Financial Services Regulatory Highlights

September 2011

Assistant Treasury Secretary Marisa Lago Addresses PwC and Georgetown Conference on Critical Financial Reform Issues at G-20 Meetings

Speaking on September 22, 2011, before a Conference on "Financial Institutions in the New Regulatory Environment: Opportunities, Constraints and Global Challenges," sponsored by PwC and Georgetown University, Assistant Treasury Secretary Marisa Lago noted the great deal of progress that had been made in the G-20 financial reform agenda, but emphasized that "our efforts are far from over. We must now make sure that any global rules are robust enough to deal with the interconnection and integration of our global economy. And, we must act promptly to minimize opportunities for regulatory arbitrage and ensure a level playing field."

Secretary Lago went on to highlight five of the most critical financial reform issues that remain "works in progress."

Strengthening Capital, Liquidity and Leverage Requirements

Secretary Lago emphasized that capital, liquidity and leverage requirements had been a focus of G-20 efforts and that a great deal had been accomplished in this area through the development of Basel 2.5 and Basel III. However, she noted that full international convergence will be achieved "only if supervisors in all major financial jurisdictions ensure that banks across the world measure risk-weighted assets similarly. This is essential to maintain a level playing field, and to ensure that markets and investors can be confident that capital adequacy ratios stated by banks are consistent across borders." Treasury is pursuing comparability by urging greater visibility into supervisors' scrutiny of how banks measure risk-weighted assets and is pleased that the Basel Committee has added this important work to its agenda.

OTC Derivatives

OTC derivatives is another area where there is a need for international convergence. Secretary Lago noted that if "we do not have international alignment in these rules, firms will move activities to jurisdictions with lower standards, and we will suffer from a 'race to the bottom,' increasing risks to the global financial system." She noted that the U.S. is actively engaged with its counterparts in Europe and Asia to encourage them to adopt equally robust standards that live up to the G-20 commitments met by the U.S. with the passage of title VII of Dodd-Frank. Secretary Lago stated that both the U.S. and the European Commission are now developing margin requirements for OTC derivatives that are not centrally cleared. She noted that Secretary Geithner recently proposed achieving global agreement on specific minimum standards for margins on uncleared derivatives in order to prevent regulatory arbitrage. These standards would be analogous to the standards for banks that have been developed through the Basel Committee.

Reducing the Systemic Risk from Large, Interconnected Financial Firms

A third vital issue is reducing the systemic risk from large, interconnected financial firms. Secretary Lago noted that G-20 Leaders are committed to developing additional capital requirements for Globally-interconnected Systemically Important Financial Institutions, G-SIFIs. The G-20 is at an advanced stage in identifying global systemically important banks. Work is at earlier stages in identifying global systemically important insurers and other institutions. She said that the U.S. welcomes the FSB and the Basel Committee proposal for a capital surcharge for G-SIFIs, especially its focus on raising common equity. Among the US priorities in this areas is that the G-SIFI capital surcharge must apply to a "wide range of the large, interconnected financial institutions across the globe to promote a level playing field. And it must be both mandatory and comparable across jurisdictions."

Resolution Regimes

As a fourth topic, Secretary Lago touched upon resolution regimes. She noted that Dodd-Frank established a special robust resolution regime that provides federal regulators with strong authorities to resolve financial institutions that pose a systemic threat to the broader financial system. These new authorities extend the resolution powers beyond traditional bankruptcy laws. But, she acknowledged that in addressing firms that operate in multiple countries, the best national resolution regime in the world will not be sufficient if other countries do not have complementary authorities. Recognizing the difficulty of achieving such legal harmony in the short-term, the Secretary stated that the US was pursuing a three-pronged effort. First, ensuring that regulators and G-SIFIs develop recover and resolution plans (living wills), which provide for advanced planning before a crisis. Second, developing criteria to improve the "resolvability" of G-SIFIs. Third, negotiating institution-specific cross-border resolution cooperation arrangements with foreign regulators.

LEI – Legal Entity Identifiers

As her last topic, Secretary Lago addressed the importance of creating LEI – legal entity identifiers. A legal entity identifier system would be an efficient way to help regulators –and firms themselves – better understand—and ultimately reduce—systemic risk

Banking Agencies

John Walsh Acting Comptroller of the Currency Reviews Status of Foreclosure Enforcement Actions

In a speech before the American Banker Regulatory Symposium on September 19, 2011, Acting Comptroller of the Currency John Walsh noted that among the issues that will be "front and center for the new Comptroller are mortgage foreclosures and mortgage servicing." Comptroller Walsh emphasized that, the scope of the enforcement actions that the OCC took in April is very broad and comprehensive and the enforcement orders tackle a large number of problems that go beyond "robo-signing" of documents -- they address the entire system of controls that must be in place to ensure that those practices don't occur in the first place.

He said the orders also raise the bar for the oversight and management of third-party service providers who process loss mitigation applications and foreclosures, and manage acquired properties, including law firms that provide services and counsel for all of these processes.

In addition to changes aimed at ensuring the process works going forward – the "fixing what's broken" piece, the OCC also had to determine what kind of restitution should be provided for homeowners that were financially harmed due to servicers In the words of Comptroller Walsh, it " is the most ambitious and complex aspect of our enforcement actions – the independent foreclosure review."

The independent review sets out to identify borrowers who suffered financial injury as a result of errors, misrepresentations, or other deficiencies in the foreclosure process. The scope of this review includes any mortgage serviced by these companies on a borrower's primary residence that was in any stage of foreclosure between January 1, 2009 and December 31, 2010. Comptroller Walsh said the OCC had begun defining an acceptable process even before it issued the enforcement orders in April: independent consultants and law firms to advise them would have to be hired to administer the review under OCC direction; a comprehensive complaint process for borrowers to submit claims was deemed a critical and necessary component of the foreclosure review; and sampling was greatly expanded to help catch foreclosure cases with potential for financial injury.

