
Financial Services Regulatory Highlights

December 2010

<i>SEC and CFTC Propose Joint Rules to Define Swap Dealer and Major Swap Participant</i>	1
<i>SEC Proposes Review Process for Mandatory Clearing of Security-Based Swaps under the Dodd-Frank Act</i>	4
<i>SEC Proposes End-User Exception to Mandatory Clearing of Security-Based Swaps</i>	5
<i>SEC Proposes Permanent Rule Requiring Municipal Advisors to Register with Agency</i>	6
<i>SEC Releases Comment Request for Credit Rating Standardization Study</i>	7
<i>SEC Publishes Notice and Request for Comment on Proposed Extension of Information Collection Related to Rule 15b11-1</i>	7
<i>Federal Reserve Publishes Proposed Rules on Debit Card Interchange Fee Standards and Exclusivity Arrangements and Routing Restrictions</i>	7
<i>Federal Reserve Proposes Expanded Coverage of Consumer Protection</i>	8
<i>FDIC Proposes Rule to Implement Collins Amendment on Capital</i>	8
<i>FDIC Sets Designated Reserve Ratio at 2 Percent</i>	9
<i>Financial Stability Oversight Council Issues ANPR on Designation of Systemically Important Financial Market Utilities</i>	9
<i>FinCEN Proposes AML Plan for Non-Bank Mortgage Lenders Mortgage Brokers and More Mortgage Bankers to File SARs</i>	10
<i>Regulatory Agencies Issue New Appraisal and Evaluation Guidelines</i>	11
<i>PCAOB Proposes Interim Inspection Program for Broker-Dealer Audits and Support Fees</i>	11
<i>End-User Exemption from Clearing Proposal Approved by the CFTC</i>	12
<i>Position Limits on Physical Commodity Futures Contracts Proposed by the CFTC</i>	13
<i>Additional Internal Conduct Standards for Swap Dealers and Major Swap Participants Approved by the CFTC</i>	13
<i>Risk Management Standards for Derivatives Clearing Organizations Approved by the CFTC</i>	14
<i>Swap Execution Facilities Regulation Approved by CFTC</i>	14
<i>Business Conduct Standards for Swap Dealers and Major Swap Participants Approved by the CFTC</i>	15
<i>Governance and Conflict of Interest Rules Proposed for DCOs, DCMs and SEF Approved by the CFTC</i>	16
<i>Comment Sought for Study of Standardized Computer-Readable Descriptions of Complex and Standardized Derivatives by the CFTC and SEC</i>	16

SEC and CFTC Propose Joint Rules to Define Swap Dealer and Major Swap Participant

On December 21, 2010, the SEC and CFTC published proposed joint rules that would further define "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant" and "eligible contract participant." The rules seek to implement Title VII of the Dodd-Frank Act which establishes a comprehensive framework for regulating the over-the counter swaps market.

Derivatives regulation in the United States follows a bifurcated approach that depends on whether a "swap" or "security-based swap" (SB swap) is at issue. The CFTC regulates "swaps," "swap dealers" and "major swap participants." The SEC regulates "security-based swaps," "security-based swap dealers" and "major security-based swap participants." The proposed joint rules seek to provide uniform regulation, unless not possible due to the unique characteristics of swaps and SB swaps.

(References herein to swaps include SB swaps in all defined terms).

Meaning of Swap Dealer

Under Dodd-Frank and the proposed rules, a swap dealer is any person who, absent an exemption: (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 activity causing itself to be commonly known in the trade as a dealer or market maker in swaps. The CFTC and SEC view these as functional or conduct-based tests for dealer status and list joint and separate indicia of dealer activity. Persons that "hold themselves out" or are "commonly known in the trade" as a dealer in swaps would: (a) solicit interest in or market swaps to potential counterparties, (b) develop and market new swap instruments and offer to enter into the same, (c) belong to a swap association in a category reserved for dealers or (d) generally be willing to offer a range of financial products, including swaps. With respect to market-making in swaps, an entity does not have to continuously offer to buy or sell swaps, unlike for market-makers in securities. The CFTC also plans to focus on an entity's relationships with its counterparties and the volume of its trades. Swap dealers tend to enter into swaps with more counterparties that are not swap dealers, whereas non-swap dealers enter swaps with dealers more often than non-dealers. Swap dealers tend to accommodate demand for swaps from other parties and propose terms for swaps. The SEC intends to interpret the SB swap dealer definition "in a manner that builds on its pre-existing dealer-trader distinction" which focuses on factors such as an entity's holding itself out as buying or selling securities at a regular place of business and providing liquidity services in transactions with investors. The SEC will adapt these criteria to reflect fundamental differences between securities and SB swaps.

Exemptions from Swap Dealer Definition

An entity that engages in *de minimis* or limited swap dealing activities will not be regulated as a swap dealer. A four part test determines whether the *de minimis* exemption is available. The tests focus on limits based in

some cases on notional amounts and in others on the number of counterparties or swap transactions.

