "swaps" excludes certain specified transactions, including (i) security-based swaps, (ii) contracts of sale of a commodity for future delivery (or an option on such a contact) and (iii) the sale of nonfinancial commodities or securities for deferred shipment or delivery, so long as such contracts are intended to be physically settled.

5 Certain earlier legislative proposals suggested that foreign exchange swaps and forwards would not be regulated, as they are typically entered into by end-users for hedging purposes and had not been the root cause of any market turmoil. However, under the Act, such transactions are not given a full exemption but, rather, discretion is granted to the Secretary of the Treasury to determine whether they should be exempt from regulation.

In making such a determination, the Secretary of the Treasury is to consider (i) whether the required trading and clearing of foreign exchange swaps and forwards would create systemic risk, lower transparency, or threaten the financial stability of the U.S., (ii) whether such transactions are already subject to a regulatory scheme that is materially comparable to that established by the Act for other classes of swaps, (iii) the extent to which bank regulators of participants in the foreign exchange market provide adequate supervision (including capital and margin requirements), (iv) the extent of adequate payment and settlement

systems for such transactions and (v) whether any exemption provided for such transactions potentially could be used to evade otherwise applicable regulatory requirements. Any such determination must be submitted to the appropriate committees of Congress and must explain the "qualitative difference" between foreign exchange swaps and forwards and other classes of swaps that would make them "ill-suited" for regulation as swaps and identify "objective differences" between foreign exchange swaps and forwards, on the one hand, and other swaps, on the other hand, that warrant an exempted status. Even if such a determination is made, foreign exchange swaps and forwards would remain subject to reporting requirements under the Act and to fraud and manipulation prohibitions.

6 Note that "mixed swaps" are security-based swaps that are also based on the value of one or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence. They are to be regulated jointly by the CFTC and SEC, after consultation with the Board of Governors of the Federal Reserve.

7 The CFTC is also required to establish factors for the exemption of entities that engage in a *de minimis* quantity of swap dealing in transactions with or on behalf of their customers.

8 Note that an exception exists for financing subsidiaries (i.e., entities whose primary business is providing financing and which use derivatives for purposes of hedging underlying commercial risks related to interest rate and foreign exchange exposures, 90% or more of which arise from financing that facilitates the purchase or lease of products, 90% or more of which are manufactured by the parent company or another subsidiary of the parent company).

9 Note that many of the provisions summarized in this Client Alert are relevant to both swaps, predominantly regulated by the CFTC, and security-based swaps, predominantly regulated by the SEC. Generally, the Act deals with such transactions in a parallel manner and, therefore, for purposes of simplicity, unless otherwise noted, only the provisions applicable to swaps are summarized herein.

10 In drafting this definition, the Act instructs the CFTC to consider a person's relative position in uncleared, as opposed to cleared, swaps and provides that the CFTC may take into account the value and quality of collateral held against counterparty exposures.

11 Nevertheless, the Act explicitly provides that "[t]axpayers shall bear no losses from the exercise of any authority under [the Act]".

12 The Act defines "federal assistance" as the use of either (i) any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility or (ii) FDIC insurance or guarantees for the purpose of making any loan to any swaps entity or purchasing any stock, equity interest or debt obligation of any swaps entity; guaranteeing any loan or debt of any swaps entity; or entering into any assistance arrangement (including tax breaks), loss sharing or profit sharing with any swaps entity.

13 The focus on these types of entities was, at least in part, likely in reaction to well-publicized recent situations where public entities, both in the U.S. and in Europe, incurred large losses on derivatives transactions (for related summaries, please see DMIR (May 2009, www.orrick.com/fileupload/1833.htm) and DMIR (March 2010, www.orrick.com/fileupload/2534.htm)).

14 "Financial entity" is defined as (i) a swap dealer, (ii) a security-based swap dealer, (iii) a major swap participant, (iv) a major security based swap participant, (v) a commodity pool, (vi) a private fund under the Investment Advisers Act of 1940, as amended, (vii) an employee benefit plan under ERISA, or (viii) a person predominantly engaged in activities that are in the business of banking or financial in nature under the Bank Holding Company Act of 1956, as amended. The Act permits the CFTC (or SEC, as the case may be) to consider whether to exempt from this definition small banks, savings associations, farm credit system institutions and credit unions, including depository institutions, farm credit system institutions or credit unions with total assets of $10 billion or less.

15 A “swap data repository” is defined as a person that collects and maintains information or records with respect to transactions or positions in, or the terms and conditions of, swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility. Swap data repositories must be registered with, and are subject to inspection and examination by, the CFTC. A DCO may registered as a swap data repository.

16 A “swap execution facility” is defined as a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that facilitates the execution of swaps between persons and is not a designated contract market.

17 In connection with security-based swaps, such a person must be a registered broker, dealer or security-based swap dealer.

18 “Real-time public reporting” is defined to mean to report data relating to a swap, including price and volume, as soon as technologically practicable after the time at which the swap has been executed.

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FINANCIAL MARKETS ALERT

AUGUST 4, 2010

Derivatives Regulation Reform and Provisions Affecting Governmental Entities in the Dodd-Frank Act

On July 21st, President Obama signed the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Financial Reform"), which was passed by the U.S. Senate on July 15th and the U.S. House of Representatives on June 30th after weeks of reconciliation talks. The legislation covers a wide variety of topics in an effort to address the causes of the recent turmoil in the financial markets. Title VII of the Financial Reform is entitled the "Wall Street Transparency and Accountability Act of 2010" (the "Act"). The Act is the culmination of numerous Administration and legislative proposals for derivatives regulation that have been considered since the beginning of the recent financial crisis, which thrust the $615 trillion over-the-counter (OTC) derivatives market into the media and legislative spotlight. As expected, the Act makes sweeping changes to the regulation of the OTC derivatives market, including certain changes that affect governmental entities active in the derivatives market.[1]

Policies and Objectives of the Act

The primary goals of derivatives reform were to increase pricing transparency and reduce systemic risk by encouraging and, in some cases, requiring derivatives to be traded on registered exchanges and cleared through registered central counterparties and by imposing margin and capital requirements on derivatives. In drafting the Act, legislators focused much of their attention on determining what types of entities should become subject to registration and other requirements under the Act. They ultimately decided on the identities of these market participants, called "swap dealers"[2] and "major swap participants."[3] However, throughout the derivatives regulation overhaul effort, legislators also focused on explicitly providing for protections for governmental and certain other special users of derivatives transactions.

This focus was, at least in part, in reaction to well-publicized recent situations where governmental entities, both in the U.S. and in Europe, incurred large losses on derivatives transactions.[4] Certain local governmental entities, in particular, discovered derivatives losses—which in some cases were enormous—in connection with transactions that they argued they did not adequately understand or for which they argued they had been overcharged. This situation led to calls by some for additional protections where public monies were at stake, and even for an outright ban on certain governmental entities entering into derivatives.[5]

Legislators struggled to find an appropriate balance between protecting such "special" counterparties to derivatives and shutting them out of the market entirely. In fact, the U.S. Senate bill prior to reconciliation with the U.S. House of Representatives bill proposed an approach that would have imposed fiduciary duties on dealers that propose or advise on, or serve as counterparties under, derivatives transactions with state and local governments or pension funds. Of course, this approach would have been in stark contrast to existing market practice, which is that parties—irrespective of their type—enter into derivatives transactions at "arms'-length." This market practice is almost always reflected in and reinforced by representations made by the parties that they understand the risks of any transaction entered into, have not relied on the advice of the other party and have made their own investment decision, engaging such experts as they deem appropriate. Once the U.S. Senate bill was proposed, the market feared that this approach would leave governmental entities largely unable to hedge interest rate risk related to floating rate debt issuances.

If you have any questions regarding the provisions of the Act relating to special entities, or on the Act generally, please contact:

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Governmental and Other Special Entities

Despite the language in earlier bills, the Act takes a balanced approach. In particular, it does not impose fiduciary duties on persons who act solely as derivatives counterparties (as opposed to as advisors) to governmental entities; rather, it provides for certain protections to be afforded when "swaps"[6] are offered or entered into by swap dealers and major swap participants and "special entities."[7]

"Special entities" are defined to include federal agencies; States, State agencies, cities, counties, municipalities or other political subdivisions of a State; employee benefit plans and governmental plans under ERISA; and endowments (including organizations described in section 501(c)(3) of the Internal Revenue Code of 1986, as amended).[8] Generally, the relevant protections under the Act depend on the role a swap dealer or major swap participant has in connection with a swap offered to or entered into with a special entity, i.e., whether such a party acts as an advisor or counterparty to the special entity.

Specific Protections for Special Entities

Specifically, the Act requires that each swap dealer or major swap participant that enters into or offers to enter into a swap with a special entity comply with the following requirements: (i) have a reasonable basis to believe that the special entity has an "independent representative" that has sufficient knowledge to evaluate each transaction and its risks, is not subject to a statutory disqualification, is independent of the swap dealer or major swap participant, undertakes a duty to act in the best interest of the special entity, provides written representations to the special entity regarding fair pricing and the appropriateness of each transaction and (ii) before the initiation of any transaction, disclose to the special entity in writing the capacity in which the swap dealer or major swap participant is acting.

The Act does not appear to provide for any exceptions to the requirement that, in effect, all special entities (irrespective of their size, business or level of sophistication) have a competent independent representative when entering into swaps with swap dealers and major swap participants. Further, the Act does not provide any specific guidance on who will qualify as an independent representative or how swap dealers and major swap participants will demonstrate that they have made an appropiate determination regarding an independent representative. Although guidance on these points is expected from the CFTC, in the future, regulated entities likely will request additional, tailored, representations from both governmental entities and their independent advisors and perform more comprehensive due diligence on independent representatives (and maintain detailed records of that due diligence).

The Act also provides that a swap dealer that acts as an advisor to a special entity has a duty to act in the best interest of the entity and must make reasonable efforts to obtain such information as is necessary to make a reasonable determination that a swap it recommends is in the best interests of such entity, including information relating to the entity's financial status, tax status and investment (or financing) objectives. Moreover, a swap dealer or major swap participant advising a special entity on swaps may not employ schemes or engage in transactions that operate to defraud that entity or engage in any act that is fraudulent, deceptive or manipulative.

As an additional protection, the Act increases the discretionary investment threshold for governmental entities to qualify as "eligible contract participants" (generally, entities permitted to enter into swaps outside of a regulated exchange) under the Commodity Exchange Act of 2000, as amended (the "CEA"), to $50 million from $25 million.[9] It also requires that the CFTC adopt business conduct requirements that, inter alia, (i) establish a duty for swap dealers and major swap participants to verify that any counterparty meets the eligibility standards for an eligible contract participant and (ii) require swap dealers and major swap participants to (a) disclose information about the material risks and characteristics of a swap, any material incentives or conflicts of interest they have in connection with a swap and (b) provide counterparties with daily marks for swaps. Swap dealers and major swap participants also must communicate in a fair and balanced manner based on principles of fair dealing and good faith.

Central Clearing Requirements

The Act makes it unlawful for any person to engage in a swap that the CFTC determines should be required to be cleared unless that person submits the swap for clearing to a registered or exempt derivatives clearing organization (DCO). An important exemption to the clearing requirement of the Act exists if one counterparty to a swap (i) is not a financial entity, (ii) is using the swap to hedge or mitigate "commercial risk" (as such term will be defined by the CFTC) and (iii) notifies the CFTC how it generally meets its financial obligations associated with uncleared swaps. Notwithstanding this exemption, such a party that satisfies these requirements and enters into a swap with a swap dealer or major swap participant may elect to require clearing of the swap and, in any such case, will have the sole right to select the DCO at which the swap will be cleared. Governmental entities

may be able to take advantage of this exemption, especially if the CFTC clarifies that governmental entities entering into traditional swaps are hedging or mitigating commerical risk.

The derivatives market for governmental entities has seen its share of turmoil during the market crisis of the past few years. Therefore, it was not surprising that the Act would take steps to provide for the protection of such parties, particularly because public monies are at stake.

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1 For a more comprehensive summary of the Act, visit www.orrick.com/fileupload/2833.pdf.

2 A "swap dealer" is defined, with certain exceptions, as any person who (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. To qualify as a swap dealer, a person must enter into swaps for such person's own account, either individually or in a fiduciary capacity, as part of a regular business. A person may be designated as a swap dealer for one or more types or classes of swaps but not others. This term is to be further defined by the regulators.