Homeowners who faced foreclosure of their primary residence will be able to request a review of their case if they believe they suffered financial injury as a result of errors, misrepresentations, or other deficiencies in the foreclosure process between January 1, 2009 and December 31, 2010. Affected borrowers in this timeframe will be contacted through direct mailings and other tracing techniques. The independent consultants will also launch a coordinated advertising campaign to help contact borrowers who cannot be reached through direct mailings or other means. Rather than instituting

14 different servicer processes, which would be a source of confusion for homeowners, the OCC insisted that all of the independent consultants use a single claims processing vendor that will provide common intake forms, a single Web site, and a common phone number for eligible individuals who want a review of their case.

Comptroller Walsh said the OCC expects independent consultants to employ a robust quality assurance process, and OCC examiners will review and assess this process on a continuing basis. If the OCC finds material issues, it will require prompt corrective action. To ensure consistency, the OCC issued guidance on financial injury, and instructed the independent consultants to use it.

Finally, the Comptroller indicated that the OCC enforcement actions require independent consultants to develop a Foreclosure Review Report identifying financial injuries with recommendations for remediation. The OCC will review these reports individually, and also plans to conduct a horizontal review of the reports to ensure there are no material inconsistencies. These reports will be used by servicers to develop and submit the remediation plans required by the OCC orders.

Federal Reserve Board Issues Final Rule Regarding Data Collection Compliance Requirements for Motor Vehicle Dealers

On September 20, 2011, the Federal Reserve Board (Board) issued a final rule amending Regulation B to provide that motor vehicle dealers are not required to comply with new data collection requirements in Dodd-Frank until the Board issues final regulations to implement the statutory requirements.

Section 704B of the Equal Credit Opportunity Act (ECOA), as added by Section 1071 of Dodd-Frank, requires financial institutions to collect and report information concerning credit applications made by women- or minority-owned businesses and by small businesses. The term “financial institution” includes any entity that engages in any financial activity. The term “financial activity” is not defined in ECOA or Dodd-Frank, but certain motor vehicle dealers covered might be engaged in “financial activity” and therefore might be financial institutions subject to the requirements of ECOA Section 704B. The purpose of this section is to facilitate fair lending enforcement and to identify business and community development needs and opportunities of women-owned, minority-owned, and small businesses.

Although the Consumer Financial Protection Bureau (CFPB) has the authority to issue rules related to Section 704B, the Board retained authority to issue rules for motor vehicle dealers. On April 11, 2011, the CFPB issued a letter concluding that financial institutions have no obligations under Section 704B until the CFPB issues regulations to implement the requirements.

This final rule is effective upon publication in the Federal Register.

Federal Reserve Publishes Small-Entity Compliance Guide and Second Set of FAQs on Debit Card Interchange Rule

On September 13, 2011, the Federal Reserve published a Small-Entity Compliance Guide (Guide) on the debit card interchange rule (Regulation II). Subsequently, on September 14, 2011, the Federal Reserve issued an updated set of FAQs regarding the rule.

The Guide utilizes a question and answer format to explain Regulation II. It covers Section 920 of the Electronic Funds Transfer Act, exemptions to the rule based on asset size, overview of the Regulation's requirements, effective dates, payment card network routing and enforceability.

The FAQs focus on general-use prepaid cards and the prohibitions on circumvention, evasion and net compensation. They clarify the exemption for certain reloadable prepaid cards including the use of a card to access a health care flexible spending account and employees pay in a payroll account. Regarding net compensation, the FAQs clarify, that the prohibition on net compensation applies only to those payments and incentives received, and fees paid, on or after October 1, 2011. This applies even if the payments are made pursuant to contracts entered into prior to October 1, 2011.

Given the importance and complexities of the final rules PwC is working on a more detailed Closer Look review for those concerned with this issue.

Consumer Financial Protection Bureau

Senate Committee Hearing for Richard Cordray as Director of the CFPB

The continued political division regarding the Consumer Financial Protection Bureau's (CFPB or Bureau) oversight structure was evident during the Senate Committee on Banking, Housing and Urban Affairs confirmation hearing on September 6, 2011. The hearing was conducted to consider former Ohio Attorney General Richard Cordray as the first director of the CFPB. The primary sticking point among parties is whether the current Bureau's structure is inherently too powerful, providing for a lack of accountability for policy decisions by a single director.

Chairman Tim Johnson (D-SD) provided his support for the Bureau's current structure in his opening comments. To counter arguments that the current CFPB structure does not have accountability he provided the following examples:

- The Financial Stability Oversight Council has the power to overturn CFPB regulations;
- By law, the CFPB's budget is capped; and
- The President has the power to fire the CFPB Director."

A vocal opponent to the Bureau's current structure is Ranking Member Richard Shelby (R-AL). Earlier this year, Senator Shelby and 43 other Senators sent a letter to President Obama highlighting their concerns and proposed reforms to the Bureau's structure. One proposed reform was to institute a panel approach to govern the CFPB as opposed to a single director. Senator Shelby highlighted the concerns in a statement during the confirmation indicating:

"All of the Bureau's power is concentrated in the hands of its Director. The Director determines which rules are enacted and which enforcement actions are brought. The Director makes all hiring decisions and decides how the agency spends its resources. Because of the expansive jurisdiction of the Bureau, every American will be affected by the Director's decisions....It is staggering the amount of control the Director will exert over the daily financial choices available to Americans."