A swap dealer that enters into swaps for its "own account, either individually or in a fiduciary capacity, but not as a part of a regular business" will not be regulated as a swap dealer, absent other swap dealer activities. The "own account" language covers acting as principal, not agent. A person who regularly enters into swaps as principal would not qualify as a swap dealer, unless it does so "as part of, or as an ordinary course of a regular business." The regulators would interpret the regular or ordinary business languages to cover a person "whose function it is to accommodate demand for swaps from other parties and enter into swaps in response to interest expressed by other parties."

An exemption from dealer status also is provided for an insured depository institution (IDI) that enters a swap with a customer in connection with originating a loan and does not engage in other dealer activities. This exclusion would apply only if the rate, asset, liability or other notional item underlying the swap is, or is directly related to, a financial term of the loan.

Major Swap Participant

Under the Dodd-Frank Act, an MSP is any person that is not a swap dealer but meets any of the following three tests: (1) maintains a "substantial position" in any "major swap category," excluding positions held for hedging or mitigating commercial risk or by an ERISA employee benefit plan to hedge or mitigate risks directly associated with operating the plan; (2) has outstanding swaps that create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets" or (3) is a "financial entity" that is (i) "highly leveraged relative to the amount of capital such entity holds" (ii) not subject to federal bank regulatory capital requirements, and (iii) maintains a "substantial position" in any major swap category.

These three tests focus on the market impact and risks presented by an entity's swap positions. The first test applies numerical thresholds to net, uncollateralized, unhedged current and future swap exposures in six



major swap categories. A "substantial position" in any major swap category would trigger MSP treatment. The second test applies larger numerical thresholds to an entity's total swap book to identify a "substantial counterparty exposure." The third test targets financial entities that are highly leveraged, not subject to capital rules, and have a "substantial position" in a major swap category, without deducting for hedging.

MSP Exclusion for Hedging Commercial Risks

The ability to exclude any position that hedges or mitigates commercial risk from the first substantial position test for MSPs offers an important potential regulatory escape hatch from swap dealer or MSP status. A swap position would hedge commercial risk if it is: (i) "economically appropriate to the reduction of risks associated with the conduct and management of a commercial enterprise that arise from the potential change in value of assets, liabilities, and services connected with the ordinary course of business of the enterprise," and (ii) is not held for "a purpose that is in the nature of speculation, investing or trading."

The CFTC plans to apply a facts and circumstances test to evaluate a particular swap and in light of the party's overall hedging and risk mitigation strategies. A swap would hedge or mitigate commercial risk if it: (A) is a *bona fide* hedge under CEA rules, (B) qualifies for hedging treatment under FASB 133 or (C) reduces risks arising from the conduct of business that arise in the ordinary course, including from foreign exchange exposure, interest rates and commercial activity

The SEC's proposed hedging rule would expressly exclude hedging for risks associated with the "present" conduct of a commercial enterprise and future risks that are "reasonably expected to arise." It does not expressly include *bona fide* hedging, but seeks to include a broad range of economic hedges. It plans to interpret the term "economically appropriate" based on whether "a reasonably prudent person would consider the security-based swap to be appropriate for managing the identified commercial risk." It states preliminarily that such a security should not introduce "any new material quantum of risks ... basis risk, or other new types of risk more than reasonably necessary to manage the identified

risk." Doing so would trigger treatment as a non-hedging speculative SB swap.

Eligible Contract Participants

The proposed regulation also implements Dodd-Frank's amendments to the definition of "eligible contract participants" in the Commodity Exchange Act and the Securities Exchange Act. This term offers protection for small entities and unsophisticated individual investors by triggering requirements for non-ECPs to enter all swap transactions on designated commodity exchanges (DCMs) or national securities exchanges. non-ECPs cannot enter swaps on swap exchange facilities (SEFs). Dodd-Frank increased the threshold to qualify as ECPs for regulated entities to \$50 million and requires individuals to have "discretionary investments" exceeding \$10 million. The proposed rule implements these higher thresholds.

Other Open Issues Identified by the Regulators

The proposed release includes many specific questions seeking insight on alternative regulatory approaches. These indicate that the final release could be materially different in some areas. Issues of note for the swap and SB dealer definitions include:

- how to treat swaps between persons under common control for the swaps dealer definition,
- application to the physical commodity market and to the electricity industry,
- how to apply the standards to entities that must limit their swaps to particular types of counterparties, such as federal home loan banks, and
- the application of dealer requirements regarding capital, margin and business conduct.
- For the major swap participant definition, the agencies ask questions regarding application to ERISA plans, sovereign wealth funds, registered investment companies and end-users.

Public Comments on the proposed Joint Rules are due on February 22, 2011.

SEC Proposes Review Process for Mandatory Clearing of Security-Based Swaps under the Dodd-Frank Act

On December 15, 2010, the SEC voted unanimously to propose rules required under the Dodd-Frank Act that would set forth the way in which the clearing agencies provide information to the SEC about security-based swaps that the clearing agencies plan to accept for clearing. This information is designed to aid the SEC in determining whether such security-based swaps are, in fact, required to be cleared.

The SEC also proposed rules that would set out the way in which those clearing agencies that are designated as "systemically important" must submit advance notices for changes to their rules, procedures, or operations that could materially affect the nature or level of risk presented at such clearing agencies.

