

Financial Services Regulatory Highlights

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The Dodd-Frank Act -- One Year Later

The Senate Banking Committee decided that the one-year anniversary of the Dodd-Frank Act (Dodd-Frank or the Act) was an ideal time to hold an oversight hearing and assess progress. The Honorable Neal Wolin, the Deputy Secretary of the Treasury, and the heads of the five federal financial regulatory agencies -- Federal Reserve Board of Governors (Fed) Chairman Bernanke, Securities Exchange Commission (SEC) Chairman Schapiro, Federal Deposit Insurance Corporation (FDIC) Acting Chairman Gruenberg, Commodities Futures Trading Commission (CFTC) Chairman Gensler and Acting Comptroller of the Currency Walsh -- all obliged by testifying. While much of the material presented was well-trod due to the constancy of one oversight hearing or another -- most often in the less friendly confines of the House of Representatives -- the combined efforts of these top policy-makers, underlined the seemingly never-ending scope of the Act.

Before honing in on some specific pieces of information, it is worth noting that Secretary Wolin emphasized five key challenges ahead:

- Continue to move forward but also continue to prioritize quality over speed.
- Make sure the efforts of the involved agencies are coordinated.
- Take care to recognize important distinctions in our financial system -- don't apply a one size fits all approach.
- Work closely with international counterparts -- especially on OTC derivatives and capital, liquidity and leverage.
- Make sure regulators have adequate funding.

Some Key Points on What's Coming

Designation of Nonbank Financial Systemically Important Financial Institutions (SIFIs)

In the "near future," FSOC will propose additional guidance regarding the designation of nonbank financial SIFIs. The Guidance will include specific metrics and will outline both quantitative and qualitative elements of the proposed analytical framework.

Enhanced Prudential Standards for SIFIs & Basel III

The Fed expects to issue proposed rules on oversight of SIFIs "later this summer" and working with the other agencies is on schedule to implement Base III. FDIC Acting Chairman Gruenberg noted that the SIFI requirements can be viewed as "counterparts to a so-called SIFI capital surcharge" that the Basel Committee published for comments.

Living Wills for SIFIs

Enhanced prudential standards are the first prong to mitigate the macro prudential risks of SIFIS. The second prong is the Orderly Liquidation Authority and Living Wills. In connection with Living Wills, Acting FDIC Chairman Gruenberg stated that the rule-making agencies are working to develop a "deliberative process for reviewing resolution plans to assess credibility" and the facilitation of an orderly resolution under the Bankruptcy Code. Careful consideration is being given to keeping information submitted with living wills confidential.

Orderly Liquidation Authority (OLA)

The FDIC is working with the SEC on joint regulation implementing OLA authority to resolve broker-dealers. The FDIC also is working with financial regulators regarding record keeping requirements for derivatives (Qualified Financial Contracts).

FSOC released this week its Study evaluating the potential impact of the imposition of haircuts on fully secured creditors of a financial company under OLA. The report concludes that the combination of OLA and new prudential supervision standards for SIFIs can be used to address market discipline and taxpayer protection without haircuts.

Swaps -- International Issues and Phasing of Requirements

Chairman Schapiro emphasized that the SEC intends to deal with the international implications of Title VII of Dodd-Frank "holistically" not in a piecemeal fashion. It will be publishing a proposal that will include its whole approach to the registration and regulation of foreign entities engaged in cross-border transactions involving U.S. parties.

The CFTC is developing a plan for application of Section 722(d) -- which states that provisions of the Act shall not apply to activities outside the US unless they have a "direct and significant connection with" activities in or effect on US commerce.

The CFTC will be seeking further input on phasing requirements for market participants, not swap dealers or MSPs.

Volcker Rule

Agency staffs are consulting and coordinating efforts to ensure comparability and consistent application across regulated entities. Comments will be solicited on a number of issues, including cost benefit analysis.

Agency funding

If the SEC does not receive additional resources, then the implementation of derivatives rules could be delayed, oversight of clearing functions and swap data repositories could be inadequate and SEC will have only a skeletal crew to deal with complex legal and regulatory issues.

Office of Financial Research

Treasury projects that by the end of September, OFR will have about 60 full time employees. OFR's main focus has been promoting use of the Legal Entity Identifier (LEI) which is viewed as gaining private sector support.

CFPB

The CFPB has begun second stage testing of a consumer response center which will initially focus on credit card complaints. The CFPB will add more products as it builds infrastructure.