CFPB Seeks Comment on Financial Products for Servicemembers

On September 6, 2011, the CFPB's Office of Servicemember Affairs published a notice in the Federal Register seeking comment on both products and services that are currently being utilized by servicemembers and their families and products that are tailored for such groups. Other areas of inquiry relate to marketing strategies used by financial institutions with focus on servicemembers and their families and financial education services available.

The information will be used to develop market analysis that will be utilized to inform the Bureaus' planning with respect to education and outreach initiatives, the monitoring of consumer complaints, and other consumer protections.

Comments on a CFPB request for information regarding financial products for servicemembers were due on September 20, 2011

Consumer Financial Protection Bureau Priorities and Developments

On September 15, 2011, Special Advisor to the Secretary of the Treasury Raj Date addressed the National Constitution Center in Philadelphia. In his remarks, Mr. Date stated that "building a smart, effective and credible supervisory program" to evaluate consumer laws and ensure they're being followed will be a top CFPB objective.

Mr. Date acknowledged concern about added supervision from the new agency and vowed that the CFPB will monitor the impact of rulemakings and supervisory activity. He said, "There is understandable concern about the inconsistency that may result from separate supervision regimes... If we find that these interventions are not working as intended, we will adjust. And if we find that additional action is needed, we will act." In his remarks, Mr. Date further asserted that the Bureau's approach to supervision will be "tough-minded" yet fair. "We will be up front with the financial institutions we supervise so that there are no surprises.....But....[m]ake no mistake: When we find unjustified practices that cause substantial consumer harm, we will take the necessary action to put an end to them."

Mr. Date remarked on key products that will have the attention of the Bureau, including mortgages, student loans, and checking accounts. He provided an update on the "Know Before You Owe" project, which focuses on streamlining mortgage disclosure forms. The project is in the fourth of five rounds of model disclosures and has so far received feedback from more than 10,000 entities.

At the PwC and Georgetown University Conference referenced above on September 22, 2011, David Silberman, Assistant Director for Research, Markets and Regulation at the CFPB, said that the Bureau would be making available in the near future its initial Examination Manual for compliance with designated consumer protection laws and regulations. Mr. Silberman noted that the Bureau's staff was about equally divided between those in supervisory and those in enforcement functions. Mr. Silberman also noted that the Bureau had a large, toolkit to protect consumers, a point well-made by Richard Cordray at his nomination hearing to be Director of the Bureau:

At the Bureau, our bigger and more flexible toolbox includes research reports, rulemaking, market guidance, consumer education and empowerment, and the ability to supervise and examine both large banks and many nonbank institutions. I know from my own experience that lawsuits can be a very slow, wasteful, and needlessly acrimonious way to resolve a problem. The supervisory tool, in particular, offers the prospect of resolving compliance issues more quickly and effectively without resorting to litigation. We are continuing to build our capacity to make effective use of this entire range of tools." Opening Statement of Richard Cordray before the Senate Banking Committee, September 6, 2011.

Commodity Futures Trading Commission

CFTC Chairman Emphasizes Two Overarching Goals of Derivatives Reform in Delivering Final Keynote Address at PwC and Georgetown University Conference

Chairman Gary Gensler of the Commodity Futures Trading Commission (CFTC) gave the concluding keynote address at the PwC and Georgetown University Conference on September 22, 2011 and placed special emphasis on "two overarching goals of reform: bringing transparency to the swaps market and lowering the risks of this market to the overall economy".

In discussing the first overarching goal, the Chairman noted that the more transparent a marketplace is the more liquid it is and the more competitive it is. "In short, when markets are open and transparent, costs are lower for companies and the people who buy their products." The Dodd-Frank Act promotes both pre-trade and post-trade transparency by moving certain standardized swaps transactions to exchanges or swap execution facilities. This will allow buyers and sellers to meet in an open marketplace where prices are publicly available. The Dodd-Frank Act also requires the real-time reporting of the price and volume of transactions. Furthermore, it requires that once a swap transaction is arranged, its valuation must be shared on a daily basis with the counterparty. In the Chairman's view, "these measures of transparency and openness reduce some of the information advantages that dealers currently have over Main Street."

Of equal importance is the second goal of lowering risk to the overall economy by directly regulating dealers for their swaps activities as well as moving standardized swaps into central clearing. Clearinghouses mitigate the risks that arise from the interconnectedness in the financial system by standing between counterparties and guaranteeing the obligations of the parties in case of default.

Noting that the CFTC has largely completed the proposal phase of its rule-writing process it has begun finalizing rules to make the swaps marketplace more open and transparent for participants and safer for taxpayers. Next in its queue of final rules are critical regulations related to speculative position limits as well as risk management for clearinghouses. The CFTC is also actively consulting and coordinating with international regulators to promote robust and consistent standards in swaps oversight. The Commission also anticipates seeking public input on the application of Section 722(d), which says that the law doesn't apply to activities outside the United States unless those activities have a direct and significant connection with or effect on U.S. commerce.

The agency is taking on a significantly expanded scope and mission. The Chairman stressed that the agency must be adequately resourced to ensure the new swaps market rules will be strictly enforced – rules that promote transparent markets, lower costs for consumers and protect taxpayers. Without sufficient funding, the CFTC will not have the resources to put enough cops on the beat for the public's protection.