In addition to regulating security-based swaps transactions, the Dodd Frank Act provides regulators with enhanced authority over financial market utilities, including clearing agencies that are designated as systemically important by the Financial Stability Oversight Council. Specifically, Title VIII of the Act requires any such designated financial market utilities to provide 60 days advance notice to its Supervisory Agency, such as the SEC, before changing its rules, procedures or operations that could materially affect the nature or level of risk that the entity presents. In connection with this notice requirement, the SEC is required to adopt rules that outline when such clearing agencies are required to file notices with the SEC.

Proposed Rule Regarding Submissions About Security-Based Swaps to Be Cleared

Under the proposed rule, a clearing agency would be required to file information with the SEC regarding any security-based swap, or any group, category — type or class of security-based swaps — that a clearing agency plans to accept for clearing. These security-based swap submissions would be filed electronically with the SEC using the existing Electronic Form 19b-4 Filing System and Form 19b-4.

The proposed rule, which would amend Rules 19b-4 and Form 19b-4 under the Securities Exchange Act of 1934 ("34 Act"), would also describe the information that each submission must contain so that the SEC would be able to determine whether the security-based swap submission should be subject to mandatory clearing. This information includes quantitative and qualitative information to assist the SEC in the assessment of the factors set forth under Dodd-Frank Act which the Commission is required to take into account in its review of the mandatory clearing requirement. The proposed rule also would specify how the clearing agency must notify its members about the submissions it makes. And, the rule would require clearing agencies to post copies of their submissions on their public websites within two business days.

Proposed Rule Regarding Advance Notice by "Systemically Important" Clearing Agencies

The SEC is proposing a rule that would require a designated "systemically important" clearing agency to provide advance notice to the SEC before it makes certain changes to its rules or procedures. That notice would need to be filed electronically with the SEC using the existing Electronic Form 19b-4 Filing System and Form 19b-4.

The proposed rule also would generally require advance notice when:

- The proposed change would affect the risk management functions performed by the clearing agency that are related to systemic risk.
- The proposed change could affect the clearing agency's ability to continue to perform its core clearance and settlement functions.

Changes that could require advance notice may include, but are not limited to, changes that materially affect participant and product eligibility, risk management, daily or intraday settlement procedures, default procedures, system safeguards, governance or financial resources of the designated clearing agency. Changes

that may not require advance notice include, but are not limited to, changes concerned solely with the administration of the designated clearing agency. Clearing agencies can file one form to accomplish the various purposes so long as the clearing agency meets the requirements of each applicable regulatory scheme before the applicable change becomes effective.

Additional Proposed Rules

In addition to the matters described above, the proposed rules would also:

- Establish the procedure by which the SEC may stay the mandatory clearing requirement at the request of

SEC Proposes End-User Exception to Mandatory Clearing of Security-Based Swaps

On December 21, 2010, the SEC published a proposed rule interpreting the exemption for non-financial counterparties that use security-based swaps (SB swaps) to hedge or mitigate commercial risk from the mandatory clearing requirements in the Dodd-Frank Act. This rule implements the so-called end-user clearing exception by promulgating notice procedures, defining hedging and mitigating commercial risk and extending the exemption to small banking institutions

Comments on the proposal are due by February 4, 2011.

The Dodd-Frank Act exempts an SB swap transaction from clearing if one party to the transaction:

- Is not a financial entity.
- Is using the swap to hedge or mitigate commercial risk, and
- Notifies the SEC of various matters, including its identity and how it generally meets its financial obligations associated with entering into non-cleared SB swaps.

A financial entity generally includes a swap dealer, major swap participant (and their SB swap equivalents), a commodity pool, a private fund, an ERISA plan, and an entity engaged in the business of banking or activities that are financial in nature under the Bank Holding Company Act. Any entity that does not fall within these

a counterparty to the security-based swap or on the Commission's own initiative.

- Seek to prevent evasion of the clearing requirement by clarifying that clearing needs to occur through a central counterparty.
- Make form and rule changes to reflect new deadlines under the Dodd-Frank Act for proposed rule changes by self-regulatory organizations.

Public comments on the proposed rules should be received by the Commission within 45 days after their publication in the Federal Register.

categories may elect not to clear its SB swaps under the end-user exemption by filing notice with the SEC.

The notice requirement primarily seeks to prevent evasion of the end-user exemption and reduce counterparty risks presented by non-cleared SB swaps. The notice must include the following:

- Whether the end-user generally expects to meet its financial obligations associated with a security-based swap by using a written credit support agreement, a written agreement to pledge or segregate assets, a written third-party guarantee, or solely its available financial resources or other means,
- The identity of the counterparty relying on the clearing exception,
- Its status as a "financial entity," finance affiliate, issuer of registered securities or reporting company, and
- Whether it is using the security-based swap to hedge or mitigate commercial risk.

This proposed rule defines "hedging or mitigating commercial risk" by cross referencing the term as it is used in a separate proposed rule that defines SB swap dealers and major SB swap participants. This latter rule permits entities to deduct hedging transactions when determining their regulatory status.