Banking Agencies

Fed Issues Final Debit Card Interchange Fees and Routing Regulations

On June 29, 2011, the Federal Reserve Board (Fed) issued a final rule implementing the debit card interchange fee and routing regulation rules pursuant to the "Durbin amendment" to Dodd-Frank.

Interchange Fees

As required by the Act, the final rule establishes standards for assessing whether debit card interchange fees received by debit card issuers are "reasonable and proportional" to the costs incurred by issuers for electronic debit transactions. Under the final rule, the maximum permissible interchange fee that an issuer may receive for an electronic debit transaction will be the sum of 21 cents per transaction and 5 basis points

multiplied by the value of the transaction. This provision regarding debit card interchange fees is effective on October 1, 2011. The original proposal had a 12 cent cap.

The Fed has also approved an interim final rule that allows for an upward adjustment of no more than 1 cent to an issuer's debit card interchange fee if the issuer develops and implements policies and procedures reasonably designed to achieve the fraud prevention standards set out in the interim final rule. If an issuer meets these standards and wishes to receive the adjustment, it must certify its eligibility to receive the adjustment to the payment card networks in which it participates. Comments on the interim final rule are due

by September 30, 2011. The fraud prevention adjustment is effective on October 1, 2011, concurrent with the debit card interchange fee limits. When combined with the maximum permissible interchange fee under the interchange fee standards, the Fed indicated that a covered issuer eligible for the fraud prevention adjustment could receive an interchange fee of up to approximately 24 cents for the average debit card transaction, which is valued at \$38.

Exemptions

Under Dodd-Frank, issuers that, together with their affiliates, have assets of less than \$10 billion are exempt from the debit card interchange fee standards. To assist payment card networks in making these determinations, the Fed on July 12th published its initial lists of institutions that are subject to, and exempt from, the debit card interchange fee standards in Regulation II, which implements the provisions of Dodd-Frank. These lists are intended to help payment card networks and others determine which issuers qualify for the statutory exemption from interchange fee standards. The list is at: www.federalreserve.gov/paymentsystems/debitfees.htm. This list will be updated annually. Also, the Fed plans to annually survey the networks and publish a list of the average interchange transaction fees each network provides to its covered and exempt issuers. This information should enable issuers, including small issuers, to more readily compare the interchange revenue they would receive from each network.

Routing Exclusivity Arrangements

The Act also directs the Fed to implement requirements that prohibit network exclusivity arrangements on debit cards and ensure merchants have choices in how debit card transactions are routed. Unlike the interchange fee provision, no asset threshold exemption applies to the

exclusivity requirements. The final rule provides that the network exclusivity provision is satisfied as long as an electronic debit transaction may be processed on at least two unaffiliated payment card networks. An official comment to the regulation clarifies that the regulation does not require an issuer to have multiple, unaffiliated networks available for each method of cardholder authentication. Under the final rule, it would be sufficient, for example, for an issuer to issue a debit card that operates on one signature based card network and on one PIN-based card network, as long as the two card networks are not affiliated. Alternatively, an issuer could issue a debit card that operates on two or more unaffiliated signature based card networks, but is not enabled for PIN debit transactions, or that operates on two or more unaffiliated PIN-based card networks, but is not enabled for signature debit transactions.

The effective date for the network exclusivity prohibition is April 1, 2012, with respect to issuers, and October 1, 2011, with respect to payment card networks. Issuers of certain health-related and other benefit cards and general-use prepaid cards have a delayed effective date of April 1, 2013 or later in certain circumstances. Issuers and networks are also prohibited from inhibiting a merchant's ability to direct the routing of the electronic debit transaction over any network that the issuer has enabled to process them. The merchant routing provisions are effective on October 1, 2011

Given the importance and complexities of the final rules (accompanying explanatory documents from the Fed were over 300 pages) PwC is working on a more detailed Closer Look review for those concerned with this issue.

FDIC Issues Second Rule to Implement Its Orderly Liquidation Authority: Claw Back of Executive Compensation, Priorities and Process for Claims

On July 15, 2011, the FDIC finalized the second of a series of rules that seek to implement its authority under Title II of the Dodd-Frank Act to liquidate a nonviable company that poses a "significant risk to the financial

stability of the United States" -- which is termed a "covered financial company in the rule or a systemically important financial institution (SIFI) in other contexts. Orderly liquidation for SIFIs is a feature of Dodd-Frank



that replaces the Bankruptcy Code for liquidating nonbank financial companies in an effort to avoid future taxpayer bail outs of financial companies deemed "too big to fail." This rule addresses three aspects of orderly liquidation -- certain definitions, priorities and claims administration. It leaves various important matters for future rulemakings, however, including the criteria for determining if a company is predominantly engaged in activities that are financial in nature or incidental thereto and therefore subject to orderly liquidation.