CFTC Proposes Timing for Final Swap Regulation and Phase-In of Clearing/Execution Mandates, Swap Documentation Requirements and Margin for Uncleared Swaps

The CFTC turned its focus to scheduling the finalization and phase in of swap regulation at its open meeting on September 8, 2011. Two topics dominated an at times contentious discussion among the commissioners - scheduling the consideration of 40-odd final rules remaining in proposed form, and predicting the sequencing and timing for compliance with three core requirements of derivatives reform -- central clearing, swap documentation and margin for uncleared swaps.

Categories of Rules for Approval in 2011 or First Quarter 2012

Chairman Gensler identified the categories of final rules he hopes to bring before the full Commission for approval by year end 2011 and in the first quarter of 2012. Adoption of final rules in these categories -- listed in the table below -- will provide for implementation of most swap regulation provided in the Dodd-Frank Act. Key matters such as swap dealer registration, definitions of "swap" and "swap dealer" and additional rules needed to implement the clearing mandate are scheduled for finalization by year end 2011. Other controversial topics, such as margin requirements and investment of customer funds, are planned for consideration in Q1 2012. The Chairman noted that although the Commission may deviate from this schedule, particularly regarding the key definitions which must be jointly finalized with the SEC, he hopes they will act to put in place final rules that permit swap regulation to phase in throughout 2012.

Implementation and Compliance Phase-In Approaches

The CFTC's plans for implementation and phase-in of compliance for clearing, trade documentation and margin for uncleared swaps were discussed in two regulatory proposals approved at the meeting. The approach to implementation of these regimes was similar. For clearing, the proposal listed specific regulations that must also become final and effective before phased-in compliance schedules begin. Compliance phase in for trade documentation and margin for uncleared swaps would simply begin after these largely stand-alone rules become final.

The Commission proposed a three, six and nine month compliance phase-in with the identified rules that would be based on classifying swap market participants into three categories depending on how active they are in the swap market. This approach follows the often mentioned view of the CFTC that compliance would be required first by the most sophisticated swap market players and last for those that are not financial institutions and are not major swap market players.

Category 1 entities would consist of swap dealers, major swap participants and a new class of entity -- "active funds". These category 1 entities would be given three months after the applicable final rules become effective to comply with the particular mandate -- whether it be clearing, swap documentation or margin for uncleared swaps. An "active fund" would be any private fund as defined in section 202(a) of the Investment Advisers Act of 1940 (private fund) that is not a third-party subaccount and that executes 20 or more swaps per month based on a monthly average over the 12 months preceding the Commission issuing a mandatory clearing determination under 2(h)(2) of the" Commodity Exchange Act.

Category 2 entities also are financial entities and include a commodity pool, a private fund that is not an active fund, an employee benefit plan under ERISA, or a person predominantly engaged in activities that are the business of banking or financial in nature under the Bank Holding Company Act. Category 2 entities cannot include a third-party subaccount, however. Category 2 entities would have six months or 180 days to comply with final, effective regulations for clearing, trade documentation or uncleared swap margin.

Category 3 entities -- which consist of any entities not otherwise found in the first two categories -- will have 9 months or 270 days to comply with applicable regulations.

The Commissioners shared projections on when this scheme for compliance might lead to a regulatory requirement, such as a swap subject to mandatory clearing. Based on a number of factors related to how the regulatory process for declaring a swap subject to mandatory clearing might work, both Chairman Gensler and Commissioner O'Malia projected that swaps in any asset class might not face a clearing mandate before the third quarter of 2012. This projection, they noted, is inexact however and is based on factors that are not entirely within the CFTC's control. One factor that could impact this timing is the timing of final effective rules for defining key terms with the SEC. Another is when derivatives clearing organizations choose to submit swaps for a clearing mandate.

The proposals for implementation and compliance will be open for comment until November 4, 2011. As the Commissioners noted, these proposals will be viewed positively or negatively depending on the perspective of the affected parties. The important factor to note is that the CFTC has provided insight into its preferred approach to compliance with the myriad rules waiting in the pipeline. While this category and entity based view of compliance may not apply to every type of rule, it lends itself to application across a many of the rulemaking topics. Short of a comprehensive or definitive time frame for phase in of swap regulation as preferred by Commissioner O'Malia, the proposals do offer new ability to project regulatory action and plan a business or compliance response.

Outline of Final Dodd-Frank Act Title VII Rules the CFTC may Consider in 2011 or the First Quarter of 2012

Remainder of 2011

- Clearinghouse Rules
- Data Recordkeeping and Reporting
- End-User Exception
- Entity Definitions/Registration
- External Business Conduct
- Internal Business Conduct (Duties, Recordkeeping and Chief Compliance Officers)
- Position Limits
- Product Definitions/Commodity Options
- Real-Time Reporting
- Segregation for Cleared Swaps
- Trading-Designated Contract Markets and Foreign Boards of Trade

First Quarter of 2012

- Capital and Margin
- Client Clearing Documentation and Risk Management
- Conforming Rules
- Disruptive Trading Practices
- Governance and Conflict of Interest
- Internal Business Conduct (Documentation)
- Investment of Customer Funds
- Swap Execution Facilities
- Segregation for Uncleared Swaps
- Straight-Through Trade Processing

Swap Data Repository Registration and Core Principles

On September 1, 2011, the CFTC issued a final rule on swap data repository (SDR) registration standards, duties and core principles. This rule is effective on October 31, 2011. Section 728 of the Dodd-Frank Act creates a new type of registered entity, a swap data repository (SDR), to collect and maintain data and information related to swap transactions and to make such data and information directly and electronically available to regulators. It also establishes registration requirements, statutory duties, core principles and certain compliance obligations for registered SDRs.