Although the hedging term is used for different purposes in the end-user exemption, the SEC considers its meaning to be the same and seeks comment on its use for the end-user exemption. In its view, hedging generally means that a SB swap generates gains or losses that offset losses or gains in an entity's commercial activities. An SB swap position would hedge commercial risk if it is:

- Economically appropriate to the reduction of risks associated with the present conduct and management of a commercial enterprise or are reasonably expected to arise in the future conduct and management of the commercial enterprise, where such risks arise from the potential change in value of assets, liabilities, and services connected with the ordinary course of business of the enterprise, and
- Is not held for "a purpose that is in the nature of speculation, investing or trading."

The SEC seeks to include a broad range of economic hedges. It plans to interpret the term "economically appropriate" based on whether "a reasonably prudent person would consider the security-based swap to be appropriate for managing the identified commercial risk." It states preliminarily that such a security should not introduce "any new material quantum of risks,...basis risk...or other new types of risk...more than reasonably necessary to manage the identified risk."

The proposed rule also would permit small banks, savings associations, farm credit system institutions and credit unions with total assets under \$10 billion to use the end-user clearing exemption. Such entities may use SB swaps to hedge or mitigate their business risks in a manner that is directly related to the business of banking. The SEC does not consider this extension to affect significant SB swap activities.

SEC Proposes Permanent Rule Requiring Municipal Advisors to Register with Agency

On December 20, 2010, the SEC voted to propose a rule creating a new process by which municipal advisors must register with the SEC. . Because the Dodd-Frank Act required these advisors to register by October 1, the Commission adopted an earlier temporary rule to permit advisors to fulfill the Act's mandates.

Under the proposed permanent registration regime, municipal advisors would have to submit more detailed information than is currently required and certify that they have met or will meet required qualifications and regulatory obligations. Like the temporary form required of municipal advisors, the registration forms envisioned by the proposed rule would require municipal advisors to provide identifying and contact information, and to disclose - by selecting from a list - the municipal

advisory activities in which they engage. Municipal advisors also would be required to provide disciplinary history information similar to the information that the SEC obtains from registered broker-dealers and investment advisers. Individual municipal advisors would be required to amend the form whenever any of the required information has become inaccurate in any way; and municipal advisory firms would be required to amend the form annually and whenever identifying and contact information or disciplinary information has become inaccurate. Public comments on the proposed rule should be received by the Commission within 45 days of publication of the rule in the Federal Register. The temporary rule will expire by no later than Dec. 31, 2011.

SEC Releases Comment Request for Credit Rating Standardization Study

On December 17, 2010, the SEC issued a request for public comment to help inform its study pursuant to Section 939(h) of the Dodd-Frank Act on the feasibility and desirability of: standardizing credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms; standardizing the market stress conditions under which ratings are evaluated; requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss

expectations under standardized conditions of economic stress; and standardizing credit rating terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.

The SEC will accept comments regarding the issues related to the study for a period of 45 days following its publication in the Federal Register.

SEC Publishes Notice and Request for Comment on Proposed Extension of Information Collection Related to Rule 15b11-1

On December 20, 2010, the SEC published in the Federal Register a notice and request for public comment regarding a proposed extension of a previously approved information collection related to Rule 15b11-1 which

requires futures commission merchants and introducing brokers that conduct a business in security futures products to register with the Commission.

Comments are due by January 19, 2011.

Federal Reserve Publishes Proposed Rules on Debit Card Interchange Fee Standards and Exclusivity Arrangements and Routing Restrictions

On December 16, 2010, the Federal Reserve Board (Board) requested comment on a proposed rule that would establish debit card interchange fee standards and prohibit network exclusivity arrangements and routing restrictions. The Board's proposal would implement the debit card interchange fee and routing provisions of the Durbin Amendment to the Dodd-Frank Act. Debit card interchange fees are established by payment card networks and paid by merchants to card issuers for each transaction.

The proposed new Regulation II, Debit-Card Interchange Fees and Routing, would establish standards for determining whether a debit card interchange fee received by a card issuer is "reasonable and proportional" to the cost incurred by the issuer for the transaction. These standards would apply to issuers that, together with their affiliates, have assets of \$10 billion or more. Certain government-administered

payment programs and reloadable general-use prepaid cards would be exempt from the interchange fee limitations.

The Board proposed two alternative interchange fee standards that would apply to all covered issuers: one based on each issuer's costs, with a safe harbor (initially set at 7 cents per transaction) and a cap (initially set at 12 cents per transaction); and the other a stand-alone cap (initially set at 12 cents per transaction). The Board also is requesting comment on possible frameworks for an adjustment to the interchange fees to reflect certain issuer costs associated with fraud prevention.

If the Board adopts either of these proposed standards in the final rule, the maximum allowable interchange fee received by covered issuers for debit card transactions would be more than 70 percent lower than the 2009 average, once the new rule takes effect on July 21, 2011.

The proposed rule would also prohibit all issuers and networks from restricting the number of networks over which debit card transactions may be processed. The Board is requesting comment on two alternative approaches: one alternative would require at least two unaffiliated networks per debit card, and the other would require at least two unaffiliated networks per debit card for each type of cardholder authorization method (such as signature or PIN). Under both alternatives, the issuers and networks would be prohibited from inhibiting a

merchant's ability to direct the routing of debit card transactions over any network that the issuer enabled to process them.