The FDIC said that this final rule will establish a "more comprehensive framework for the implementation of the FDIC's orderly liquidation authority and will provide greater transparency to the process for orderly liquidation" of a SIFI. It also believes that the rule, which becomes effective on August 15, 2011, permits "stakeholders" to plan transactions going forward.

The final rule contains three subparts which address: (A) definitions for insurance companies and their subsidiaries, personal service agreements, recoupment of executive compensation and fraudulent transfers, (B) priorities for and treatment of various payments including unsecured amounts, administrative expenses and certain claimants including those with rights of set off, and (C) procedures for determining claims against the company and its receiver.

Among the highlights of the final rule, is its lowering of the legal standard for permitting claw back of executive compensation from current and former senior executives or directors deemed "substantially responsible for the failed condition of the covered financial company" from

the proposal. Originally, the FDIC proposed a standard of conduct that would deem an executive "substantially responsible" if he or she failed to conduct his or her responsibilities with the requisite degree of skill and care required by that position. The standard in the final rule defines "substantially responsible" as the failure to conduct his or her responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances. That is, negligence will suffice; gross negligence is not required.

The subpart regarding priorities ranks unsecured claims by the U.S. government for repayment of funds paid to facilitate orderly liquidation or mitigate its effects among the class of claims paid at the higher statutory level. Unsecured obligations to the United States incurred by the covered financial company in the ordinary course of its business prior to the appointment of the receiver will be paid at the priority of general unsecured or senior liabilities of the covered financial company. It also will rank claims arising out of the loss of setoff rights at a priority ahead of other general unsecured creditors if the loss of the setoff is due to the receiver's sale or transfer of an asset. Certain interest calculations and the payment of obligations of a bridge financial company are also addressed.

The claims procedures sets for the process for FDIC notice to creditors, creditor filing of claims and FDIC decisions regarding payment of claims. This focuses on deadlines and timing. It also covers the treatment of contingent claims and secured claims.

Banking Agency Guidance on Counterparty Credit Risk Management -- Especially Intended for Banking Organizations with Large Derivatives Portfolios

On June 29, 2011, the Fed, FDIC, OCC and OTS issued Interagency Supervisory Guidance on Counterparty Credit Risk (CCR) Management (Guidance). The CCR guidance defines counterparty credit risk as the risk that the counterparty to a transaction could default or deteriorate in creditworthiness before the final settlement of a transaction's cash flows. The guidance

notes that CCR differs from loan credit risk because CCR creates a bilateral risk of loss because the market value of a transaction can be positive or negative to either party. The future market value of the exposure and the counterparty's credit quality are uncertain and may vary over time as underlying market factors change. The guidance states that it is "intended for use by banking



organizations, especially those with large derivatives portfolios," in setting their risk management practices, as well as by supervisors as they assess and examine such institution's management of CCR. For other banking organizations without large derivatives portfolios, risk managers and supervisors are expected to apply the guidance as appropriate, given the size, nature and complexity of the CCR profile of the organization.

The guidance creates expectations divided into six major subject areas -- Governance, Risk Measurement, Systems Infrastructure, Risk Management, Managing Central Counterparty Exposures, and Legal and Operational Risk Management. Not surprisingly the guidance is heaviest with respect to risk measurement, which includes six topics -- Counterparty Credit Risk Metrics, Aggregation of Exposures, Concentration, Stress Testing, Credit Valuation Adjustments, and Wrong-Way Risk -- and with respect to risk management which includes four topics -- Counterparty Limits, Margin Policies and Practices, Validation of Models and Systems, and Close-out Policies and Practices.

Highlights from recommended practices are as follows:

Governance and Management Reporting: Board or committee thereof should "clearly articulate" risk tolerance for CCR, approve relevant policies, establish framework for limiting individual counterparty exposures and concentrations of exposures. Senior management should implement a consistent risk measurement and management framework that provides ongoing monitoring, reporting (including to the board), and control of CCR exposures.