3 A "major swap participant" is defined as any person who is not a swap dealer and (i) maintains a "substantial position" in swaps for any of the major swap categories (excluding positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan), (ii) whose outstanding swaps create "substantial counterparty exposure" that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets or (iii) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate federal banking agency and maintains a substantial position in outstanding swaps in any major swap category. In drafting this definition, the Act instructs the Commodity Futures Trading Commission (CFTC) to consider a person's relative position in uncleared, as opposed to cleared, swaps and provides that the CFTC may take into account the value and quality of collateral held against counterparty exposures. A person may be designated as a major swap participant for one or more categories of swaps without being classified as a major swap participant for all classes of swaps. The ultimate scope of the definition of major swap participant will be largely determined by the CFTC definition of "substantial position", which is to be set at the threshold that the CFTC determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the U.S. This term is to be further defined by the regulators.

4 Perhaps the most notable case in the U.S. involves Jefferson County, Alabama. Several years ago, Jefferson County refinanced its fixed rate debt to variable rate debt and entered into interest rate swaps, which it later alleged exceeded the notional amount of bonds being hedged and may have been awarded in a less-than-competitive manner. Its interest rate swap positions helped push the county to the brink of bankruptcy. In another Alabama case filed in October 2008, the Alabama Public School and College Authority sought to void a swaption (or an option to enter an interest rate swap) that it sold to a bank in 2002. Disputes have also arisen in connection with derivatives entered into by local governmental entities in Europe. For example, in April 2009, Italian financial police seized approximately €476 million of assets of four large banks in connection with a probe relating to a derivative transaction entered into by the city of Milan. The seizure was ordered by a judge in connection with an investigation of whether the banks fraudulently made over €100 million in "illicit profits" under that transaction.

5 For example, the Pennsylvania Senate Finance Committee considered a bill in May to ban school districts and local governmental entities from entering into interest rate swaps related to bond issuances in the wake of one school district's swap-related losses of more than $10 million (purportedly due to "excessive" fees and a termination payment). Also, prompted by a rash of losses incurred (and negative values accrued) by many Italian municipalities during the credit crisis and against the backdrop of the investigation into the city of Milan's derivatives, the Italian Senate Finance Committee in March unanimously approved a proposal to restrict the use of derivatives by municipalities to towns having at least 100,000 residents (other than capitals of provinces), ban upfront payments and compel municipalities to obtain an opinion from the Economy Ministry before execution of any transaction.

6 Virtually every derivative instrument commonly traded by governmental entities fits within this definition, which includes, inter alia, interest rate swaps, caps and floors, credit default swaps, total return swaps, weather swaps, energy swaps, equity

swaps, equity index swaps, agricultural swaps, commodity swaps and any "agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap." Primary regulatory authority over swaps is granted to the CFTC.

7 Note that, as their definitions suggest, it is highly unlikely that governmental entities would be subject to regulation under the Act as either swap dealers or major swap participants.

8 For purposes of simplicity, this Alert does not summarize or address issues relating to special entities that are employee benefit plans and governmental plans under ERISA.

9 Note, however, that the CEA continues to permit governmental entities to enter into derivatives with financial institutions, brokers, dealers and other specified parties without regard to any discretionary investment threshold. Also note that the discretionary investment threshold does not explicitly exclude bond proceed investments, as certain earlier drafts of derivatives regulation had proposed.

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FINANCIAL MARKETS ALERT **AUGUST 3, 2010**

Dodd-Frank Wall Street Reform and Consumer Protection Act: Credit Rating Agency Provisions with Comments on Application to Public Finance

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The legislation covers a wide variety of topics in an effort to address the causes of the recent financial crisis. With regard to credit rating agencies, the legislation covers the following topics: increased accountability, internal controls to avoid conflicts of interest and to better ensure the accuracy of ratings, elimination of reliance on ratings by federal agencies, and public disclosure of the information on which ratings are based to allow investors and other users to evaluate accuracy and to compare the performance of different agencies.

As indicated below, many of the requirements to be imposed have been left by Congress to regulations to be prescribed by the SEC and many actions that had been proposed in Congress have been relegated to studies to be conducted over the next several years. Generally, the SEC is required to issue final regulations with regard to credit rating agencies within one year of the date the legislation is enacted.

This summary describes the provisions of the legislation relating to rating agency regulation generally, and where the summary raises issues particularly relevant to public finance, there are additional comments describing the implications of the law to public finance.

1. Accountability

Liability for Information Filed Section 15E of the Securities Exchange Act of 1934 (the '34 Act) includes provisions relating to the registration of Nationally Recognized Statistical Rating Organizations ("NRSROs") with the SEC. In various parts of Section 15E, there had been references to information to be "furnished" to the Commission. NRSROs will now be required to "file" such information with the Commission, and will therefore be subject to liability under Section 18 of the '34 Act in the event that any such filings contain false or misleading statements of material fact.

"Accuracy" The legislation also empowers the SEC to temporarily suspend or permanently revoke the registration of an NRSRO with respect to a particular class of securities if, among other things, the Commission finds that the NRSRO "has failed over a sustained period of time . . . to produce ratings that are accurate for that class or subclass of securities . . ."

"Expert" Liability Rule 436(g) under the Securities Act of 1933 (the '33 Act), which provides that credit ratings assigned by an NRSRO are not considered part of a registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the '33 Act, is nullified. Written consent of an NRSRO must thus be obtained by a registrant in order to include a credit rating in a registration statement, and NRSROs are therefore subject to liability under Section 11 of the '33 Act for misstatements or omissions of material facts in connection with credit rating disclosure.

Rule 436(g), which is rescinded by the legislation, had provided an exception for ratings from the requirement of Rule 436(a), which provides that any issuer that includes a report or opinion of an expert quoted in a registration statement must file with the registration statement a consent of the expert. Most issues of municipal securities are not subject to the registration requirements because of the exemption under Section 3(a)(2) of the '33 Act. The consent requirement of Rule 436(a) does not apply to exempt municipal securities and therefore no consent of the rating agencies is required in order to include ratings in Official Statements for such exempt municipal securities.

The '33 Act Section 11 civil liability for an expert, who has consented to the use of a report or opinion in a registration statement, applies only to issues subject to the registration requirements. Section 11 has no application to municipal securities that are exempt from the registration requirements and, therefore, does not subject a rating agency to such liability merely by reason of inclusion of its rating in an Official Statement for exempt municipal securities.

2. Internal Controls

Section 15E has also been amended to require NRSROs to "establish, maintain and enforce an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings".

Annual Report Requirement The SEC is required by the legislation to prescribe rules requiring NRSROs to submit to the SEC annual internal controls reports describing the responsibility of the NRSRO's management in establishing and maintaining internal controls, assessing the effectiveness of their internal control structures, and containing an attestation of the CEO.

3. Conflicts of Interest

Separation of Ratings from Sales and Marketing The SEC will also be required to issue rules to prevent sales and marketing considerations from influencing the production of ratings. The legislation mandates that exceptions to the rules be provided for small NRSROs where separation of sales and marketing is not practical.

Look-back Requirement NRSROs will be required to put in place procedures reasonably designed to ensure that, if any employee of an issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating had previously been employed by the NRSRO and participated in determining a credit rating of that entity during the one-year period before the rating action, the NRSRO will conduct reviews to determine whether conflicts of interest influenced the rating, and will revise the rating as appropriate. The SEC will be required to periodically review the look-back procedures and code of ethics policies of each NRSRO.

Employment Transitions NRSROs will be required to report to the SEC (and the SEC will be required to disclose to the public) when an individual who had been an employee of the NRSRO within the previous five years becomes employed by an obligor, issuer, underwriter, or sponsor of a security or money market instrument that was rated by the NRSRO during the twelve months before the employee transitioned to his or her new position, in cases where the employee was a senior officer of the NRSRO or participated in or supervised someone participating in rating the obligor, issuer, underwriter, or sponsor.

Rule to Prevent Conflicts of Interest The legislation sets forth the sense of Congress that the SEC should exercise its rulemaking authority to prevent improper conflicts of interest arising from NRSRO employees providing services to issuers, including consulting and advisory services, in addition to providing credit ratings to those issuers.

4. Corporate Governance

Independent Board Each NRSRO must have a board of directors, at least half but no fewer than two members of which are independent. To be <u>independent</u>, a board member may not, other than in the capacity of member of the board, accept a fee from the NRSRO, be associated with the NRSRO or any affiliated company, or be involved in determining a rating in which it has a financial interest. Some of the independent members must be users of NRSRO ratings.

Duties of Board The NRSRO board of directors will be required to oversee the establishment, maintenance, and enforcement of policies and procedures for determining credit ratings and addressing and dealing with conflicts of interest, the effectiveness of the internal control system, and compensation and promotion policies.

If the SEC determines that compliance with these provisions is an unreasonable burden for a small NRSRO, the SEC may permit such NRSRO to delegate these responsibilities to a committee which includes at least one person who is a user of NRSRO ratings.

5. Regulation of NRSROs

Office of Credit Ratings The SEC will be required to establish an Office of Credit Ratings within the SEC to administer rules regarding the practice of determining ratings, promoting rating accuracy, and ensuring that ratings are not influenced by conflicts of interest.

- Examinations The Office of Credit Ratings will be required to conduct examinations of NRSROs at least annually to review management of conflicts of interest, internal controls, governance, and implementation of its policies, procedures, and rating methodologies.

- Inspection Reports The SEC will make available to the public a summary of its findings with regard to material regulatory deficiencies, including whether the NRSRO has appropriately addressed recommendations of the SEC and any responses by the NRSRO.

- Penalties The SEC will be required to establish fines and other penalties applicable to NRSROs violating the provisions of Section 15E.

Private Right of Action

- Statements Made by Credit Rating Agencies Section 15E(m) of the '34 Act is amended so that the penalty and enforcement provisions of the '34 Act apply to statements made by a credit rating agency in the same manner and to the same extent as they apply to statements made by a registered public accounting firm or a securities analyst under the securities laws. These statements are not deemed to be forward-looking statements for purposes of the safe harbor pursuant to Section 21E of the '34 Act. There is no longer a bar against private rights of action as there previously had been under Section 15E(m). The potential liability of rating agencies under the new legislation applies to statements made by rating agencies in connection with municipal securities as well as to ratings of other types of securities.

- State of Mind Section 21D(b)(2) of the '34 Act is amended so that, with respect to private securities fraud actions for money damages against a rating agency or a controlling person, it is sufficient that a complaint state with particularity the facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk, or (ii) to obtain reasonable verification of such factual elements from other sources the credit rating agency considered competent, and that were independent of the issuer and underwriter. The specific state of mind provisions applicable to private actions against rating agencies would apply in a case brought in connection with municipal securities.

Duty to Report Tips Alleging Material Violations of Law

Each NRSRO must report to the appropriate authority any credible information it receives alleging that an issuer of securities rated by the NRSRO has committed or is committing a material violation of law.

6. Disclosure of Credit Ratings

SEC Rule as to Disclosure The SEC must issue a rule requiring NRSROs to publicly disclose information on the initial credit rating given to each obligor, security, and money market instrument, and on any subsequent rating change. The direction to the SEC does not have an exception for municipal securities. In fact, the legislative direction to the SEC to adopt transparency rules states that they are to be made "for each type of obligor". Thus, public disclosure rules adopted by the SEC are likely to specifically reference information about municipal ratings as well as other categories of ratings.

Content and Type of Disclosure The disclosures made by each NRSRO must (i) be comparable so that users can compare credit ratings performance across NRSROs, (ii) be clear and informative, (iii) include performance information over a range of years and for a variety of types of credit ratings, including for withdrawn credit ratings, (iv) be freely available and easily accessible on its website, and (v) include an attestation that the rating is based solely on an independent evaluation of the risks and merits of the instruments being rated.

Form Accompanying Ratings The SEC will require each NRSRO to prescribe a form to accompany each publication of a credit rating which is easy to use, comparable across security type, and readily available to credit rating users.