SDR Duties

Under the Dodd-Frank Act and the CFTC rule, an SDR will have the duty to:

- Accept data;
- Confirm with both counterparties to the swap the accuracy of data submitted;
- Maintain data;
- Provide direct electronic access to the CFTC or its designee;
- Provide public reporting of data;
- Establish automated systems for monitoring and analyzing data (including the use of end-user clearing exemptions);
- Maintain user privacy;
- On a confidential basis and upon request with notice to the CFTC, make data available to other regulators;
- Have emergency procedures;
- Have system safeguards, including business continuity and disaster recovery;
- Maintain sufficient financial resources;
- Provide market participants with a disclosure document setting forth the risks and costs associated with using the SDR's services; and
- Provide fair and open access and fees and charges that are equitable and non-discriminatory.

SDRs will have members that include derivatives clearing organizations. An SDR may hold other registrations for example, as a bank or a security-based swap data repository.

Acceptance of Data

An SDR must establish, maintain and enforce policies and procedures for the reporting of swap data to it, and shall accept and promptly record all data in its selected asset class. If a registered SDR accepts swap data of a particular asset class, it must accept data for all swaps of that asset class.

Confirmation of Data Accuracy

An SDR must establish policies and procedures to ensure the accuracy of swap data and other regulatory information required to be reported. The SDR must confirm the accuracy of the swap data submitted. This does not require affirmative communication with both counterparties when the data is received from an SEF, DCM, DCO or third-party service provider under certain conditions, or when the SDR forms a " reasonable belief" that the data is accurate, that both counterparties agreed to the data and the counterparties were provided with a 48 hour correction period.

If data is submitted by an SD, MSP or other counterparty that is not registered with the CFTC in one of these capacities, the SDR must "affirmatively communicate" with both counterparties to the swap about the accuracy of the data. After data is initially reported, the reporting parties must correct errors in that data on an ongoing basis.

An SDR must have policies and procedures that prevent a valid swap from being invalidated, altered or modified through the confirmation or recording process. It also must have procedures and facilities for effectively resolving disputes over the accuracy of the swap data.

Recordkeeping

An SDR must:

- Maintain its books and records in accordance with the requirements of the Part 45 regulations, which require that SDRs maintain reported swap data throughout the life of such swap transactions plus five years thereafter, during which time the swap data must be readily accessible by the SDR and available to the CFTC via real-time electronic access. A registered SDR that elects to accept and disseminate swap transaction and pricing data in real time must comply with the real time public reporting and recordkeeping requirements prescribed in other CFTC regulations.

- Provide direct electronic access to the CFTC or its designee (including another registered entity) and provide information in such form and at such frequency as the CFTC may prescribe to comply with the public reporting requirements.
- Establish, maintain and enforce written policies and procedures reasonably designed to protect the privacy and confidentiality of all SDR information that is not subject to real-time public reporting.
- Make available all data obtained by the SDR to specified foreign and domestic regulators. Specific procedures and conditions have been established under which particular regulators and others may obtain access to data maintained by an SDR.
- Adopt specific policies and procedures for the responsible exercise of emergency authority in the event of natural, man-made, information technology, and other, emergencies.

Monitoring, Screening and Analyzing Swap Data

SDRs must establish automated systems for monitoring, screening and analyzing swap data, including compliance and frequency of end-user clearing exemption claims by individuals and affiliated entities. It also must develop systems and resources as necessary to execute any monitoring, screening, or analyzing function assigned by the CFTC.

Securities and Exchange Commission

SEC Proposes Dodd-Frank Required Rule on Prohibiting Material Conflicts of Interest in Securitizations

On September 19, 2011, the Securities & Exchange Commission (SEC) proposed a new rule under the Securities Act of 1933 ("33 Act") to implement the prohibition under Section 621 of the Dodd-Frank Act on material conflicts of interest in connection with certain securitizations. Proposed Rule 127B under the 33 Act would prohibit certain persons who create and distribute an asset-backed security, including a synthetic asset-backed security, from engaging in transactions, within one year after the date of the first closing of the sale of the asset-backed security, that would involve or result in a material conflict of interest with respect to any investor in the asset-backed security. The proposed rule also would provide exceptions from this prohibition for certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making.

While there are many difficult interpretive and policy issues posed in the proposal, the SEC notes that "perhaps the most challenging issue in implementing Section 27B is to identify those conflicts of interest involving securitization participants and investors that are "material" and intended to be prohibited under Section 27B and our proposed rule.

The proposed rule does not define the term "material conflict of interest." The SEC noted that any attempt to precisely define this term in the text of the proposed rule might be both over- and under-inclusive in terms of identifying those types of material conflicts of interest intended to be prohibited, especially given the complex and evolving nature of the securitization markets, the range of participants involved, and the various activities performed by those participants. Accordingly, the SEC proposes to clarify the scope of conflicts of interest that are material and intended to be prohibited under Section 27B and the proposed rule through interpretive guidance rather than through a detailed definition in the proposed rule.

In particular, the SEC noted that it was not aware of any basis in the legislative history of Section 621 to conclude that this provision was expected to alter or curtail the legitimate functioning of the securitization markets, as opposed to targeting and eliminating specific types of improper conduct. Moreover, as a preliminary matter, the SEC believe that certain conflicts of interest are inherent in the securitization process, and accordingly that Section 27B and its proposed rule should be construed in a manner that does not unnecessarily prohibit or restrict the structuring and offering of an ABS.

The SEC expressed its preliminary belief that a formulation of a conflict of interest that is material would directly address those types of activities that Section 27B was intended to prohibit – e.g., situations in which a securitization participant engages in a transaction through which it benefits when the related ABS fails or performs adversely or has the potential to fail or perform adversely and there is a substantial likelihood that a reasonable investor would consider the fact of such benefit important to his or her investment decision.