Risk Measurement - Credit Valuation Adjustments: Within risk measurement, the topic of Credit Valuation Adjustments (CVA) receives extensive treatment. As defined, CVA refers to adjustments to transaction valuation to reflect the counterparty's credit quality. CVA is the fair value adjustment to reflect CCR in the valuation of derivatives. The guidance notes that the importance of CVA has grown over the last few years, partly because of a change in the accounting rules that requires banking organizations to recognize the earnings impact of changes in CVA.

The guidance notes that during the financial crisis a large portion of CCR losses were because of CVA losses rather than actual counterparty defaults. CVA has thus become more important in risk management, as a mechanism to value, manage and make appropriate hedging decisions to mitigate exposure to the mark-to-market impact of CCR. The guidance discusses in some granularity general standards for CVA measurement, for management of CVA, and CVA VaR. With respect to the latter, the guidance directs banking organizations with material CVA to measure the risk of associated loss on an ongoing basis. The guidance notes that in addition to stress tests of CVAs, banking organizations may develop VaR models that include CVA to measure potential losses. Noting these models are in the early stages of development, the guidance nonetheless suggests they may prove more effective over traditional models, by capturing the variability of CCR exposure, the variability of the counterparty's credit spread and the dependency between them

Counterparty Limits: Banks should have formal, meaningful limits on exposures that are based on peak exposures for individuals and incorporated into exposure monitoring systems that are independent of relevant business lines. Risk controls should provide for ongoing monitoring of exposures against such limits, require action to mitigate limit exceptions and trigger escalated reporting as appropriate.

Margin policies: Banks should ensure that they have adequate margin and collateral "haircut" guidelines for all products with CCR.

Risk Management Functions: A range of primary and secondary CCR metrics should promote a comprehensive understanding of CCR, changes in varying environments, and reflect single counterparty exposures, groups of counterparties (for example, by internal rating, industry, geographical region), the consolidated CCR portfolio and largest exposures (e.g., top 20). Assessments should be made of current exposure, future exposure, stressed exposures, credit valuation adjustments to reflect the counterparty's credit quality, correlation risks and may include VaR models. The systems should cover OTC derivatives, securities

financing transactions, and other pre-settlement exposures), as well as aggregation of other forms of credit risk to the same counterparty (for example, loans, bonds, and other credit risks).

Risk Control Functions: These should include counterparty limits, margin practices, validating and backtesting models and systems, managing close-outs, managing central counterparty exposures, and controlling legal and operational risks arising from derivatives activities.

Reporting Contents: Reporting should include concentration analysis, CCR stress testing results, allow for understanding exposures and potential losses under severe market conditions and explain any measurement weaknesses or limitations that may influence the accuracy and reliability of the CCR risk measures.

Systems Infrastructure Considerations: Systems infrastructure should "keep up with changes in the size and complexity of [a bank's] CCR exposures, and the OTC derivatives market...[and] capture and measure the risk of transactions that may be subject to CCR." Banks should have "strong operational processes across all derivatives markets," and should "strive for a single comprehensive CCR exposure measurement platform [or] minimize the number of system platforms and methodologies, as well as manual adjustments to exposure calculations. When using multiple exposure measurement systems, management should ensure that transactions whose future values are measured by different systems are aggregated conservatively."

Fed and FTC Issue Final Rules on Credit Score Disclosures

On July 15, 2011, the Fed and FTC issued two final rules to implement some Dodd-Frank requirements regarding credit disclosure to consumers under the Fair Credit Reporting Act and the Equal Credit Opportunity Act. Disclosure is required if a credit score is used to set material terms of credit or to take adverse action on a credit request. One rule addresses disclosure of credit scores to consumers under various circumstances (Regulation B). The other rule also requires credit disclosure and changes certain pricing notices (Regulation V).

The Dodd Frank amendments requiring disclosure of credit scores became effective on July 21, 2011. The final rules interpreting these requirements will become effective on August 15, 2011. The Fed discussed requests

by commenters for a delayed effective date of up to 12 months, but then stated that it would put in an effective date that is 30 days after publication in the Federal Register. Absent further instructions from the regulator, this appears to create a relatively immediate compliance burden.

The amendments to the Fed's Regulation B implement the requirement for a creditor to notify a credit applicant when it has taken adverse action against the applicant. The rule also amends model notices to be used. The amendments to regulation V amend the risk-based pricing rules to require disclosure of credit scores and information relating to credit scores in risk-based pricing notices if a credit score of the consumer is used in setting the material terms of credit.