- Qualitative Content: The form will be required to include disclosure of (i) the credit rating, (ii) the main assumptions and data used in making the rating determination, (iii) potential limitations of the credit rating, (iv) information on the reliability, accuracy, or quality of the data used in making a credit rating determination, (v) information as to limitations of essential data such as limits on the scope of historical data and limits on accessibility to certain documents, (vi) whether and to what extent third party due diligence services were used by the NRSRO, a description of the information that third party reviewed, and a description of the third party's conclusions, (vii) an assessment of the quality of information available in making the rating determination, and (viii) information as to conflicts of interest.

- Quantitative Content: The form will be required also to include disclosure of (i) factors that could lead to a change in the credit rating and the magnitude of change to be expected under various market conditions, (ii) information on the content of the rating, including the historical performance of the rating, and the expected probability of default and consequent loss, and (iii) information on the sensitivity of the rating to assumptions made in the rating process.

Third Party Due Diligence The issuer or underwriter of any asset-backed security will be required to make publicly available the findings and conclusions of any third party due diligence report it obtains. Any third party due diligence provider employed by an NRSRO, issuer, or underwriter must provide written certification to the NRSRO that it conducted a thorough review of the data and documentation used by an NRSRO to make a rating determination in a form to be established by the SEC, and the NRSRO will be required to disclose the certification to the public.

Since the requirements for disclosure of third party due diligence reports applies to "any asset-backed security", it would seem not to apply to issues of municipal securities. However, some public finance issues have the characteristics of an "asset-backed security". The legislation has no definition of asset-backed securities and no exception for issues of municipal securities. The problem has been compounded by recent proposed regulations of the SEC applicable to asset-backed securities or structured products in which the definition of terms do not clearly exclude issues of municipal securities or tender option bonds based on municipal securities. This issue is likely to be the subject of continuing comment letters to the SEC and may require requests to the staff for "no-action" letters.

Elimination of Regulation FD Exemption Under Regulation FD, if an issuer or any person acting on behalf of an issuer discloses material nonpublic information about the issuer or its securities to certain enumerated entities, the issuer must make such disclosure public. The current rule exempts disclosures made to credit rating agencies. The SEC is required to revise Regulation FD within 90 days of enactment of the legislation to remove the exemption for disclosures to credit rating agencies.

The elimination of the Regulation FD exemption is not likely to significantly impact public finance. Regulation FD applies to reporting companies under the '34 Act, which normally include the same companies whose securities are subject to the registration requirements of the '33 Act and, therefore, does not apply to municipal issuers. The primary purpose of Regulation FD is to prevent selective disclosure of nonpublic information that may be used for purposes of insider trading. In public finance there is an insider trading prohibition under section 10 of the '34 Act and SEC Rule 10b-5. Accordingly, some issuers of municipal securities use Regulation FD as a general guide to avoid selective disclosure, but other means of avoiding insider trading can be equally effective.

If Regulation FD is used as a template for disclosure of nonpublic information by municipal issuers to rating agencies, it should be noted that within Regulation FD there are exceptions in addition to the rating agency exemption that is to be removed. Regulation FD is not violated if the nonpublic information disseminated by an issuer will not be obtained by certain classes of persons listed in Regulation FD (such as broker-dealers) that are considered likely to trade on the basis of the nonpublic information. Information given to rating agencies in the course of an issuer obtaining a rating is not likely to be leaked to any person in the listed classes of persons deemed likely to trade. As long as the nonpublic information is not communicated to any person (within the defined classes listed), the issuer has no obligation to disclose the nonpublic information to the public generally. If it is leaked, and the issuer becomes aware of the leak, the issuer is to "promptly" disclose the information to the public. There is a further exception for information given to a person "who owes a duty of trust or confidence to the issuer", or to a person "who expressly agrees to maintain the disclosed information in confidence". An issuer can have a rating agency sign a confidentiality agreement to evidence that this exception is being relied upon. Confidentiality agreements are commonly signed by rating agencies.

The legislation requires the SEC to revise Regulation FD within 90 days to remove the rating agency exemption. Issuers of municipal securities should follow the development of this revision to be sure there is no spillover effect on the usefulness of Regulation FD as a template in public finance.

7. Methodologies and Procedures

SEC Rules as to Procedures and Methodologies The SEC must prescribe rules requiring NRSROs to:

- ensure that credit ratings are determined using procedures and methodologies that are approved by the board of the NRSRO and in accordance with the NRSRO's policies and procedures,
- ensure that material changes to credit rating procedures and methodologies are applied consistently to all credit ratings, as applicable, within a reasonable period of time, and that the reasons for the change are publicly disclosed, and
- notify credit rating users of the version of a procedure or methodology used to determine a particular rating, when a material change to a procedure is made, when an error is identified, and the likelihood that a material change in procedure will result in a rating change.

Use of Information from Outside Sources NRSROs must consider information about an issuer that it receives from a source other than the issuer or underwriter when producing a rating, if the NRSRO finds the information credible and potentially significant to the rating decision.

Qualifications for Credit Rating Analysts The SEC will be required to issue rules designed to ensure that persons employed by an NRSRO to perform credit ratings meet standards of training, experience, and competence necessary to produce accurate ratings and are tested for knowledge of the credit rating process.

Universal Rating Symbols The SEC must require NRSROs to establish, maintain, and enforce written policies and procedures that (i) assess the likelihood that an issuer of a security or money market instrument will default or fail to make payments in a timely manner in accordance with the terms of the instrument, (ii) clearly define the symbol used to denote the credit rating, and (iii) apply credit rating symbols in a consistent manner.

8. Removal of Statutory References to Credit Ratings

Removal of Statutory References Certain statutory references to credit ratings are required to be removed, effective two years after the date of enactment. Regulatory bodies will be required to develop their own standards of credit-worthiness to replace these references.

Feasibility Study The SEC will be required to undertake a study on the feasibility and desirability of standardizing credit rating terminology and meanings. The SEC must submit a report of its findings and recommendations to Congress within one year after enactment.

9. Review and Modification of Federal Agency Reliance on Ratings

Each federal agency is required to review and modify its regulations to remove references to credit ratings and substitute its own standard of credit-worthiness. Upon conclusion of the process, each federal agency must submit a report to Congress describing the modifications made.

10. Studies

NRSRO Independence The SEC must conduct a study of the independence of NRSROs and of how such independence affects the ratings issued. The SEC must evaluate management of conflicts of interest raised by an NRSRO providing services in addition to awarding ratings, and the potential impact of rules prohibiting an NRSRO from providing such other services to issuers it rates. A report on the results must be submitted to Congress within three years of enactment.

Alternative Business Models The GAO must conduct a study on alternative means for compensating NRSROs in order to create incentives for NRSROs to provide more accurate credit ratings. A report on the results must be submitted to Congress within 18 months of enactment.

Creation of Independent Professional Analyst Organization The GAO must conduct a study on the feasibility and merits of creating an independent professional organization for rating analysts employed by NRSROs that would be responsible for establishing independent standards for governing the profession and a code of ethical conduct, and for overseeing the profession. A report on the results must be submitted to Congress within one year of enactment.

Assigned Credit Ratings Study and Rulemaking

- Study The SEC must conduct a study of (i) the credit rating process for structured finance products and the conflicts of interest associated with issuer-pay and subscriber-pay models, (ii) the feasibility of establishing a system whereby NRSROs are assigned to determine credit ratings of structured finance products, including an assessment of potential ways to determine fees, appropriate methods for paying fees, and the extent to which such a system could be viewed as the creation of a moral hazard by the Federal Government, (iii) the range of metrics that could be used to determine the accuracy of credit ratings, and (iv) alternative compensation schemes that would incentivize more accurate credit ratings. A report on the results must be submitted to Congress within two years of enactment.

- Establishment of Assignment System After submission of the report, the SEC must, as it determines is necessary or appropriate, establish a system for the assignment of NRSROs to determine initial credit ratings of structured finance products, such that the issuer, sponsor, or underwriter of the structured finance product does not make the assignment.

Section 15E(w) of the '34 Act, as that provision would have been added by section 939D of H.R. 4173 (111th Congress), as passed by the Senate on May 20, 2010, would have established a system pursuant to which a self-regulated Credit Rating Agency Board would assign NRSROs to determine initial credit ratings of structured finance products. The SEC will be required to implement the system described in Section 15E(w) unless the SEC determines that an alternative system would better serve the public interest and the protection of investors.

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FINANCIAL MARKETS ALERT | **JULY 21, 2010**

Dodd-Frank Act Expands Authority of the Municipal Securities Rulemaking Board

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On July 15, 2010, The Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which had previously been passed by the House. It has been reported that the President will sign the bill next week.

The Reform Act contains a substantial expansion of the rulemaking authority of the Municipal Securities Rulemaking Board (MSRB). The MSRB was established by Congress under the 1975 amendments to the Securities Exchange Act of 1934 as a self-regulatory organization in connection with broker-dealer transactions in municipal securities and related municipal securities business activities of broker-dealers. Unlike FINRA and the stock exchange self-regulatory organizations, the MSRB was created directly by Congress in section 15B of the 1934 Act, and section 15B(c)(1) specifically provides that any violation of a rule of the MSRB is a violation of law. The provisions expanding MSRB jurisdiction are primarily in Subtitle H, section 975 of the Reform Act and will appear as amendments to section 15B of the 1934 Act.

Prior to the Reform Act, MSRB jurisdiction extended only to broker-dealers and to their transactions in municipal securities. The Reform Act broadened the class of persons covered by MSRB jurisdiction, and rulemaking authority is no longer limited to activities related to municipal securities, but includes transactions in an array of financial products (notably, municipal derivatives and investment contracts) involving "municipal entities" or "obligated persons."

Municipal Advisors

The Reform Act requires that municipal advisors be registered with the SEC, similarly to the registration requirement for broker-dealers. A municipal advisor is defined as a person that, (i) provides advice to a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, or (ii) undertakes a solicitation of a municipal entity. The definition specifically includes financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders and swap providers. The definition excludes broker-dealers acting as underwriters and investment advisers registered under the Investment Advisers Act of 1940. The definition also excludes attorneys offering legal advice or providing services that are of a traditional legal nature, and engineers providing engineering advice.

The Reform Act authorizes the MSRB to adopt rules that provide professional standards for municipal advisors (e.g. testing of personnel and supervisory rules), and that prescribe means reasonably designed to prevent acts, practices, and courses of business conduct as are not consistent with a municipal advisor's fiduciary duty to its clients. A municipal advisor is deemed to have a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor.

There is an antifraud rule specifically applicable to municipal advisors with respect to: advice to a municipal entity or obligated person, financial products, the issuance of municipal securities or in the solicitation of a municipal entity or obligated person. The Reform Act further provides that no municipal advisor may engage in any act, practice or course of business that is not consistent with the municipal advisor's fiduciary duty or that is in contravention of any rule of the MSRB.

Municipal Financial Products

The Reform Act extends MSRB rulemaking jurisdiction to regulate transactions by broker-dealers and advice by broker-dealers or municipal advisors concerning municipal financial products, in addition to the MSRB's traditional rulemaking authority with respect to broker-dealer transactions in municipal securities. A municipal financial product is defined as municipal derivatives, guaranteed investment contracts and investment strategies.

An investment strategy is defined to include plans or programs for the investment of municipal securities, and the recommendation of and brokerage of municipal escrow investments.

A guaranteed investment contract is defined to include any investment that has specified withdrawal or reinvestment provisions and a specifically negotiated or bid interest rate, and also includes any agreement to supply investments on two or more future dates, such as a forward supply contract.

The bill that was reported out by the conference committee deleted the definition of municipal derivatives that had been in the Senate bill. Under S.3217, a municipal derivative had been defined by the Senate in section 975 as "any financial instrument or contract designed to hedge a risk (including interest rate swaps, basis swaps, credit default swaps, caps, floors, and collars)". It is not clear whether the definition will be reinserted when Congress adopts technical amendments to the bill.

Regardless of the definition of municipal derivatives that is finally applied to MSRB rulemaking authority, the jurisdiction of the MSRB in respect of derivatives is likely to overlap with the new rulemaking authority of the CFTC and the SEC to regulate derivatives. The agencies will have to reach an accommodation with the MSRB on the issues to be covered by MSRB rules.

Solicitation of Municipal Entities and Obligated Persons

The Reform Act grants jurisdiction to the MSRB to adopt rules regulating the use of outside consultants by broker-dealers and municipal advisors who, for compensation, solicit municipal entities or obligated persons for the purpose of obtaining an engagement of a broker-dealer or municipal advisor for municipal financial products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity.