According to the recently released 2010 Federal Reserve payment study, debit card use in the United States now exceeds all other forms of noncash payments and, by number of payments, represents approximately 35 percent of total noncash payments. Comments on the proposal are due by February 22, 2011.

Federal Reserve Proposes Expanded Coverage of Consumer Protection

On December 13, 2010, the Federal Reserve Board (Fed) proposed two rules that would expand the coverage of consumer protection regulations to credit transactions and leases of higher dollar amounts. The proposed rules would amend Regulation Z (Truth in Lending) and Regulation M (Consumer Leasing) to implement a provision of the Dodd-Frank Act. Effective July 21, 2011, the Dodd-Frank Act requires that the protections of the Truth in Lending Act (TILA) and the Consumer Leasing Act (CLA) apply to consumer credit transactions and consumer leases up to \$50,000, compared with \$25,000 currently. This amount will be adjusted annually to reflect any increase in the Consumer Price Index.

certain practices with respect to those loans. Currently, consumer loans of more than \$25,000 are generally exempt from TILA. However, private education loans and loans secured by real property (such as mortgages) are subject to TILA regardless of the amount of the loan.

The CLA requires lessors to provide consumers with disclosures regarding the cost and other terms of personal property leases. An automobile lease is the most common type of consumer lease covered by the CLA. Currently, a lease is exempt from the CLA if the consumer's total obligation exceeds \$25,000.

TILA requires creditors to disclose key terms of consumer loans and prohibits creditors from engaging in

Comments on the proposals must be submitted by February 1, 2011.

FDIC Proposes Rule to Implement Collins Amendment on Capital

The FDIC has approved issuance of an interagency proposed rulemaking to implement certain provisions of Section 171 of the Dodd-Frank Act -- more commonly known as the Collins Amendment.

The proposed rule replaces the transitional floors in the advanced approaches rule with permanent risk-based capital floors equal to the capital requirements computed using the agencies' general risk-based capital rules. The preamble to the proposed rules notes that the agencies may amend the generally applicable capital requirements over time, and that such amended requirements would serve as the new floor for banking organizations using the advanced approaches.

Section 171 provides that the capital requirements generally applicable to insured banks shall serve as a floor for other capital requirements the agencies establish. The advanced approaches of Basel II allow for reductions in risk-based capital requirements below those generally applicable to insured banks, and accordingly need to be modified to be consistent with Section 171.

"The Collins Amendment, in my view, will do more to strengthen the capital of the U.S. financial system than any other section of the Act," said FDIC Chairman Sheila C. Bair. "Large financial institutions need the capital

strength to stand on their own without government assistance. The Collins Amendment appropriately ensures that large institutions operate with at least as much capital in proportionate terms as is required of thousands of Main Street banks nationwide."

The proposal also modifies the agencies' general capital requirements in a way intended to provide the Federal

Reserve with additional flexibility to craft capital requirements for nonbanks it supervises as a result of determinations by the Financial Stability Oversight Council. Other provisions of the Collins amendment will be addressed in subsequent rulemakings. Comments are due 60 days from publication in the Federal Register.

FDIC Sets Designated Reserve Ratio at 2 Percent

The Board of Directors of the FDIC approved a final rule on December 14, 2010 to set the deposit insurance fund's designated reserve ratio (DRR) at two percent of estimated insured deposits. The rule becomes effective on January 1, 2011. FDIC Chairman Sheila C. Bair stated, "Given previous statutory limitations on the ability of the FDIC to build reserves in excess of 1.25%, our resources heading into the financial crisis were woefully inadequate. This new rule will allow us to better prepare for the future. It will also give the industry greater certainty around the premium structure. While the two percent designated reserve ratio established by the board is higher, the trade-off will be lower, more predictable premiums over time. By building higher reserves during the good times, we will significantly reduce the risk of pro-cyclical assessments when the inevitable next downturn occurs."

The Dodd-Frank Act set a minimum DRR of 1.35 percent, and left unchanged the requirement that the FDIC Board set a DRR annually. The Board must set the

DRR according to the following factors: risk of loss to the insurance fund; economic conditions affecting the banking industry; preventing sharp swings in the assessment rates; and any other factors it deems important.

The decision to set the DRR at two percent was based on a historical analysis by its staff of losses to the insurance fund. The analysis showed in order to maintain a positive fund balance and steady, predictable assessment rates, the reserve ratio must be at least two percent as a long-term, minimum goal. The final rule is part of a comprehensive fund management plan proposed by the FDIC Board on October 19, 2010. The plan is meant to provide insured institutions with moderate, steady assessment rates throughout economic cycles, and to maintain a positive fund balance even during severe economic times. The Board expects to act on the remaining aspects of the comprehensive plan—assessment rates and assessment dividends—in the first quarter of next year.

Financial Stability Oversight Council Issues ANPR on Designation of Systemically Important Financial Market Utilities

The Financial Stability Oversight Council (FSOC) has issued an Advanced Notice of Proposed Rulemaking (ANPR) seeking comment on how it will identify and designate systemically important financial market utilities (FMUs). The Dodd-Frank Act generally defines a "financial market utility" as any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or

other financial transactions among financial institutions or between financial institutions and that person.