Bank Agencies Issue Final Rules on Retail Foreign Exchange Transactions

Over the last few weeks, the FDIC and OCC adopted final rules authorizing the institutions they supervise to engage in certain foreign currency exchange transactions with retail customers. The Federal Reserve has recently proposed similar rules for comment by October 11, 2011.

Both final rules apply to foreign currency futures, options on futures, and options, as defined in the Commodity Exchange Act, and to transactions that are “functionally or economically similar” to futures and options, such as “rolling spot” trades. Traditional spot and forward contracts would not be covered by this rule.

According to the final rules, the FDIC and OCC will require supervised banks engaged in or wishing to engage in transactions covered by this rule to prepare and submit a detailed business plan demonstrating board approval of the activity, and obtain written

approval from the FDIC or OCC to provide such products, among other requirements.

The final rules apply only to covered transactions with a retail customer. A retail customer would include certain small businesses and individuals with \$10 million or less invested on a discretionary basis and who is not using the trades to reduce risks associated with other investments.

The final rules took effect on July 15, 2011. In addition, on July 21, 2011, the OCC became the supervisory banking agency for federal savings associations. The OCC plans to regulate retail foreign exchange transactions conducted by federal savings associations under the same terms of its final rule. The OCC anticipates issuing an interim final rule with request for public comment that would expand the scope of this regulation to cover federal savings associations.

Fed and FDIC Issue Final Rules Repealing Prohibition on Paying Interest on Demand Deposits

The FDIC and Fed recently issued final rules repealing their respective regulatory prohibitions on paying interest on demand deposits, effective July 21, 2011. The rules implement changes mandated by Section 627 of Dodd-Frank. The final FDIC rule repealed Section 329 of the FDIC's regulations dealing with the prohibition, but moved to Section 330 provisions of Section 3299

defining what constitutes the payment of interest, including the criteria for determining when premiums are not treated as interest. The FDIC believes that these interpretations would be helpful in interpreting Section 343 of Dodd-Frank which extended unlimited deposit insurance coverage for non-interest-bearing transactions accounts until December 31, 2012.

OCC Issues Guidance on Prepaid Access Products

On June 28, 2011, the OCC issued guidance on prepaid access products to ensure that banks develop and implement comprehensive risk-management programs that reflect the nature and complexity of prepaid access products. Prepaid access products include general purpose reloadable cards, government benefits cards, retail gift cards and mobile phones.

According to the guidance, risk-management programs for such products should: have clearly defined objectives, expectations, and risk limits; a due diligence process for selecting third-party vendors; an oversight

process for monitoring performance, fraud losses, and suspicious activity; and policies and procedures that ensure clear consumer disclosures on pricing, fees, transaction limits, and other requirements. The guidance also provides that banks should have in place:

- Robust audit and compliance functions to ensure ongoing compliance with internal policies and all applicable laws and regulations; and
- Parameters for reporting to the bank's board of directors that enable the board to periodically

evaluate a bank's effectiveness in executing the prepaid program and to determine if the program is achieving stated objectives.

The OCC expects national banks to use this guidance as a supplement to existing OCC guidance on retail payment systems, prepaid cards and third-party service providers.

OCC Issues Final Rule to Transfer OTS Functions to the OCC

On July 20, 2011, the OCC issued a final rule to implement several provisions of Title III of the Dodd-Frank Act that relate to the transfer of functions from the OTS to the OCC on July 21, 2011. It contains amendments regarding the OCC's preemption and visitorial authority as weak as its functions and operations, including fees assessed on supervised institutions.

The final rule also makes changes to OCC's regulations that are necessary to implement certain revisions to the

banking laws resulting from the Dodd Frank Act. These changes include a three year moratorium on changes in control of credit card banks, industrial banks, and trust banks, with certain exceptions, and revisions to reflect the permanent increase in deposit insurance coverage applicable to federal branches and agencies of foreign banks.

The final rule became effective July 21, 2011, except with respect to certain provisions.