Municipal Entities and Obligated Persons

A municipal entity is broadly defined to mean any State, political subdivision of a State, or municipal corporate instrumentality of a State, including: (i) any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality, (ii) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof, and (iii) any other issuer of municipal securities.

The definition of an obligated person is derived from SEC Rule 15c2-12 and is defined in the Reform Act to mean any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person, committed by contract or other arrangement to support the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities. The obligated person definition in the Reform Act does not have the Rule 15c2-12 exclusion for credit providers and liquidity facilities because obligated persons are not regulated under the Reform Act; they, along with municipal entities, are beneficiaries of certain rules regulating broker-dealers and municipal advisors.

The purpose of the definitions of municipal entities and obligated persons is to make clear the beneficiaries of certain of the MSRB rules. For example, section 15B(b)(2) provides that the MSRB is to make rules governing advice to municipal entities or obligated persons by broker-dealers and municipal advisors regarding municipal financial products and the issuance of municipal securities, whereas section 15B(c)(1) makes a municipal advisor a fiduciary to a municipal entity, but not to an obligated person.

Enforcement of MSRB Rules

Prior to the Reform Act, the MSRB was limited to rulemaking, and enforcement of MSRB rules was by FINRA, the SEC, and appropriate bank regulators. The Reform Act extends authority to the MSRB to "provide guidance and assistance in the enforcement of, and examination for, compliance with" MSRB rules to the SEC, FINRA or the appropriate bank regulators. Related sections of the Reform Act require FINRA to adopt rules to request guidance from the MSRB in the interpretation of MSRB rules. Section 979 of the Reform Act, which formalizes the office of municipal securities within the SEC , directs the office to coordinate with the MSRB for rulemaking and enforcement actions.

MSRB Board Composition

The MSRB Board is composed of 15 persons with three-year staggered terms. Previously, the board was composed of five persons representing broker-dealers, five persons representing commercial banks having municipal finance departments, and five persons representing the public. In the future, the board is to consist of eight public members, at least one of whom is to represent institutional investors and at least one of whom is to represent municipal entities. Of the seven members associated with a broker-dealer and a bank municipal department, or a municipal advisor (regulated representatives), at least one is to represent broker-dealers that are not banks, at least one is to represent municipal securities dealers that are commercial banks, departments of banks or subsidiaries of banks, and at least one is to represent municipal advisors.

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FINANCIAL MARKETS ALERT

AUGUST 6, 2010

144A Transactions: Impact of Dodd-Frank and Proposed SEC Reg AB II

Issuers and financial intermediaries in securitization offerings made pursuant to Rule 144A of the U.S. Securities Act of 1933 should be aware of the implications of the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in the United States on July 21, 2010, as well as the proposed changes to U.S. SEC Regulation AB on their future issuances.

Historically, Rule 144A transactions have not been subject to the disclosure and reporting requirements applicable to public registered deals or to the provisions of Reg AB, which was introduced to address registration, disclosure and reporting requirements for publicly issued asset-backed securities ("ABS").

However, as a result of changing sentiment toward the risks of securitization transactions, the Dodd-Frank Act and the SEC's proposed amendments to Reg AB may increase the disclosure and reporting burden of 144A issuers and other deal participants and are likely to impose new substantive requirements on these transactions. A summary of the relevant provisions is set out below.

Securitization Provisions in the Dodd-Frank Act

The Dodd-Frank Act imposes a variety of new requirements for securitization transactions, some of which will be applicable to Rule 144A transactions.

- Risk Retention: The Federal banking agencies (defined as the OCC, the Fed and the FDIC) and the SEC are required to jointly propose regulations by April 17, 2011 to require "securitizers" to retain an economic interest in a portion of the credit risk of any securitized asset. A "securitizer" is defined as (A) an issuer of an asset-backed security or (B) a person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer. No distinction is made between public deals and Rule 144A offerings in the legislation related to risk retention, and it is not clear whether the Federal banking agencies will make any such distinction.

- Representations and Warranties; Enforcement Mechanisms: The SEC has been called upon to pass regulations by January 17, 2011 relating to securitization disclosure and representations and warranties. These regulations would likely affect Rule 144A offerings in the following ways:

    - In any report accompanying a rating on a securitization, rating agencies will be required to include a description of the representations and warranties and enforcement mechanisms available to investors as well as how those provisions differ from such provisions in similar types of securitizations.

    - A securitizer (as defined above) will be required to disclose any fulfilled and unfulfilled repurchase requests across all of its transactions in order to allow investors to "identify asset originators with clear underwriting deficiencies".

Please visit (http://edocket.access.gpo.gov/2010/pdf/2010-8282.pdf) to access the SEC's proposed ABS rules.

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Additional detail regarding matters discussed in this section and a summary of the provisions in the Dodd-Frank Act affecting securitizations can be found here.

Credit Rating Agency Provisions in the Dodd-Frank Act

The new requirements imposed by the Dodd-Frank Act to improve the regulation of credit rating agencies will also have implications for 144A issuers.

- Due Diligence Reports: The issuer or underwriter of any asset-backed security will be required to make publicly available the findings and conclusions of any third party due diligence report it obtains. While there had been some concern that this provision would be immediately applicable, the SEC has stated that it believes it has until July 21, 2011 to adopt regulations to implement these provisions. No distinction is made between public deals and Rule 144A offerings in the legislation requiring this disclosure. There is no indication whether the SEC will make any such distinction.

  - Although it is not clear what sort of information is encompassed by "third party due diligence report", a review of the legislative history of the Dodd-Frank Act suggests that it is meant to refer to the type of loan-level diligence done by third party diligence contractors.

- Information Provided to Rating Agencies: To the extent that an issuer is a reporting company under the Securities Exchange Act of 1934, the elimination of the exemption under Regulation FD for information provided to credit rating agencies may be applicable. Under Regulation FD, if an issuer discloses material nonpublic information about the issuer or its securities to certain enumerated entities, then the issuer must make that disclosure public. The current rule exempts disclosures made to credit rating agencies. The SEC has until October 19, 2010 to adopt regulations to remove that exemption.

- Information Relating to Credit Rating: The SEC must issue regulations by July 21, 2011 to require credit rating agencies to publicly disclose information on the initial credit rating given to each obligor, security, and money market instrument, and on any subsequent rating change. Each credit rating agency will be required to provide, among other things, the assumptions used in making the rating determination, an assessment of the quality of information available to make the rating determination, and details of any third party due diligence services used by the credit rating agency.

Additional detail regarding the matters discussed in this section and a summary of the provisions in the Dodd-Frank Act affecting credit rating agencies can be found at www.orrick.com/fileupload/2829.htm.

SEC Proposals for Public and Private Offerings of ABS

On April 7, 2010, the SEC unanimously approved for public comment proposed rules that, if adopted, would substantially revise Reg AB and other rules regarding the offering process, disclosure and reporting for ABS, including rules relating to enhanced disclosure standards for privately-placed ABS. The comment period for these proposals, which the industry has been referring to collectively as "Reg AB II," ended on August 2, 2010.

- Disclosure and Public Notice: In connection with the unregistered sale of "structured finance products" to a "qualified institutional buyer" in reliance on the safe harbor from registration under Rule 144A (or to an "accredited investor" under Regulation D), the proposed rules would require the issuer to:

  - provide to prospective investors, upon request, substantially the same information that the issuer would be required to provide in the public markets, both upon issuance and on an ongoing basis;

  - file a public notice of the initial placement of the ABS to be sold under Rule 144A; and

  - undertake to provide offering materials to the SEC upon request.

- Scope: The SEC has defined the term "structured finance product" more broadly than the definition of "asset-backed security" under Reg AB in an effort to make the proposed rules applicable to the wide range of private securitization products previously seen in the market, such as CDOs and synthetic securities.

- Private Placement and Resales: The proposed rules would apply to ABS offerings undertaken in reliance on the safe harbors afforded by Rule 144A and Regulation D, but would not apply to structured finance products offered and sold exclusively in reliance upon the private placement statutory exemption of Section 4(2) of the Securities Act of 1933 and the Section 4(1-1/2) exemption for private resales (in other words, without invoking the protections of the safe harbors).

For more information on Reg AB II, including a summary of the proposed disclosure requirements for public offerings of ABS that would apply to Rule 144A transactions under the circumstances described above, please visit http://reaction.orrick.com/reaction/email/pdf/article.pdf.

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FINANCIAL MARKETS ALERT | **JULY 21, 2010**

Sweeping New Whistleblower Incentives and Protections in Financial Reform Bill

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act. The legislation covers a wide range of topics in an effort to address the causes of the recent turmoil in the financial markets. It includes significant new whistleblower protections, including the creation of SEC and CFTC (Commodities Futures Trading Commission) whistleblower programs, a dramatic expansion of current whistleblower protections under the Sarbanes-Oxley Act of 2002, and a new whistleblower cause of action for employees performing tasks related to consumer financial products or services. Significantly, the legislation creates alternative paths for whistleblowers to assert their rights, often with different and conflicting rights, procedures and remedies.

New SEC and CFTC Whistleblower Incentives and Protections

The Dodd-Frank Act provides powerful monetary incentives for whistleblowers to report securities and commodities law violations to the SEC and CTFC, as well as strong protections for doing so. The legislation provides for whistleblowers who provide the respective Commissions with original information about violations of securities or commodities laws to be awarded a share of between 10% and 30% of monetary sanctions ultimately imposed by the Commissions that exceed $1 million.

The Act also prohibits employer retaliation against whistleblowers who provide information to the SEC or CFTC, assist in any investigation or legal action of the SEC or CFTC related to such information, or engage in any other protected activity under the Sarbanes-Oxley Act. An employee claiming retaliation under Dodd-Frank may bring an action directly in federal district court (as opposed to the procedure under SOX, where a complainant is first required to file an administrative complaint with the Department of Labor, OSHA).

By allowing whistleblowers (defined by the Act as individuals who have reported a violation to the Commissions) to file complaints of retaliation for SOX-protected activity directly in federal court, the Dodd-Frank Act would appear to permit such employees to bypass the OSHA administrative process completely and go directly to court, an option many employees may prefer given the high percentage of jurisdictional dismissals and the low number of merit findings by OSHA on SOX whistleblower claims. Moreover, the potential for the recovery of whistleblower "incentives" under Dodd-Frank will also likely result in less use of the DOL's SOX complaint procedure.

In sharp contrast to SOX's previous 90-day statute of limitations, the statute of limitations under these provisions of the Dodd-Frank Act has been dramatically expanded: for whistleblowers who engage in SEC-related whistleblower conduct or other SOX-protected activity, an action must be filed either within six years after the date when the violation occurs or within three years after the date "facts material to the right of action are known or reasonably should have been known by the employee," but not more than 10 years after the date of the violation. This long limitations period not only expands employers' potential liability under the Act, it could create problems for employers who do not typically maintain employee records for 10 years. The statute of limitations for whistleblowers reporting violations of commodities laws to the CFTC is a more moderate two year period.

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Upon a finding of retaliation against a whistleblower who has reported a violation of securities laws or engaged in other SOX-protected activity, the Dodd-Frank Act provides for the whistleblower's reinstatement, double back pay (as opposed to just back pay, as under SOX), attorneys' fees and other costs. There is no explicit provision for the recovery of non-pecuniary damages, such as emotional distress or loss of reputation damages. With respect to whistleblowers who report violations of the commodities laws, the Act provides for reinstatement, back pay (as opposed to double back pay), and "special damages," including attorneys' fees and costs. It is possible that "special damages" may include at least some forms of non-pecuniary damages. SOX cases are currently split on the issue. The Act does not provide for recovery of punitive damages.

The CFTC whistleblower section in addition provides that its rights and remedies "may not be waived by any agreement, policy, form, or condition of employment, including by a predispute arbitration agreement," and that "[n]o predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section." Based on this language, it appears that employers will not be able to compel arbitration of CFTC whistleblower claims, nor will they be able to include a release of CFTC whistleblower claims in their general releases or settlement agreements with employees.

The Dodd-Frank Act requires the SEC to establish a separate office within the Commission to administer and enforce the Act's whistleblower provisions. The SEC and CFTC have 270 days from the passage of the Act to issue final regulations implementing these whistleblower provisions. However, whistleblowers providing information to the SEC or CFTC are immediately covered under the Act's bounty provisions. That is, as long the whistleblower provides "original information" after the Act is signed by the President, the whistleblower will be eligible for a potential award. Moreover, a whistleblower may receive an award for reporting violations that occurred even prior to the passage of the Act. Accordingly, there are concrete steps employers should start taking now to protect themselves, which are discussed at the end of this Alert.