Comments on the proposed rule are due on December 19, 2011.

SEC Issues Concept Release on the Use of Derivatives by Investment Companies under the Investment Company Act

The SEC and its staff have been reviewing the use of derivatives by management investment companies registered under the Investment Company Act of 1940 (40 Act) and by business development companies under the 40 Act (collectively referred to as "funds"). To obtain input on a wide range of issues relevant to the use of derivatives by funds, the SEC issued on August 31, 2011 a lengthy, detailed and, in many respects, highly technical Concept Release that focuses on the use of derivatives under a number of provisions of the 40 Act, including with respect to senior securities (debt) restrictions, diversification requirements, exposure to securities related issuers, portfolio concentrations, and valuation of derivatives.

The SEC notes in its Release that the activities of funds, including their use of derivatives, are regulated extensively under the 40 Act, and SEC rules and guidance. The Release broadly describes "derivatives" as instruments or contracts whose value is based upon, or derived from, some other asset or metric (referred to as the "underlier," "underlying," or "reference asset"). Funds employ derivatives for a variety of purposes, including increasing leverage to boost returns, gaining access to certain markets, achieving greater transaction efficiency, and hedging interest rate, credit, and other risks. At the same time, derivatives can raise risk management issues for a fund relating, for example, to leverage, illiquidity (particularly with respect to complex OTC derivatives), and counterparty risk, among other issues.

Background and Purpose of the Concept Release

A key impetus for the Release appears to be the dramatic growth in the volume and complexity of derivatives investments over the past two decades, and funds' increased use of derivatives. The SEC staff generally has been exploring the benefits, risks, and costs associated with funds' use of derivatives and issues relating to the use of derivatives by funds -- such as:

- Whether current market practices involving derivatives are consistent with the leverage, concentration, and diversification provisions of the 40 Act;
- Whether funds that rely substantially upon derivatives, particularly those that seek to provide leveraged returns, maintain and implement adequate risk management and other procedures in light of the nature and volume of their derivatives investments;
- Whether funds' boards of directors are providing appropriate oversight of the use of derivatives by the funds;
- Whether existing rules sufficiently address matters such as the proper procedures for a fund's pricing and liquidity determinations regarding its derivatives holdings;
- Whether existing prospectus disclosures adequately address the particular risks created by derivatives; and
- Whether funds' derivative activities should be subject to any special reporting requirements.

The stated goal of the review by the SEC and its staff is to evaluate whether the regulatory framework, as it applies to funds' use of derivatives, continues "to fulfill the purposes and policies underlying the Act and is consistent with investor protection." The purpose of the Concept Release is to assist with this review and solicit public comment on the current regulatory regime under the 40 Act as it applies to funds' use of derivatives.

The SEC intends to use the comments to help determine whether regulatory initiatives or guidance are needed to improve the current regulatory regime and the specific nature of any such initiatives.

Issues Explored by the Release under the 40 Act

In its Release, the SEC first describes common uses of derivatives by funds and seeks input on the costs and benefits associated with the use of derivatives, whether different types of funds use derivatives for different purposes and whether ETFs use derivatives, among other questions.

However, the bulk of the Release analyzes the use of derivatives in light of several key statutory provisions of the 40 Act, with most of the discussion focused on Section 18 of the 40 Act which essentially limits the ability of a fund to borrow by issuing "senior securities" (debt securities and preferred stock). The SEC's longstanding position has been that funds can remain in compliance with Section 18 if they "cover" senior securities by maintaining "segregated accounts" to limit the risk of loss. Under this "segregated account approach," a fund would establish and maintain with the fund's custodian a segregated account containing liquid assets equal to the indebtedness incurred by the fund with the issuance of the senior security.

However, the ways that the SEC Staff have approached the valuation of segregated assets have engendered criticism and the Release discusses several approaches to valuation, including one recommended in the 2010 ABA Derivatives Report as well as approaches in a number of jurisdictions for measuring and limiting risk, including in the EU, Singapore, Hong Kong and Canada. The SEC is seeking specific detailed comments on the segregated account approach and the ways it can be improved.

In briefer discussions, the Release reviews and seeks input on (i) derivatives valuation issues as they arise in determining whether a fund is classified as "diversified" or "non-diversified" based on its total assets, (ii) whether in interpreting Section 12(d)(3) which prohibits a fund from investing in "securities related issuers" (e.g., broker-dealers, underwriters or investment advisers), should apply when a securities related issuer is a counterparty to a fund in a derivatives transaction or the issuer of a reference asset in a derivatives transaction with the fund, (iii) how derivatives transactions with funds should be valued for purposes of determining application of fund concentration provisions in a particular industry or group of industries, and (iv) in determining a fund's net asset value, how do funds determine the value of derivatives for which market quotations are not readily available.

The public comment period closes on November 7, 2011.

SEC Issues an Advance Notice of Proposed Rulemaking on the Treatment of Issuers of Asset Backed Securities under the Investment Company Act

The SEC is considering proposing amendments to Rule 3a-7 under the 40 Act, the rule that provides certain asset backed securities issuers with a conditional exclusion from the definition of Investment Company in the 40 Act. The SEC may consider amendments to Rule 3a-7 that could reflect market developments since 1992, when Rule 3a-7 was adopted, and recent developments affecting asset backed issuers, including passage of the Dodd-Frank Act and the SEC's recent rulemakings regarding the asset backed markets. To assist the SEC in its review it is issuing an Advance Notice of Proposed Rulemaking (ANPR) and soliciting broad public comment. The SEC also is withdrawing its 2008 proposal to amend Rule 3a-7, which was published at 73 FR 40124 (July 11, 2008).