A financial market utility may be designated as significantly important if the Council determines that the failure, or a disruption to the functioning, of a financial market utility could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten

the stability of the financial system of the United States. Systemically important financial market utilities will be subject to enhanced, but not yet fully disclosed, regulatory oversight.

The ANPR notes that FMUs exist in a number of markets and provide many benefits, but also concentrate risk. The payment and settlement processes of such systems are also highly interdependent, either directly through contractual, operational or affiliation linkages, or indirectly through liquidity flows or common participants.

The purpose of the ANPR is to gather information as the FSOC begins to develop the specific criteria and analytical framework by which it will designate FMUs as systemically important. To that end, the ANPR presents a series of wide-ranging questions centering around criteria that must guide the FSOC's designations.

Of particular note is a separate statement by CFTC Chairman Gensler that accompanies the ANPR. Chairman Gensler notes the valuable role played by clearinghouses in the futures markets and endorses a comprehensive and robust regulatory oversight of clearinghouses due to their enhanced role under Title VII of Dodd-Frank in clearing standardized swaps. Chairman Gensler indicated that the CFTC currently oversees 14 clearinghouse and expects that number to rise to 20. He urges the FSOC to designate systemically important clearinghouses by mid-summer 2011, so that such clearinghouse will be aware of the enhanced standards they will be expected to meet before the mandatory clearing of standardized swaps become effective.

Comments are due by January 20, 2011.

FinCEN Proposes AML Plan for Non-Bank Mortgage Lenders Mortgage Brokers and More Mortgage Bankers to File SARs

On December 6, 2010, the Financial Crimes Enforcement Network (FinCEN) proposed a requirement that non-bank residential mortgage lenders and originators, like other types of financial institutions, establish anti-money laundering (AML) programs and comply with suspicious activity report (SAR) regulations. AML Programs are required to include, at a minimum:

- The development of internal policies, procedures, and controls;
- The designation of an AML Compliance officer;
- An ongoing employee training program; and
- An independent audit function to test the program.

Under current FinCEN regulations the only mortgage originators that are required to file SARs are banks and insured depository institutions. The proposal would close a regulatory gap that allows other originators, such as mortgage brokers and mortgage lenders not affiliated with banks, to avoid having AML and SAR filing obligations.

SARs are a critical source of information for law enforcement in investigating and prosecuting mortgage fraud related crimes. FinCEN believes that new regulations requiring non-bank residential mortgage lenders and originators to adopt AML programs and report suspicious transactions would be consistent with those business's due diligence and information collection processes to assess creditworthiness in lending, and could augment FinCEN's initiatives in this area. Additionally, the effectiveness of these proposed AML/SAR regulations may be enhanced by new rules imposed under the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act) that require development of a nationwide licensing system and registry for certain mortgage professionals.

Comments will be accepted by FinCEN until February 7, 2011.

Regulatory Agencies Issue New Appraisal and Evaluation Guidelines

On December 2, 2010, the federal banking agencies (Agencies) issued final Interagency Appraisal and Evaluation Guidelines (Guidelines) to provide further clarification of the Agencies' appraisal regulations and supervisory guidance to institutions and examiners about prudent appraisal and evaluation programs. The Guidelines, including their appendices, update and replace existing supervisory guidance documents to reflect developments concerning appraisals and evaluations, as well as changes in appraisal standards and advancements in regulated institutions' collateral valuation methods. In implementing the Dodd-Frank Act, the Agencies will determine whether future revisions to the Guidelines may be necessary. However, the Agencies are issuing the Guidelines to promote consistency in the application and enforcement of the Agencies' current appraisal requirements and related supervisory guidance. The Agencies considered the Dodd-Frank Act and other federal statutory and regulatory changes affecting appraisals. The Guidelines

are also responsive to the majority of public comments, which confirmed that additional clarification of existing regulatory and supervisory standards would strengthen the real estate collateral valuation and risk management practices across insured depository institutions.

The Guidelines contain four Appendices that clarify current regulatory requirements and supervisory guidance. Appendix A provides further clarification on real estate-related financial transactions that are exempt from the Agencies' appraisal regulations. Appendix B addresses an institution's use of analytical methods or technological tools in the development of an evaluation. Appendix C clarifies the minimum appraisal standards required by the Agencies' appraisal regulations for analyzing and reporting appropriate deductions and discounts in appraisals. Based on comments on the Proposal, the Agencies added this additional appendix. Appendix D (previously Appendix C in the Proposal) provides a glossary of terms.

PCAOB Proposes Interim Inspection Program for Broker-Dealer Audits and Support Fees

On December 14, 2010, the Public Company Accounting Oversight Board (PCAOB) proposed a rule to establish an interim inspection program for registered public accounting firms' audits of brokers and dealers, as well as rules related to assessing and collecting a portion of its Accounting Support Fee from brokers and dealers to fund PCAOB oversight of audits of brokers and dealers. Certain amendments to existing funding rules for issuers were also proposed for public comment.