Sweeping Amendments To § 1514A of the Sarbanes-Oxley Act

The Dodd-Frank Act expands the scope of SOX's whistleblower protections in several key ways.

- The statute of limitations has been broadened from 90 to 180 days to file a complaint with OSHA. (The import of this change is dwarfed, however, by the Act's six-year statute of limitations to bring such claims directly in federal court.)

- SOX plaintiffs are now entitled to a jury trial, which was an unsettled question under SOX case law.

- Non-publicly traded subsidiaries of publicly traded companies are now covered by SOX, by amendment to the definition of "publicly traded company" to include any "subsidiary or affiliate whose financial information is included in the consolidated financial statements of such company." Prior to this amendment, the Department of Labor took the position that employees of non-publicly traded subsidiaries were generally not covered by the Act absent a showing of a substantial nexus between the parent and subsidiary, substantially narrowing the scope of coverage.

- "Nationally recognized statistical ratings organizations" are now covered by SOX, so employees of these organizations will now have the benefit of SOX whistleblower protection.

- Pre-dispute arbitration agreements will no longer be enforceable under SOX (except perhaps in the collective bargaining agreement context), nor will the rights and remedies under SOX be capable of waiver by agreement. This means that employers will no longer be able to compel arbitration under SOX, nor will they be able to include a release of SOX claims in their general releases or settlement agreements with employees.

New Consumer Financial Whistleblower Protections

The Dodd-Frank Act also creates a new whistleblower cause of action for employees performing tasks related to the offering or provision of consumer financial products or services. Section 1057 of the Act prohibits retaliation against employees who provide information to their employers or to the government they reasonably believe to be a violation of the Consumer Financial Protection Act of 2010 (which is Title X of the Dodd-Frank Act) or any other provision of law subject to the jurisdiction of the Bureau of Consumer Financial Protection, which Bureau is to be established under the Act. This provision also protects employees who object to, or refuse to participate in, any activity that the employee reasonably believes to be a violation of any law, rule, or standard of the Bureau, who testify in proceedings relating to same, or who file, institute or cause to be filed any proceeding under any Federal consumer financial law. Aggrieved employees are required to file a complaint with the Secretary of Labor within 180 days of an alleged violation, and the DOL's procedure for handling such complaints, as well as the burdens of proof, remedies, and ability of a complainant to file an action in federal district court and demand a jury trial, are somewhat similar to the scheme to which employers have become accustomed under SOX.

Next Steps for Employers

In light of these important changes to the landscape of employee whistleblower protections, including the strong monetary incentives provided to employees to report compliance issues to the SEC and CFTC, employers would be well served to review their internal whistleblower procedures and policies as soon as possible to ensure that they require internal reporting and the maximum opportunity to address compliance concerns before employees provide information to federal agencies in pursuit of generous bounties. In addition, subsidiaries and affiliates of publicly traded companies who will now be covered by SOX should review, and if necessary, enhance, as well as train line management in, their existing anti-retaliation procedures to protect against SOX whistleblower claims by their employees.

ORRICK

FINANCIAL MARKETS ALERT

JULY 27, 2010

Dodd-Frank Provisions Relating to Corporate Governance, Executive Compensation and Disclosure

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On July 15, 2010, the U.S. Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and President Obama signed the bill into law on July 21. The sweeping law will have significant effects across the financial services industry and will impact not only financial services companies, but also all U.S. consumers and most U.S. companies, private and public. While many of the substantive changes included in the legislation will be left to regulatory agencies for implementation, and although the legislation mandates studies over the next several months and beyond by various regulatory agencies with regard to many areas covered by the bill, Dodd-Frank will affect our clients' financing and business decisions immediately. The full text of Dodd-Frank can be accessed at http://reaction.orrick.com/reaction/email/pdf/Dodd-Frank.pdf.

In this client alert we are focusing on changes affecting corporate governance, executive compensation, public company disclosures, whistleblower protections and investor standards. Several of our colleagues are preparing client alerts on portions of the bill relating to their specific areas of practice.

Under Dodd-Frank shareholders of U.S. public companies will have a nonbinding "say on pay" vote for named executive officers, new standards relating to the independence of compensation committees and compensation advisors are mandated, current and former executive officers may be forced to return compensation if a restatement of financial statements triggers a "clawback", brokers' ability to vote shares for which they do not receive instructions will be further limited, proxy disclosures will be enhanced, the Securities and Exchange Commission ("SEC") is granted express authority to enact shareholder access to the company proxy, smaller reporting companies and non-accelerated filers will be relieved from providing auditor attestation of the effectiveness of internal controls and procedures, whistleblower protections are expanded and the definition of "accredited investor" will be updated. The majority of these items are subject to additional rulemaking by the SEC which will likely impact companies beginning with 2011 annual meetings and proxy statements.

Shareholder Say on Pay Vote; Frequency; Golden Parachute

Section 951 of Dodd-Frank amends Section 14A of the Securities Exchange Act of 1934 (the "Exchange Act") to require a non-binding vote of shareholders no less frequently than once every three years to approve the compensation of a public company's named executive officers – this is the so-called "say on pay" resolution discussed in press accounts of Dodd-Frank. Additionally, Dodd-Frank requires a public company to include a resolution no less frequently than every six years for a non-binding shareholder vote to determine whether the say on pay vote described in the prior sentence should take place every one, two or three years. Dodd-Frank requires the first of each of these non-binding resolutions to be included in the proxy for the first annual or other shareholder meeting occurring after the date that is six months after the enactment of Dodd-Frank. That means that companies holding a shareholder meeting after January 21, 2011, will need to include these resolutions.

In addition to the say on pay vote with respect to the compensation of the named executive officers, Section 951 of Dodd-Frank separately requires disclosure (the contours of which are to be determined by SEC rulemaking) of the terms of "golden parachute" payments to named executive officers in connection with an acquisition, merger, consolidation of an public company or a proposed sale of all or substantially all of the assets of an such public company. The disclosure must be contained in the consent solicitation or proxy in which shareholders are being asked to approve the acquisition, merger, consolidation of the company or a proposed sale of all or substantially all of the assets of the company in any meeting occurring on or after January 21, 2011 (six months after the enactment of Dodd-Frank). The referenced proxy or consent solicitation must include a resolution for a non-binding shareholder vote to approve the golden parachute payments, unless such payments (or the agreements or understandings documenting the payments) have already been subject to a say on pay vote as described in the prior paragraph.

Additionally, Section 951 of Dodd-Frank authorizes the SEC to exempt, by rule or order, an issuer or class of issuer from all of the say on pay requirements described above and the section specifically orders the SEC to consider a disproportionate effect that the requirements may have on small issuers.

Finally, all institutional investment managers (such as the managers of most mutual funds) that are subject to Section 13f of the Exchange Act must report at least annually how they voted on any of the say on pay-related votes described above.

The combination of the new say on pay resolutions and the further limits on broker discretionary voting, described below, will further strengthen the influence of proxy advisory firms such as Institutional Shareholder Services and Glass Lewis as they issue voting recommendations.

What to do: Public companies should begin to prepare to include these resolutions for any meetings occurring after January 21, 2011. In addition, extra care and attention should be devoted to drafting compelling arguments for executive compensation arrangements (including a full description of parachute payments) in the Compensation Discussion and Analysis in the proxy that accompanies the first say on pay vote.

Independence of Compensation Committee And Compensation Advisors

Section 952 of Dodd-Frank requires the SEC to act to require national securities exchanges and national securities associations to enact listing standards that prohibit the listing of equity securities for any issuer that does not have an independent compensation committee under the standards set forth in Section 952. Issuers that are controlled companies, limited partnerships, involved in bankruptcy proceedings, foreign private issuers or open-ended management investment companies registered under the Investment Company Act of 1940 may all be exempted from these new listing standards.

The standards set forth in Section 951 require that all compensation committee members be members of the board of directors of the issuer and "independent." The SEC's rulemaking shall require listing standards that consider factors such as the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory, or other compensatory fee paid by the issuer and whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer. Section 951 provides the SEC with authority to allow the exchanges to adopt listing standards that exempt a particular relationship from these rules as the exchanges determine is appropriate taking into consideration the size of an issuer or other relevant factors.

What to do: These requirements are substantially similar to current rules for audit committee independence under Rule 10A-3 so companies should review the independence determinations made with respect to the current or proposed members of their compensation committees to determine if the members would meet the current audit committee independence standards of Rule 10A-3 and their exchange.

Section 952 further provides that compensation committees of public companies may, in their sole discretion, hire compensation consultants, legal counsel or other advisors and that public companies must provide for appropriate funding, as determined by the compensation committee, for reasonable compensation of compensation consultants, legal counsel or other advisors. For annual meetings of shareholders (or special meeting in lieu of the annual meeting) occurring on or after July 21, 2011, Dodd-Frank will require proxy disclosure whether the compensation committee retained or obtained advice of a compensation consultant. Further disclosure will be required if the work of the compensation consultant has raised any conflict of interest, including the nature of such conflict and how the conflict is being addressed.

Section 952 also requires compensation committees to consider standards to be adopted by SEC rulemaking when selecting compensation consultants, legal counsel or other advisors. The SEC's rulemaking should include factors that affect the

independence of such advisors including other services provided by the advisor to the issuer, the amount of fees received by the advisor as a percentage of total revenue of the advisor, conflict of interest policies of the advisor any business or personal relationship between the advisor an a member of the compensation committee and any stock of the issuer owned by the advisor.

What to do: Companies should review the current advisors to the compensation committee to consider the potential disclosures that may be required by SEC rulemaking implementing this section as the disclosures will likely go beyond those already required by Regulation S-K Item 402(e). They should also review the charter of the compensation committee to ensure that it provides the authority to hire advisors.

Additional Proxy Disclosures

Sections 953, 955 and 972 of Dodd-Frank direct the SEC to issue rules relating to various disclosure items in public company proxies. The effective dates of these new rules will be contained in the final SEC adopting releases. These new SEC rules will include disclosures concerning:

- the relationship between pay and performance;
- pay comparisons between the total annual compensation paid to a company's chief executive officer and all the median annual compensation of other employees;
- hedging activities by insiders; and
- board structure and leadership.

What to do: Issuers should monitor closely the SEC rulemaking with respect to the pay comparison, as considerable time, expenditures and effort are currently required to determine the proper disclosure of the total compensation of the named executive officers, and the expansion of this effort to include comparable calculations for all non-CEO employees will require significant care and effort. Companies should pay close attention to the SEC rulemaking in this area to see how the calculation of total compensation by all employees is to be carried out.

The additional disclosures required by Section 972 with respect to board leadership structure do not appear to be materially different than those imposed by the SEC in the late 2009 adoption of Regulation S-K Item 407(h).

Item 402 of Regulation S-K already includes a discussion of hedging policies as one of the items that companies should discuss in their Compensation Discussion and Analysis; however, such policies or discussions may have been limited to named executive officers.

What to do: Dodd-Frank expands hedging disclosure to cover policies applicable to all employees and directors, so companies will need to update their proxy disclosure to describe the policy, if any, applicable to these additional groups. Many companies have adopted insider trading policies that prohibit hedging transactions by officers and directors in company shares – they may want to consider whether these prohibitions should be broadly applied to all of their employees.

Compensation "Clawback" Provisions

Section 954 of Dodd-Frank requires that the SEC adopt rules to require national securities exchanges and national securities associations to enact listing standards that will require issuers (1) to provide disclosure of compensation policies relating to incentive based compensation and (2) to enact clawback policies that allow issuers to recover any incentive-based compensation from current or former executive officers for the prior three years in the event of a financial restatement due to material noncompliance with any financial reporting requirement under the securities laws. The effect of Section 954 will be that all companies listed on a national exchange will be required to have a clawback policy covering all current and former executive officers – the prior rules only required companies to seek recoupment from the CEO and the CFO. The amount of the recovery would be equal to the difference between the amount of incentive-based compensation received and the amount that should have been received under the restated financial results. Unlike current Sarbanes-Oxley clawback rules, Dodd-Frank does not require misconduct by the company or its executives to trigger the clawback and it expands the clawback to look back three years rather than one.