Revisiting Rule 3a-7-- the Ratings Requirement

Asset backed issuers typically meet the definition of Investment Company under the 40 Act but generally cannot operate under the Act's requirements and restrictions. In 1992, the SEC adopted Rule 3a-7 specifically to exclude from the Investment Company definition certain asset backed securities that meet the Rule's conditions. In particular, to rely on Rule 3a-7, an asset backed issuer must issue fixed income securities that entitle holders to receive payments that depend primarily on the cash flow from eligible assets. The rule provides that the issuer's fixed income securities generally must be rated in one of the four highest ratings categories by a Nationally Recognized Statistical Rating Agency (NRSRO). The SEC indicated that it is considering the elimination of this rating requirement because it is concerned that such ratings have not served as a "proxy" to address Investment Company Act related issues. In this regard, when Rule 3a-7 was adopted, the SEC understood the rating to be based not only on creditworthiness but also on certain structural requirements and safeguards -- a situation which may not always be the case. The SEC seeks particular comment on whether ratings criteria should be replaced by other conditions

Possible New Conditions for Rule 3a-7

Prescriptive or Principles Based Approach. To address the potential for conflicts of interest or abusive practices emanating from the asset backed structure, the SEC questions whether Rule 3a-7 should be more prescriptive -- imposing specific requirements or limitations on operations and structure -- or whether the SEC should follow a principles based approach relying more on disclosure of how the issuer is organized to address structural issues?

Ratings vs. Independent Review

The Commission is considering whether to replace the rating condition in the Rule with a condition that would provide for an independent review of an asset backed issuer and its intended operations prior to the sale of its securities. Should the issuer provide a similar "certification" in its operating documents? The required independence of the potential "independent evaluator," whether a NRSRO could be an evaluator and the disclosure and scope of such evaluation are some of many issues the Commission is seeking input on.

Should Servicer Requirements Be Addressed More Directly under the Rule?

The Commission is seeking comment on whether Rule 3a-7 should be amended to strengthen the preservation and safekeeping of the issuer's assets and cash flow. The current Rule does not limit the practice of servicers commingling the cash flow of asset backed securities with their own assets for periods of time. Should that be prohibited? The Commission after noting the irregularities that recently surfaced surrounding the ownership of certain securitized mortgages, asks how the requirement that an independent trustee have a perfected security interest in the eligible assets be strengthened?. Should the ways in which the cash flow from asset backed securities is invested include a condition on how it may be invested under the Rule and who receives the returns?

Determining Eligibility to Use Rule 3a-7

The Commission requests comment on whether the requirements of Regulation AB or the shelf eligibility requirements for asset backed securities may serve as a means to address some of the Commission's concerns with Rule 3a-7? What would be the effect of any such Rule changes, including on some asset backed issuers that privately offer their securities based on Rule 3a-7?

The Exclusion Provided by 3a-7 in Light of Changes in the Asset Backed Markets

The SEC also is interested in better understanding how the manner in which the exclusion provided by the Rule affects the status of holders of securities issued by Rule 3a-7 issuers. The SEC notes that many asset backed issuers under Rule 3a-7 were established by companies that sought to capture -- by holding the equity or residual interest in these issuers - the spread between the yield of the assets being securitized and the financing cost of the securities being issued. In this regard, the SEC notes that approximately 11.5% of the CDOs issued globally were issued to remove assets from the balance sheet of the originator. The rest consisted of arbitrage CDOs. Should such companies be considered as being engaged in the business of investing in securities and regulated as investment companies under the Act? The SEC makes the point that at the time the Rule was adopted most private-sector sponsors of asset backed securities typically securitized financial assets that they themselves had originated to facilitate the operation of their non-investment company businesses. Thus, at the time the rule was adopted, the purpose and operations of asset backed issuers were thus fundamentally different from investment companies.

The comment period closes on November 7, 2011.

SEC and CFTC Seek Public Comment on Whether Stable Value Contracts Should be Treated as Swaps under Dodd-Frank Act

The SEC and the CFTC have published in the Federal Register a request for public comment that is expected to assist in conducting a joint study on stable value contracts required by Section 719(d) of the Dodd-Frank Act. Section 719(d) requires the SEC and CFTC to jointly conduct a study to determine whether stable value contracts (SVCs) fall within the definition of a "swap," and if so, whether exempting such contracts from the swap definition is appropriate and in the public interest. Dodd-Frank calls for the SEC and CFTC to make the determination in consultation with the Department of Labor, the Department of the Treasury, and the state entities that regulate the issuers of stable value contracts. Unless and until any regulations are adopted and effective pursuant to Section 719(d), SVCs will not be subject to regulation as swaps under Title VII of Dodd-Frank.

Dodd-Frank defines an SVC as any contract, agreement, or transaction that provides a crediting interest rate and guaranty or financial assurance of liquidity at contract or book value prior to maturity offered by a bank, insurance company or other State or federally regulated financial institution for the benefit of any individual or commingled fund available as an investment in certain defined employee benefit plans and defined deferred compensation plan that is maintained by an eligible employer or a qualified tuition plan.

The Commissions' staffs indicated their understanding that stable value funds (SVFs) are a type of investment commonly offered through 401(k) and other defined contribution plans with the objective of providing preservation of principal, liquidity, and current income at levels that are typically higher than those provided by money market funds. The Commissions' staffs further understand that SVCs are components of SVFs that SVF sponsors or managers purchase from SVC providers, including banks and insurers, that provide a guarantee, or "wrap," by the service provider to pay plan participants at "book value" should the market value of the SVF be worth less than the amount needed to pay that book value.