Under the interim inspection program, the PCAOB would begin to inspect auditors of brokers and dealers and identify and address with the registered firms any significant issues. The PCAOB also expects that insights gained through the interim program will inform the

scope and elements of a permanent program. The PCAOB expects to propose rules for a permanent program after no more than two years of an interim program. During the interim program, the PCAOB would at least provide annual public reports on the progress of the interim program and significant issues identified, but the PCAOB would not expect to issue firm-specific inspection reports before permanent program is established.

The proposed rule would not change the rules or standards that govern audits of broker-dealers. Those audits will continue to be carried out under generally accepted auditing standards. Comments are due to the PCAOB by no later than February 15, 2011.

End-User Exemption from Clearing Proposal Approved by the CFTC

The CFTC approved a much anticipated proposed rule that interprets when an entity uses swaps to "hedge or mitigate commercial risk" and therefore is exempt from clearing swaps on an exchange under the Dodd-Frank Act. This "end-user exemption" is available to a non-financial entity if it also provides notice explaining how it meets the financial obligations associated with entering into non-cleared swaps.

The CFTC generally considers hedging to mean that a swap generates gains or losses that offset losses or gains in an entity's commercial activities. Whether a swap hedges commercial risk under CFTC rules would require analysis of the facts and circumstances when the swap trade is executed in light of the overall hedging and risk mitigation strategies. Hedging would include swaps that:

- Are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise that arise in the ordinary course of business from the potential change in value of a person's assets, liabilities or services, including from foreign exchange rate changes,
- Reduce risks that arise in the ordinary course of business from a fluctuation in interest, currency or foreign exchange rate exposures arising from a person's assets or liabilities,

- Qualify as bona fide hedge under the Commodity Exchange Act, or
- Qualify for hedging treatment under FASB 133.

Hedging by definition does not include any swap held for speculation, investing or trading.

End-users claiming the hedging exemption must provide notice through a Swap Data Repository about its methods for mitigating counterparty credit risk on the uncleared swap. This notice also must disclose the identity of the end-user and whether an affiliate or financial entity is involved.

The Dodd-Frank Act permits the CFTC to extend the end-user exemption to small banks, savings associations, farm credit system institutions and credit unions. The proposal seeks comments on this issue.

The CFTC announced this proposal on December 9, 2010. The actual regulation will not be public until published in the Federal Register, which is pending as of December 22, 2010.

Fact sheet:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/eue_factsheet.pdf

Q&A:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/eue_qa.pdf

Position Limits on Physical Commodity Futures Contracts Proposed by the CFTC

The CFTC approved proposed position limits on commodity futures and options contracts in physical and exempt commodities (and their economic equivalent) traded on a designated contract market (DCM). These limits also apply to the economic equivalent of such DCM swaps, but not to bona fide hedge positions. This proposed rule follows an earlier proposal to require position reports for these instruments. These rules seek to implement the Dodd-Frank mandate to "combat excessive speculation while ensuring sufficient market liquidity and efficient price discovery."

The position limits cover 28 physical-delivery contracts and their economic equivalent derivatives. Exempt commodities include gold, silver, palladium, copper, platinum, crude oil, natural gas, heating oil and gasoline. Agricultural commodities include corn, soybeans, wheat, cocoa, coffee and cotton.

Spot-month position limits will be set at 25% of deliverable supply for a commodity, with a conditional

spot-month limit of five times that amount for entities with positions exclusively in cash-settled contracts. Non-spot month position limits will be set for each referenced contract at 10% of open interest in that contract up to the first 25,000 contracts, and 2.5% thereafter.

The proposed rule also provides for a "position visibility reporting regime" that resembles current reporting obligations for bona fide hedgers.

The CFTC announced this proposal on December 16, 2010. The actual regulation will not be public until published in the Federal Register, which is pending as of December 21, 2010.

Fact Sheet:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/pl_factsheet.pdf

Q&A:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/pl_qa.pdf

Additional Internal Conduct Standards for Swap Dealers and Major Swap Participants Approved by the CFTC

The CFTC approved a proposed rule that would require swap dealers and MSPs to provide for timely and accurate swap confirmation, processing, netting and documentation standards. These post-trade requirements would include portfolio reconciliation and compression to reduce risk and improve operational efficiency.

The confirmation procedures include a requirement for same day confirmations between swap dealers, MSPs and financial entities and for same day acknowledgement between swap dealers or MSPs and other counterparties. Certain confirmation or acknowledgement procedures apply to events that result in a new swap or a change in terms of a swap.

Swap dealers and MSPs would have to engage in portfolio reconciliation of swaps that are not cleared by a

derivatives clearing organization. Reconciliation would occur on a daily, weekly or quarterly basis depending on the size of the swap portfolio and deadlines would apply for resolving discrepancies. The rule also would require portfolio reconciliation involving counterparties that are not swap dealers or MSPs, with less stringent deadlines.

Portfolio compression and recordkeeping requirements apply to swaps between swap dealers and MSPs. Multilateral portfolio compression exercises are required for eligible swaps. All fully offsetting swaps between swap dealers and MSPs would have to be terminated within one day and parties must engage annually in bilateral portfolio compression exercises with other swap dealers and MSPs, subject to exceptions.