What to do: Those companies that have adopted clawback policies with conduct standards will need to amend the policies to broaden their scope and make other changes to ensure they comply with the SEC rules as adopted.

Broker Discretionary Voting

Brokers will face additional limits on their ability to vote shares in the absence of direction from beneficial owners under Section 957 of Dodd-Frank. In 2009 the NYSE already eliminated this "discretionary voting" for uncontested director elections and Dodd-Frank will expand these limits to prevent discretionary voting by brokers for shareholder votes with respect to executive compensation or "any other significant matter."

What to do: In 2010 most companies already evaluated the impacts of the NYSE rules on their proxy strategy – they should revisit this strategy again in light of the new say on pay votes described above and this expansion of the limits on brokers' discretionary voting.

SEC Authority to Enact Shareholder Access to Company Proxy

For many years the SEC has considered ways to expand shareholder access to the proxy materials sent by issuers to include shareholder-nominated director candidates. These considerations have led to several SEC rule proposals but have not yet resulted in definitive rules. Section 971 of Dodd-Frank grants the SEC explicit authorization to issue rules to permit shareholder use of an issuer's proxy solicitation materials for the purpose of nominating individuals to the board. Like, Section 951 of Dodd-Frank, this section also authorizes the SEC to exempt, by rule or order, an issuer or class of issuer from all of the proxy access rules and the section specifically orders the SEC to consider a disproportionate effect that the requirements may have on small issuers. On July 14, 2010, the SEC issued a concept release on the U.S. proxy system which can be found at http://www.sec.gov/rules/concept/2010/34-62495.pdf.

Relief Relating to Auditor Attestation of Internal Controls

Section 989G of Dodd-Frank provides a permanent exemption of the auditor attestation of the effectiveness of internal controls requirements of Sarbanes-Oxley Section 404(b) for non-accelerated filers (including smaller reporting companies). Since the adoption of Sarbanes-Oxley Section 404(b) in 2003, the SEC has granted a number of temporary exemptions to smaller companies. Dodd-Frank provides the permanent relief for non-accelerated filers that many were hoping for.

Additional Disclosures and Prohibited Pay Arrangements for Covered Financial Institutions

Section 956 of Dodd-Frank provides enhanced disclosure obligations and prohibits certain pay practices for "covered financial institutions" – which includes depositary institutions, broker-dealers registered under the Securities Exchange Act, credit unions, investment advisors, Fannie Mae, Freddie Mac and any other institution included by the rules of Federal regulators -- so long as such institution has assets greater than $1 billion. The disclosures, which must be made to Federal regulators, include the structure of incentive-based compensation arrangements which provide executive officers with "excessive compensation" or could lead to material financial loss by the institution. The section further authorizes Federal regulators to enact rules (and mandates that such rules be prescribed within nine months of the enactment of Dodd-Frank) to prohibit any types of incentive-based compensation arrangements that regulators determine encourages inappropriate risks by covered financial institutions. The contours of these disclosures and compensation prohibitions will be determined through extensive rulemaking by a number of Federal regulators and covered financial institutions should pay attention to the progress of these regulations in the coming months and years.

Accredited Investor Standards

Section 413 of Dodd-Frank requires the SEC to modify its rules under the Securities Act of 1933 (Regulation D) regarding the definition of "accredited investor." The accredited investor definition is amended to exclude the value of a person's primary residence when applying the $1 million individual net worth test. This change became effective on July 21, 2010, with no transition period or grandfathering for private offerings that are in progress on that date but not yet completed. Section 413 of Dodd-Frank also requires the SEC to undertake a review of the other portions of the accredited investor definition in light of the economy and other factors and to implement new rules following such review if it determines that other changes are necessary in order to protect investors and the public interest.

What to do: Companies issuing securities to investors who are natural persons in private placements should immediately review the procedures in place for determining whether such investors are "accredited" under Regulation D.

Whistleblower Protections

Section 929A of Dodd-Frank expands the whistleblower protections of Sarbanes-Oxley to additional employees. Non-publicly traded subsidiaries of publicly traded companies are now covered by Sarbanes-Oxley, by amendment to the definition of "publicly traded company" to include any "subsidiary or affiliate whose financial information is included in the consolidated financial statements of such company." Prior to this amendment, the Department of Labor took the position that employees of non-publicly traded subsidiaries were generally not covered by the Act absent a showing of a substantial nexus between the parent and subsidiary, substantially narrowing the scope of coverage.

Other sections of Dodd-Frank make additional important changes to the landscape of employee whistleblower protections, including new strong monetary incentives provided to employees to report compliance issues to the SEC and CFTC.

What to do: Companies would be well served to review their internal whistleblower procedures and policies as soon as possible to ensure that they require internal reporting and the maximum opportunity to address compliance concerns before employees provide information to federal agencies in pursuit of generous bounties. In addition, subsidiaries and affiliates of publicly traded companies who will now be covered by Sarbanes-Oxley should review, and if necessary, enhance, as well as train line management in, their existing anti-retaliation procedures to protect against Sarbanes-Oxley whistleblower claims by their employees.

ORRICK

FINANCIAL MARKETS ALERT | **JULY 29, 2010**

Securities Litigation Risks For Public Companies Arising From The Dodd-Frank Wall Street Reform and Consumer Protection Act

We encourage you to contact us if you have any questions regarding the Final Rule. Please contact:

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On Wednesday, July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") into law. While the primary focus of the Dodd-Frank Act is on banks, financial institutions and derivative instruments, it contains important provisions that may create securities litigation risks for publicly-traded companies. The following are what we view as the most important such provisions.

1. Expanded Aiding and Abetting Liability in SEC Cases.

Section 929O of the Dodd-Frank Act will make it easier for the SEC to target those who allegedly "aid and abet" securities fraud. The new provision lowers the requisite state of mind for aiding and abetting in SEC enforcement actions. The old standard under Section 20(e) of the Exchange Act of 1934 ("Exchange Act") was "actual knowledge." Under the new standard, the SEC can bring aiding and abetting charges for "reckless" conduct. In addition, Sections 929M and 929N of the Dodd-Frank Act provide that the SEC may now bring aiding and abetting claims under the Securities Act of 1933 ("Securities Act"), the Investment Company Act of 1940 ("Investment Company Act"), and the Investment Advisers Act of 1940 ("Investment Advisers Act").

Importantly, however, the Dodd-Frank Act does not create a private right of action for aiding and abetting claims and leaves undisturbed the Supreme Court's bar on such claims in Central Bank.

2. Clarification of Control Person Liability.

Section 929P(c) clarifies that the SEC may charge controlling persons. This means that corporations and individuals may face joint and several SEC liability even where they were not directly involved in the underlying conduct the SEC is challenging. Congress inserted this provision to address the government's concern that Section 20(a) of the Exchange Act could have been interpreted to restrict control person claims only to private plaintiffs, and not the SEC

3. Amendment to Regulation FD.

Section 939B of the Dodd-Frank Act eliminates the exemption in Rule 100(b)(2)(iii) of Regulation FD for credit rating agencies. Therefore, public companies may not selectively disclose nonpublic material information to credit rating agencies unless the information is made pursuant to some existing exemption like a confidentiality and nondisclosure agreement. The Act requires the SEC to eliminate the exemption in Regulation FD in the next 90 days.

4. Expanded Market Manipulation Liability.

Section 929L of the Dodd-Frank Act extends market manipulation liability (arising under Sections 9, 10(a) and 15(c) of the Exchange Act) to all non-government issued securities, including options, over-the-counter securities, and short sales. Previously, only Section 10(b) and Rule 10b-5 provided remedies for such trading.

5. Increased Powers for the SEC.

A. Jurisdiction Over Foreign Securities Transactions.

Section 929 of the Dodd-Frank Act, possibly the most significant addition to the SEC's powers, overturns the Supreme Court's Morrison decision to the extent that it applies to the SEC. For more information regarding the Supreme Court's Morrison decision see Orrick's Alert entitled U.S. Supreme Court Limits Extraterritorial Application of Securities Fraud Statute which can be accessed here. Section 929 allows the SEC to have foreign jurisdiction over a matter brought under the antifraud provisions of the Exchange Act and Investment Advisers Act if the matter involves: (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

B. Penalties in Administrative Proceedings.

Section 929P(a) of the Dodd-Frank Act allows the SEC to seek penalties in administrative proceedings. Previously, only a federal court could award penalties, so the SEC often chose to file civil proceedings. Going forward, the SEC may now bring more of its cases as administrative proceedings. Individuals and companies involved in such proceedings are disadvantaged by limited rights to pretrial discovery; limited evidentiary rules; no right to a jury trial; and an administrative "appeal" to the SEC commissioners themselves, who originally voted to bring the action.

C. Nationwide SEC Trial Subpoenas.

Section 929E of the Act enables both the SEC and defendants in SEC federal court actions to issue nationwide trial subpoenas. Although this has long been the case in SEC administrative proceedings, the SEC was subject to the limits of the Federal Rules of Civil Procedure in civil cases. This broadened power to the SEC may affect strategy regarding whom the SEC and defendants choose to depose during the course of discovery, because it removes perhaps the most frequently invoked ground for unavailability of a witness to appear at trial.

D. Sharing Information with Other Agencies.

The SEC and other government agencies have long entered into "access" or sharing agreements, although doing so created a risk of such agencies waiving privileges. Section 929K of the Dodd-Frank Act now preserves any privileges that may apply to information that the SEC exchanges with other federal agencies, the PCAOB, any self-regulatory organization, and any state or foreign agencies. This provision arguably has the potential to increase coordination and cooperation among securities enforcement agencies, although there is some doubt as to whether the waiver issue has been a significant impediment to such sharing arrangements in the past.

E. Increased Budget.

Section 991 of the Dodd-Frank Act effectively doubles the SEC's budget over the next five years from $1.3 billion in fiscal 2011 to $2.25 billion in 2015. Additionally, the Dodd-Frank Act creates a reserve fund for use by the SEC of up to $100 million that will be funded by registration fees collected by the SEC under the Securities Act and the Investment Company Act. Presumably, the budget increase and reserve fund will bolster the Enforcement Division and, combined with the array of new rules, will lead to a significant increase in SEC investigations, examinations and lawsuits.

6. New Executive Compensation "Clawback" Rules.

Section 954 of Dodd-Frank Act adds new Section 10D to the Exchange Act requiring all companies listed with national securities exchanges and associations to enact "clawback" policies. Such policies must recover any incentive-based compensation (including stock options) from current or former executive officers for the prior three years in the event of a financial restatement due to material noncompliance with any financial reporting requirement under the securities laws. The amount of the recovery is the difference between the amount of incentive-based compensation received and the amount that should have been received under the restated financial results.

Section 954 is different from Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX") in four significant respects. First, the new provision is enforceable, not just by the SEC, but by plaintiffs' attorneys in derivative cases if companies fail to seek such relief. Such plaintiffs may initiate litigation regarding restatements that did not occur, yet which allegedly would have, but for some claimed conflict of interest by management. At the very least, the new rules will make a company's restatement decisions even more arduous. Second, while Section 304 only allows disgorgement from the company's CEO and CFO, the Dodd-Frank Act covers the company's current and former "executive officers," which arguably means all Section 16 officers. Third, the Dodd-Frank Act lowers the trigger for clawbacks to instances of "material noncompliance with applicable accounting principles," whereas Section 304 of SOX requires a restatement resulting from "misconduct." Fourth, the Dodd-Frank Act expands the look-back period in SOX Section 304 from one year to three years. Section 954 also raises thorny state law issues if a current or former executive chooses to fight the clawback. This is because the legislation appears to conflict with a board's business judgment authority to forego such actions where the costs of litigation may outweigh the recovery. The Dodd-Frank Act does not contain a deadline for the SEC to issue rules to the national securities exchanges pursuant to Section 954 or a deadline for the national exchanges to pass such rules.

7. Independent Counsel Requirements for Compensation Committees.

Section 952 of the Dodd-Frank Act requires the SEC to issue rules within one year requiring all publicly traded corporations to establish independent compensation committees to the extent they have not done so already. The Dodd-Frank Act further requires those independent committees to select independent advisors, including legal counsel. While the national securities exchanges currently have independence rules in place, the Dodd-Frank Act requires the SEC to issue rules to require the compensation committee to consider the independence of their advisors when selecting them. Such advisors include consultants, legal counsel or other advisors, and the SEC rules will identify factors affecting independence such as the other work the advisor performs for the corporation. The compensation committees will be solely responsible for retaining advisors and determining their independence. This provision may increase challenges to the independence of compensation committee decisions and their advisors, and could force many companies and their boards to hire additional counsel.