The Commissions' staffs are seeking comment on several areas, including swap definitional and exemptive issues, market and product structure issues, regulatory issues and compliance issue if SVCs were determined to be swaps. Public comments are due September 26, 2011.

MSRB Withdraws Pending Municipal Advisor Rule Proposals

On September 12, 2011, the Municipal Securities Rulemaking Board (MSRB) announced it has withdrawn several rule proposals it filed with the SEC last month. Citing substantial concern regarding the timing of a permanent municipal advisor definition, the MSRB stated it would delay certain of its proposed rules regarding until the SEC adopts a permanent definition under the Securities Exchange Act of 1934. The affected rule proposals, as detailed in last month's Regulatory Highlights, address fiduciary duty, pay to play, fair dealing, supervision, gifts and assessments.

The MSRB has been given a statutory mandate by Dodd-Frank to regulate municipal advisers. In seeking to fulfill its mandate, the MSRB issued draft rules, sought public comment and took into account the potential scope of the SEC's proposed definition of municipal advisor. However, the MSRB is concerned that because the SEC's definition has not been finalized, some firms and individuals will not participate in the SEC comment process on the MSRB proposals.

The MSRB stated that its rulemaking process for municipal advisors will continue. Once the SEC adopts a definition of municipal adviser, the MSRB will resubmit its rule proposals to the SEC for approval.

SEC to Publish for Public Comment Updated Market-Wide Circuit Breaker Proposals to Address Extraordinary Market Volatility

On September 27, 2011, the SEC announced that the national securities exchanges and the Financial Industry Regulatory Authority (FINRA) are filing proposals to revise existing market-wide circuit breakers that are designed to address extraordinary volatility across the securities markets. When triggered, these circuit breakers halt trading in all exchange-listed securities throughout the U.S. markets.

The proposals being filed would update the market-wide circuit breakers by among other things reducing the market decline percentage thresholds necessary to trigger a circuit breaker, shortening the duration of the resulting trading halts, and changing the reference index used to measure a market decline.

The proposals would revise the existing market-wide circuit breakers by:

- Reducing the market decline percentage thresholds necessary to trigger a circuit breaker from 10, 20, and 30 percent to 7, 13, and 20 percent from the prior day's closing price.
- Shortening the duration of the resulting trading halts that do not close the market for the day from 30, 60, or 120 minutes to 15 minutes.
- Simplifying the structure of the circuit breakers so that rather than six there are only two relevant trigger time periods — those that occur before 3:25 pm. and those that occur on or after 3:25 pm.
- Using the broader S&P 500 Index as the pricing reference to measure a market decline, rather than the Dow Jones Industrial Average.
- Providing that the trigger thresholds are to be recalculated daily rather than quarterly.

If approved by the SEC, the new market-wide circuit breaker rules would replace the existing market-wide circuit breakers, which were originally adopted in October 1988 and have only been triggered on one day in 1997.

Notably, the market-wide circuit breakers were not triggered during the severe market disruption of May 6, 2010, which led the exchanges and FINRA in consultation with SEC staff to assess whether the circuit breakers needed to be modified or updated in light of today's market structure. In addition, the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues recommended in February 2011 that the SEC and CFTC review the current operation of the market-wide circuit breakers, and consider appropriate modifications.

The SEC will seek comment on the proposed rule changes, which are subject to SEC approval following a 21-day public comment period.

SEC Issues Concept Release on Interpretations of Section 3(c)(5)(C) of the Investment Company Act

September 7 2011, the SEC published in the Federal Register a Concept Release seeking public comment on the interpretation of Section 3(c)(5)(C) of the Investment Company Act. Section 3(c)(5)(C) generally provides an exclusion from the definition of investment company any person who is primarily engaged in, among other things, "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Many companies engaged in the business of acquiring mortgages and mortgage-related instruments such as some real estate investment trusts rely on this statutory exclusion. Given the evolution of mortgage-related pools and the development of new and complex mortgage-related instruments, since Section 3(c)(5)(C) was enacted in 1940, the SEC is reviewing interpretive issues relating to the status of mortgage-related pools under the Investment Company Act and whether mortgage related pools might be making judgments about their status under the Act without sufficient SEC guidance on the interpretive issues that arise under that provision. The SEC also is concerned that staff no-action letters that have addressed the statutory exclusion in Section 3(c)(5)(C) may have been contained, or led to, interpretations that are beyond the intended scope of the exclusion. Moreover, the SEC is concerned that certain types of mortgage-related pools today appear to resemble in many respects investment companies such as closed-end funds and may not be the types of companies that were intended to be excluded from regulation under the Act by Section 3(c)(5)(C).

Thus, the SEC has released the Concept Release to assure that their regulatory approach is updated to reflect the current market environment while still meeting their investor protection goals.

The Concept Release provides an overview of the mortgage-related pools and solicits comment on their management styles, corporate governance, and similarities to traditional investment companies. In addition, the SEC seeks comment on a number of topics, including, but not limited to: the current state of guidance and interpretation concerning Section 3(c)(5)(C), whether there are uncertainty or differing views among companies as to the availability of the statutory exclusion, and whether the exclusion is generally being used consistent with the underlying purposes and policies. underlying that provision. Finally, the SEC seeks views on what steps, if any, including possible rulemaking, it should take to provide greater clarity, consistency or regulatory certainty regarding the status of mortgage-related pools under the Investment Company Act.

Public comments on the Concept Release should be received by the SEC by November 7, 2011.

Additional Information

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