The CFTC announced this proposal on December 16, 2010. The actual regulation will not be public until



published in the Federal Register, which is pending as of December 21, 2010.

Fact sheet:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cprpcr_factsheet.pdf

Q&A:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cprpcr_qa.pdf

Risk Management Standards for Derivatives Clearing Organizations Approved by the CFTC

Derivatives clearing organizations (DCO) must comply with numerous Dodd-Frank provisions that seek to achieve fair and open access through financial resource and operational requirements, oversight of participants and factors for determining eligibility of a product for clearing by a DCO. The CFTC approved a proposed rule that provides an application form for registering as a DCO and creates standards for compliance with DCO principles regarding participant and product eligibility, risk management, settlement procedures, treatment of funds, default rules and procedures, system safeguard. The proposed rule also implements heightened system safeguard standards and enforcement authority for

systemically important DCOs and supplements previously approved DCO reporting requirements.

The CFTC announced this proposal on December 16, 2010. The actual regulation will not be public until published in the Federal Register, which is pending as of December 21, 2010.

Fact Sheet:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/rm_factsheet.pdf

Q&A:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/rm_qa.pdf

Swap Execution Facilities Regulation Approved by CFTC

The CFTC approved a proposed rule that creates operational principles for swap execution facilities (SEFs). SEFs must offer market participants the option to post firm and indicative quotes to multiple parties using any trading platform or system, including request for quote systems or order books. The proposed regulation prescribes the features of request for quote systems and order books. It also identifies the registration and operational requirements for SEFs. The proposed rule affects current trading systems and platforms for trading swaps, market participants trading swaps and intermediaries facilitating the trading of swaps. The proposed rule would provide temporary grandfathering relief for SEF applicants that cannot

meet the requirements on the effective date of the final rule

The CFTC announced this proposal on December 16, 2010. The actual regulation will not be public until published in the Federal Register, which is pending as of December 21, 2010.

Fact sheet:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/sefs_factsheet.pdf

Q&A:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/sefs_qa.pdf

Business Conduct Standards for Swap Dealers and Major Swap Participants Approved by the CFTC

The CFTC approved proposed due diligence and disclosure obligations for swap dealers and major swap participants (swap entities) that interact with counterparties, including "special entities" such as government agencies. Under these "external business conduct standards," swap entities generally would need to have compliance policies that ensure compliance with the Commodity Exchange Act, provide diligent supervision and "know your counterparty" oversight and retain records for prescribed periods. They also would prohibit fraudulent, deceptive and manipulative acts, disclosure of material confidential counterparty information and trading ahead or front running counterparty swaps. Swap entities would have numerous affirmative duties aimed at eligibility, fair dealing, transparency and suitability.

Swap dealers must act in the "best interest" of any special entity it advises, an enhanced duty. Pay to play provisions would prohibit a swap entity from entering swaps with a municipal entity within two years after making certain political contributions to specified officials at the municipal entity.

These external business conduct standards would not apply to transactions initiated by a counterparty on a designated contract market or swap execution facility where counterparty's identity is unknown. Certain requirements would not apply to counterparties that are swap dealers or major swap participants.

The CFTC announced this proposal on December 9, 2010. The actual regulation was published in the Federal Register for December 22, 2010.

Governance and Conflict of Interest Rules Proposed for DCOs, DCMs and SEF Approved by the CFTC

The CFTC approved proposed rules that would further interpret the Dodd-Frank Act's governance requirements and conflicts of interest principles for derivatives clearing organizations (DCOs), designated contract markets (DCMs) and swap execution facilities (SEFs) (together, "swap facilitators"). The governance provisions address the composition and qualifications of members of the board of directors of swap facilitators. The conflict of interest proposals mandate reporting when the board takes actions contrary to the recommendations of internal compliance and risk functions. The proposed rule also addresses conflict of interest issues regarding decisions about matters that include swaps eligible for clearing, membership, self-regulation and access. Swap facilitators must implement

a "regulatory program" to identify and make decisions about existing and potential conflicts of interest. A third party regulatory service provider may provide this regulatory program.

The CFTC announced this proposal on December 9, 2010. The actual regulation will not be public until published in the Federal Register, which is pending as of December 21, 2010.

Fact Sheet:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/gr_factsheet.pdf

Q&A:

http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/gr_qa.pdf

Comment Sought for Study of Standardized Computer-Readable Descriptions of Complex and Standardized Derivatives by the CFTC and SEC

The CFTC asked for public comments to inform its study of the feasibility of requiring the derivatives industry to adopt standardized, computer-readable algorithmic descriptions for complex and standardized financial derivatives. These descriptions must facilitate computerized analysis of individual derivative contracts and calculate net exposures to complex derivatives. They also must be useable simultaneously by participants in the derivatives industry, including regulators. Finally, the study must evaluate whether the

algorithmic description, together with "standardized and extensible legal definitions," may serve as the binding legal definition of derivative contracts.

The CFTC will conduct this study jointly with the SEC, which regulates security-based swaps. They must coordinate with international financial institutions and regulators, and issue the study by March 11, 2011. The CFTC issued this request on December 9, 2010 and seeks public comments by December 31, 2010.

Additional Information

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