8. Non-Binding Vote on Pay and Golden Parachutes.

Section 951 of the Dodd-Frank Act requires that, within six months after the date of enactment, companies must (1) provide their shareholders with additional disclosure on executive compensation, (2) conduct a non-binding vote on executive compensation, and (3) conduct a vote to determine whether a say on pay vote must be held annually or every two or three years. Similarly, companies must provide shareholders with a non-binding vote on golden parachutes in all M&A transactions. While the votes are non-binding, the results of the votes and added disclosure obligations will likely provide material for plaintiffs in fiduciary duty and M&A litigation. For more information regarding Section 951 of the Dodd-Frank Act see Orrick's Alert entitled Dodd-Frank Provisions Relating to Corporate Governance, Executive Compensation and Disclosure posted www.orrick.com/doddfrank.com.

9. Whistleblower Provisions.

Section 922 provides a whistleblower shall be entitled to a bounty of 10%-30% of a monetary recovery if their tip leads to an SEC enforcement action resulting in sanctions of more than $1 million in a successful enforcement action or proceeding. To qualify for a bounty, the whistleblower must provide the SEC with information that it did not already know from another source. Section 922 also provides that the whistleblower can submit anonymous tips and need not identify themselves until the government pays the bounty.

Oftentimes, securities class action plaintiffs will rely on information from confidential witnesses to support the allegations in their complaints and some courts have considered such witness statements at the motion to dismiss stage. Section 922 of the Dodd-Frank Act will likely increase the number of "confidential witnesses" at the disposal of the plaintiffs' bar because it provides monetary incentives for such individuals. In addition, Section 922 creates significant new protections for such persons such as confidentiality provisions. For more information regarding Section 922 of the Dodd-Frank Act see Orrick's Alert entitled Whistleblower Provisions in the Dodd-Frank Act.

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FINANCIAL MARKETS ALERT

OCTOBER 18, 2010

FDIC Final Rule for "Safe Harbor" Protection for Securitizations

On September 27, the Board of Directors of the FDIC approved a Final Rule (the "Final Rule") that governs the rights of the FDIC, as conservator or receiver of a failed insured depository institution (a "Bank"), over financial assets previously transferred by such Bank in connection with a securitization or participation transaction. The Final Rule sets forth the circumstances under which the FDIC will provide a "safe harbor" to investors by not repudiating contracts or reclaiming property and the circumstances under which the FDIC will provide investors with other, more limited, protections. The Final Rule should be considered in light of the provisions of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act and the SEC's proposed "Regulation AB II", both of which cover certain of the matters that are also covered by the Final Rule. While the provisions of the Dodd-Frank Act and of Regulation AB II will be applicable to securitizations whether or not a Bank is involved, the requirements of the Final Rule should be applicable only to Bank transactions. A copy of the Final Rule can be found here.

Background

The FDIC's Powers as Conservator or Receiver

The FDIC, as conservator or receiver of a Bank, has the statutory authority to repudiate contracts to which such Bank is a party.[1] If the FDIC "repudiates" a contract, the Bank's obligations under the contract are terminated. The FDIC may repudiate a contract if it deems the contract to be burdensome and finds that repudiation would promote the orderly administration of the Bank's affairs. A repudiation must occur within a reasonable time after the appointment of the FDIC as conservator or receiver. A counterparty's claims in connection with a repudiation are limited to actual direct compensatory damages determined as of the date of appointment of the conservator or receiver and generally are subordinate to depositors' claims.

The FDIC, as conservator or receiver of a Bank, is prohibited by statute from using its repudiation power to avoid a legally enforceable and perfected security interest unless such interest was taken in contemplation of insolvency or to hinder, delay or defraud the Bank or its creditors.

Prior Safe Harbor Rule

The FDIC adopted a rule in 2000 (the "Prior Rule") providing that the FDIC, as conservator or receiver of a Bank, would not use its statutory authority to disaffirm or repudiate contracts

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Useful Resource

[1] The statute does not expressly authorize the FDIC to repudiate contracts of Bank affiliates that are not insured depository institutions. Accordingly, without further involvement by the Bank, the FDIC should have no rights with respect to assets originated by a Bank affiliate and transferred by such affiliate in connection with a securitization or participation.

in order to reclaim financial assets transferred by a Bank in connection with a securitization or participation if the transfer met all conditions for sale accounting treatment under GAAP.

Accounting Developments

On June 12, 2009, FASB modified GAAP through FAS 166 and FAS 167, which represent accounting standards that make it more difficult for a transferor of assets in a securitization to meet the conditions for sale accounting treatment. Generally under the new GAAP standards, a party who directs the activities that most significantly impact the economic performance of a transaction and who has variable interests that expose the holder to either economic benefits and/or the obligation to absorb losses that could potentially be significant to the transaction will be required to consolidate the assets underlying a securitization.

These modifications became effective for annual financial statement reporting periods that began after November 15, 2009. As a result of these changes, many Bank securitizations would not be able to benefit from the safe harbor provided by the Prior Rule. To read more about FAS 166 and FAS 167, please click here.

The Interim Final Rule

In November 2009, the FDIC issued an Interim Final Rule that amended the Prior Rule to provide for safe harbor treatment for asset transfers in connection with participations and securitizations created on or before March 31, 2010 (later extended to September 30, 2010) that, among other things, complied with the conditions for sale accounting treatment under GAAP as in effect prior to November 15, 2009 (in other words, prior to the adoption of FAS 166 and 167).

The Advance Notice of Proposed Rulemaking and the Notice of Proposed Rulemaking

The FDIC approved an Advance Notice of Proposed Rulemaking (the "ANPR") on December 15, 2009, and a Notice of Proposed Rulemaking (the "NPR") on May 11, 2010, in each case to solicit comments on a sample rule to address the matters that are now the subject of the Final Rule.[2]

SEC Regulation AB II

On April 7, 2010, the SEC approved for public comment proposed rules that, if adopted, would substantially revise the registration, disclosure and reporting requirements for publicly issued asset-backed securities in Regulation AB.[3] The SEC's proposals, which the industry has been referring to collectively as "Regulation AB II", would result in changes to Regulation AB and other rules regarding the offering process, disclosure and reporting for publicly issued asset-backed securities, and impose new disclosure standards for privately placed asset-backed securities. The comment period for these proposals ended on August 2, 2010. Please click here to view the SEC's Regulation AB II proposal and click here to view a summary of certain key provisions of Regulation AB II.

Dodd-Frank Act

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The law covers a wide variety of topics in an effort to address the causes of the recent financial crisis and provides for, among other things, improved regulation of securitizations and credit rating agencies. Many of the requirements to be imposed have been left by Congress to regulations to be prescribed by the SEC and other regulators, and many actions that had been proposed in Congress have been relegated to studies to be conducted over the next several years. A copy of the Dodd-Frank Act can be found here. To read more about the Dodd-Frank Act, please click here.

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[2] The FDIC received 37 comment letters on the ANPR and 23 comment letters on the NPR. Click here to view the comment letters to the ANPR and here to view the comment letters to the NPR.

[3] Securities and Exchange Commission Regulation AB, 17 C.F.R. §§ 229.1100-1123

The Final Rule

Coverage of the Final Rule

The Final Rule provides protection to participations and securitizations issued both during and after a specified transition period. See "The Safe Harbor and Other Protections" below. Post transition period securitizations are eligible for such protections if such transactions comply with the applicable requirements in paragraphs (b) and (c) of the Final Rule, some of which are described under "Conditions of the Final Rule" below.[4]

Determining Compliance with the Final Rule

In response to ANPR and NPR comments urging greater certainty, the FDIC has provided that compliance with many of the conditions of the Final Rule may be measured by whether the securitization documents require the actions specified in the Final Rule, rather than whether such actions are actually taken. For example, the Final Rule provides that "the documents shall require that the sponsor retain an economic interest in a material portion, defined as not less than five (5) percent, of the credit risk of the financial assets."

The Safe Harbor and Other Protections

Subject to the conditions in paragraphs (b) and (c) of the Final Rule, some of which are described under "Conditions of the Final Rule" below, the Final Rule provides that the FDIC, as conservator or receiver of a Bank, will not, in the exercise of its statutory authority to disaffirm or repudiate contracts, reclaim, recover, or recharacterize as property of the Bank or the receivership the financial assets transferred by the Bank in connection with certain securitizations or participations (the "Safe Harbor"). In other cases, the Final Rule provides more limited protections.

Safe Harbor for Securitizations and Participations during the Transition Period:

If a transfer of assets in connection with a Bank securitization or participation transaction satisfies the GAAP conditions for sale accounting treatment as in effect prior to November 15, 2009, a Safe Harbor is provided by the Final Rule for the following transactions, notwithstanding that the transfer does not satisfy the new GAAP conditions for sale accounting treatment:

- Securitizations and participations where the financial assets are transferred on or before December 31, 2010.
- Securitizations by revolving or master trusts at any time, as long as the trust had issued some securities prior to September 27, 2010.
- Issuances of obligations under open commitments up to the maximum amount of such commitments as of September 27, 2010 if one or more obligations are issued under such commitments on or before December 31, 2010.

Safe Harbor and Other Protections for Securitizations after the Transition Period:

The Final Rule also provides a Safe Harbor for transfers of financial assets by a Bank in connection with a securitization that satisfy the new GAAP conditions for sale accounting treatment, provided that the securitization also satisfies the conditions in paragraphs (b) and (c) of the Final Rule, some of which are described under "Conditions of the Final Rule" below.

Transfers of financial assets in connection with a securitization that do not satisfy the new GAAP conditions for sale accounting treatment would be treated as a secured lending. In such circumstances, where the securitization satisfies the conditions in paragraphs

[4] The Final Rule by its terms specifically does not apply to securitizations by, or guaranteed by, a "Specified GSE", defined as (i) the Federal National Mortgage Association and any affiliate thereof; (ii) Federal Home Loan Mortgage Corporation and any affiliate thereof; (iii) the Government National Mortgage Association; and (iv) any federal or state sponsored mortgage finance agency.

It is unclear what is intended by this exclusion. The effect appears to be that if a Bank enters into a securitization guaranteed by a Specified GSE, the protections afforded by the Final Rule would not be available. It is not clear why this should be the case. As the Specified GSEs are not Banks, it is also not clear why there was a need to exclude from the Final Rule securitizations by the Specified GSEs.

(b) and (c) of the Final Rule, some of which are described under "Conditions of the Final Rule" below, the Final Rule provides the protections described below, which are more limited than a full Safe Harbor:

- Monetary Default: If the FDIC, as conservator or receiver for the Bank, remains in monetary default under the securitization due to its failure to apply collections received by it from the financial assets for ten business days after notice requesting the exercise of contractual rights because of that default, the FDIC will consent to the pursuit by investors of their contractual rights as long as no involvement by the FDIC is required other than reasonably requested consents, waivers or transfer documents in the ordinary course of business, and the FDIC's consent will fully satisfy its and the Bank's obligations for all amounts due.

- Repudiation: If the FDIC, as conservator or receiver for the Bank, gives written notice of repudiation of the securitization agreement under which the transfer was made but within ten business days does not pay damages equal to the par value of the securities as of the date of the receivership, less any principal payments made through the date of repudiation, plus accrued and unpaid interest through the date of repudiation to the extent actually received through payments on the underlying financial assets, the FDIC will consent to the pursuit by investors of their contractual rights as long as no involvement by the FDIC is required other than reasonably requested consents, waivers or transfer documents in the ordinary course of business. If the FDIC does pay such damages, all liens or claims on the underlying financial assets will be released.

Prior to a repudiation or, in the case of a monetary default, prior to the effectiveness of the FDIC's consent to the pursuit by investors of their contractual rights, the FDIC as conservator or receiver for the Bank will consent to payments being made to investors in accordance with the securitization documents, to the extent actually received through payments on the financial assets received through the date of notice of repudiation. The Final Rule also provides that the FDIC will consent to any servicing activity required in furtherance of the securitization (subject to the FDIC's rights to repudiate the servicing agreements), in connection with securitizations that meet the conditions of the Final Rule.

If a transfer of assets in connection with a securitization does not satisfy the new GAAP conditions for sale accounting treatment and the transaction is therefore treated as a secured lending for accounting purposes, and also does not satisfy the conditions in paragraphs (b) and (c) of the Final Rule, some of which are described under "Conditions of the Final Rule" below, then the rights of the investors will be determined under other relevant laws. If the transfer can be properly characterized as a sale for legal purposes, the investors should be entitled to the securitized assets and the collections on the assets, as long as the securitized assets and the collections are identifiable. If the transfer is properly characterized as a secured borrowing for legal purposes, then the investors may be permitted to exercise their rights against the collateral or the FDIC may pay the investors the value of the collateral. The FDIC may assert that the value is determined as of the date of appointment of the FDIC as receiver or conservator and that the value does not include any interest accruing after the date of appointment.

In any event, if the transaction does not satisfy the conditions in paragraphs (b) and (c) of the Final Rule, there may be delays before investors can exercise their rights and investors may be required to comply with judicial and administrative procedures in order to establish their rights.

Safe Harbor for Participations after the Transition Period:

The Final Rule defines a participation as the transfer or assignment of an undivided interest in all or part of a financial asset, that has all of the characteristics of a "participating interest," from a seller, known as the "lead," to a buyer, known as the "participant," without recourse to the lead, pursuant to an agreement between the lead and the participant.

For transfers of assets in connection with participations that satisfy the new GAAP conditions for sale accounting treatment, the FDIC will not use its repudiation power to reclaim, recover, or recharacterize as property of the Bank or the receivership the assets transferred by the Bank without reference to whether such participations satisfy the other requirements of the Final Rule. The FDIC expects that most transfers of assets in connection with participations will continue to meet the new GAAP conditions for sale accounting treatment.

Conditions of the Final Rule

Capital Structure and Credit Support

The Final Rule provides that the documents creating a securitization must provide that payment of principal and interest on the securities issued be primarily based on the performance of the underlying assets and, except for interest rate or currency mismatches between the financial assets and the obligations, cannot be contingent on market or credit events that are independent of the assets.

The Final Rule contains additional requirements for securitizations of residential mortgage loans. These securitizations may have a maximum of six credit tranches, with no sub-tranches (other than time-based sequential pay or planned amortization and companion sub-tranches of the most senior tranche), grantor trusts or other structures.

In residential mortgage loan securitizations, although there may be credit support at the individual loan level, with the exception of credit support or guarantees by Fannie Mae, Freddie Mac, Ginnie Mae and any federal or state sponsored mortgage finance agency, external credit support or guarantees to enhance the credit quality of the loans at the pool level or the securities issued by the securitization are prohibited. Temporary payment of principal and/or interest may be supported by liquidity facilities including facilities designed to permit the temporary payment of interest following appointment of the FDIC as conservator or receiver.

Disclosure

Under the Final Rule, securitization transaction documents must require that, on or prior to issuance of the securities and when periodic reports are delivered, and in any event at least quarterly, information about the securities and underlying financial assets must be disclosed to all potential investors at the security level and at the asset or pool level, as appropriate for the type of underlying financial assets. The transaction documents must require that such disclosure, at a minimum, comply with the disclosure standards of Regulation AB or Regulation AB II (depending on which is then in effect) in order to be eligible for the protections of the Final Rule. This requirement applies to both private placements and public issuances, without regard to whether the disclosure requirements of Regulation AB or Regulation AB II would apply. Information that is unknown or unavailable to the sponsor or issuer after reasonable investigation may be omitted if the offering document makes clear that the specific information is unavailable. As indicated below, both Regulation AB II and the Dodd-Frank Act also impose enhanced disclosure requirements in connection with securitizations, which requirements are applicable to Bank securitizations covered by the Final Rule as well as non-Bank securitizations.

The Final Rule also provides that securitization transaction documents must require that the issuer provide investors with information regarding the credit performance of the securities and the underlying assets, including periodic and cumulative asset performance data, delinquency and modification data, asset substitutions and removals, servicer advances, as well as losses that were allocated to each tranche and the remaining balance of assets supporting each tranche, and the percentage of each tranche in relation to the securitization as a whole.

The securitization transaction documents must also require disclosure of the nature and amount of compensation paid to, and the extent of any risk of loss retained by, the originator, the sponsor, any rating agency or third-party advisor, any broker and the servicer, as well as of changes to compensation paid to the transaction parties and the amount and nature of any payments of deferred compensation.

Securitizations that include any residential mortgage loans face additional disclosure requirements under the Final Rule:

- Sponsors must affirm compliance in all material respects with applicable statutory and regulatory standards for origination of mortgage loans, including that the mortgages were underwritten at the fully indexed rate relying on documented income, and that they comply with supervisory guidance governing the underwriting of residential mortgages.
- Sponsors must disclose a third party due diligence report on compliance with these standards and the representations and warranties with respect to the loans.
- The securitization transaction documents must require that a servicer disclose any ownership interest it or an affiliate has in other whole loans secured by the same real property that secures a loan included in the pool.[5]

[5] The Final Rule defines a "servicer" as any entity responsible for the management or collection of some or all of the financial assets on behalf of the issuing entity or making allocations or distributions to holders of the securities, including reporting on the overall cash flow and credit characteristics of the financial assets supporting the securitization to enable the issuing entity to make payments to investors on the securities. The term "servicer" does not include a trustee that makes distributions to holders if the trustee receives such distributions from a servicer and the trustee does not otherwise perform the functions of a servicer.

Disclosure Requirements under Regulation AB II and the Dodd-Frank Act

Through the promulgation of Regulation AB in 2004, the SEC introduced comprehensive regulations addressing disclosure and reporting requirements for asset-backed securities. The SEC has indicated that the proposed changes to such disclosure and reporting obligations reflected in Regulation AB II were prompted by the recent financial crisis, which "highlighted that investors and other participants in the securitization market did not have the necessary tools to be able to fully understand the risk underlying asset-backed securities and did not value those securities properly or accurately." In an effort to enhance investor protection and promote more efficient asset-backed securities markets, the SEC concluded that three areas of fundamental change are needed:

- Enhanced disclosure and reporting for publicly-issued asset-backed securities.
- Better alignment of the interests of issuers and sponsors of asset-backed securities with those of investors.
- Enhanced disclosure and transparency for privately placed asset-backed securities.

The Dodd-Frank Act also provides for heightened disclosure and reporting with respect to securitizations through the following requirements:

- The SEC must adopt regulations requiring issuers to disclose asset level or loan level information, as well as data identifying loan brokers and originators, compensation paid to such parties, and the amount of risk retained by the loan originator and the securitizer.
- Section 15(d) of the Securities Exchange Act of 1934 has been amended to eliminate, with respect to asset-backed securities, the automatic suspension of the duty to file periodic reports with the SEC.
- The SEC must adopt regulations in connection with the disclosure of representations and warranties in asset-backed securitizations.
- Credit rating agencies will be required to provide a report accompanying a credit rating that includes a description of representations and warranties included in the securitization transaction as well as of enforcement mechanisms and a description of how the provisions differ from those in similar securitizations.[6]
- Credit rating agencies will be required to disclose qualitative and quantitative information about a credit rating.
- "Securitizers" will be required to disclose fulfilled and unfulfilled repurchase requests across all securitization trusts aggregated by the securitizer so that investors may identify underwriting deficiencies.[7]
- The SEC must require credit rating agencies as well as the issuer or underwriter of an asset-backed security to make publicly available the findings and conclusions of any third party due diligence report it obtains.

Documentation and Servicing Standards

Although the Final Rule imposes specific documentation and servicing requirements for all types of securitizations, the Final Rule imposes additional requirements in these areas for securitizations of residential mortgage loans.

For example, the Final Rule provides that the securitization transaction documents must require that residential mortgage servicers act for the benefit of all investors, not just a particular class, and that servicers apply industry best practices for asset management and servicing. Also, servicing agreements must give residential mortgage servicers authority, subject to oversight by a master servicer or oversight advisor, to mitigate losses to maximize the net present value of the financial assets, and must require that the servicer commence loss mitigation activities within 90 days of a loan becoming delinquent.

The Final Rule provides that servicing agreements cannot require a primary servicer to advance delinquent payments of principal and interest for more than three payment periods unless financing or reimbursement facilities are available which are not dependent on foreclosure proceeds.

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[6] On October 4, the SEC issued a proposed rule relating to these requirements. Click here to see the proposed rule.
[7] On October 4, the SEC issued a proposed rule relating to these requirements. Click here to see the proposed rule.

Deferred and Performance Based Compensation

The Final Rule contains compensation requirements that apply only to securitizations of residential mortgage loans. These include a requirement that the securitization transaction documents provide that compensation for services to rating agencies or similar third-party evaluation companies must be payable over five years based on the performance of surveillance services and of the underlying residential mortgage loans, with a maximum of 60% of total estimated compensation payable at closing. The Final Rule does not indicate how the performance of the loans or of surveillance services should be measured.

In addition, the securitization transaction documents must require that compensation to servicers include incentives for servicing and loss mitigation actions that maximize the net present value of the financial assets.

Origination and Risk Retention Requirements

For all forms of securitizations, the Final Rule requires that, prior to the effective date of the risk retention regulations required to be established under the Dodd-Frank Act (discussed below), the securitization transaction documents must require that the sponsor retain at least 5% of the credit risk of the financial assets. This can be accomplished by the "sponsor"[8] taking an interest of at least 5% of each tranche transferred to investors or by the sponsor retaining in its portfolio a "representative sample" in an amount equal to at least 5% of the securitized assets. This retained interest may not be sold, pledged or hedged, except for hedging of interest rate or currency risk, during the term of the securitization.

The Final Rule contains an "auto-conform" provision that will replace the credit risk retention requirements described above with those implemented under the Dodd-Frank Act when they become effective.

Additional origination requirements under the Final Rule apply to securitizations of residential mortgage loans. The Final Rule provides that the securitization transaction documents must include a representation that all mortgage loans shall have been originated in all material respects in compliance with statutory, regulatory, and originator underwriting standards then in effect and a representation that the mortgages were underwritten at the fully indexed rate, relying on documented income, and comply with all existing supervisory guidance.

Also, the Final Rule requires that the transaction documents for securitizations of residential mortgage loans must require that a reserve fund be established equal to at least 5% of the cash proceeds payable to the sponsor to cover repurchases of loans resulting from breaches of representations and warranties. Amounts remaining in this fund one year after the issuance of the securities will be released to the sponsor.

Risk Retention under the Dodd-Frank Act and Regulation AB II

The Dodd-Frank Act requires that, by April 17, 2011 (270 days from enactment of the Act), the Federal banking agencies and the SEC must establish credit risk retention regulations for securitizations providing that:

- 5% or more of the credit risk must be retained for all securitizations, except as otherwise provided.
- A securitizer will be required to retain less than 5% of the credit risk if the originator meets prescribed underwriting standards.
- No risk retention is to be required for securitizations of "qualified residential mortgages" (to be defined in the regulations).
- Credit risk retention for CDOs and resecuritizations is to be determined by the regulatory agencies.
- The credit risk retention requirement for commercial loan securitizations may be satisfied by retention of a first loss position by a third party purchaser meeting standards to be imposed by the regulatory agencies.

These regulations are to become effective one year after publication of final rules in the case of securitizations of residential mortgages and two years after publication of final rules in the case of all other securitizations.

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[8] The Final Rule defines the "sponsor" as a person or entity that organizes and initiates a securitization by transferring financial assets, either directly or indirectly, including through an affiliate, to an issuing entity, whether or not such person owns an interest in the issuing entity or owns any of the obligations issued by the issuing entity.

By comparison, under Regulation AB II, the SEC proposes that the sponsor or an affiliate must retain at least 5% of each tranche of a securitization (in the case of revolving asset master trusts, an "originator's interest" of at least 5% of the nominal amount of the securitized exposures), net of any related hedge positions.

As indicated above, the Safe Harbor protection afforded to investors by the FDIC for certain transactions is not afforded to the same extent for most newly issued securitizations that do not meet GAAP sale requirements. Such securitizations are afforded more limited protections that must be taken into account when structuring and evaluating transactions.

Feel free to contact any of the authors of this Alert, any of the members of our *Financial Markets group* or other Orrick attorneys with whom you work to discuss any questions you may have with regard to the foregoing.