OCC Issues Guidance on Mortgage Foreclosure Practices

On June 30, 2011, the OCC issued supervisory guidance outlining its expectations for national banks' oversight and management of their mortgage foreclosure practices. The guidance is aimed at ensuring that national banks offering mortgage services adhere to appropriate foreclosure management standards. Specifically, banks should:

- Ensure that their foreclosure governance procedures are sufficient to manage and control operational, compliance, legal, and reputation risk associated with foreclosure activities
- Suspend, when legally possible, foreclosure proceedings for borrowers successfully performing trial period modifications
- Ensure that attestations in foreclosure-related affidavits are truthful, accurate, and supported by file documentation
- Maintain all documents required to support lawful foreclosure actions

- Comply with all laws and regulations related to mortgage foreclosures
- Properly structure and manage arrangements with third party vendors, including law firms, to ensure that vendors have the skills necessary to perform the assigned functions

The OCC also has directed national banks to conduct self-assessments of their foreclosure-management practices by September 30, 2011. Banks that identify weaknesses in their foreclosure processes through the self-assessment should take immediate corrective action. Banks should also determine if the weaknesses resulted in any financial harm to borrowers and provide remediation, as appropriate. OCC examiners will review a bank's self-assessment and any corrective actions, if applicable, during the next quarterly review or examination of the bank.

Consumer Protection Agencies

CFPB Describes Its Bank Supervision Plans

As of July 21, 2011, the Consumer Financial Protection Bureau "will be a cop on the beat - examining banks and protecting consumers," said Elizabeth Warren, former Special Advisor to the Secretary of the Treasury on the CFPB. To help begin performing its oversight function, on July 12, 2011, the CFPB outlined its approach to supervising "large depository institutions" for compliance with certain federal consumer financial protection laws.

The CFPB's bank supervision program will oversee 111 insured depository institutions, and their subsidiaries and affiliates. Each of these institutions has more than \$10 billion in total assets, and collectively account for 80 percent of banking assets in the United States. The CFPB plans to supervise and examine these large institutions through teams formed from more than 100 experienced examiners on staff who were largely recruited from the banking agencies. Examiners will be managed out of satellite offices in Chicago, New York, San Francisco, and Washington, DC. It eventually plans to have several hundred examiners.

CFPB supervision will be on-going, with pre-examination scoping and review of information, data analysis, on-site examinations, and regular

communication with regulated entities and their prudential regulators. For the largest and most complex banks, the CFPB will implement a year-round supervision program that will be customized to reflect the consumer protection and fair lending risk profile of the organization. The CFPB indicated that monitoring will be a constructive process, ensuring that consumer risks are addressed and compliance programs are strengthened.

During an examination, the CFPB will review an institution's internal procedures and conduct interviews to assess the institution's ability to detect, prevent, and remedy violations that may harm consumers. The institution's compliance with requirements "during the entire life cycle of the product or service will be reviewed, including how a product is developed, marketed, sold and managed." Fair lending reviews will be conducted to detect and address potential discriminatory practices.

In the coming weeks, the CFPB will communicate additional details of its supervisory policies and procedures and conduct informational roundtables. It also will post on its website its initial Examination Manual.

CFPB Releases Bulletin Regarding Amendments to the Alternative Mortgage Transaction Parity Act

On June 27, 2011, the CFPB released a bulletin describing Dodd-Frank Act amendments to the Alternative Mortgage Transaction Parity Act (AMTPA), which became effective on July 21, 2011 (Transfer Date). AMTPA was enacted in 1982 to authorize state-chartered or-licensed "housing creditors" to make variable rate loans and other alternative mortgage transactions that would otherwise have been prohibited by state law, so long as the creditors comply with certain federal regulations. Dodd Frank transferred enforcement of AMPTA to the CFPB from the OCC, National Credit Union Administration and Office of Thrift Supervision.

Dodd Frank also amended AMPTA to include language describing which state laws affecting alternative mortgage transactions are preempted by AMPTA. AMPTA will no longer preempt certain general state restrictions on mortgage transactions, including restrictions on prepayment penalties or late charges.

The amendments to AMPTA do not affect any alternative mortgage transaction made on or before the Transfer Date.

FTC Issues Final Rule Banning Deceptive Mortgage Advertising under the Card Act

On July 19, 2011, the Federal Trade Commission (FTC) issued a final rule banning deceptive mortgage advertising. The rule prohibits persons from making material misrepresentations in commercial communications regarding the terms of mortgage credit products, including, but not limited to: interest charged, the annual percentage rate; existence and nature of fees, payment terms, prepayment penalties, association of the provider with a government agency or government benefit, and preapproval.

The rule applies to persons and entities subject to the FTC's jurisdiction, including non-bank mortgage lenders, mortgage brokers, mortgage servicers, real estate brokers, advertising agencies, home builders, lead generators, rate aggregators, and any other for-profit company that may market or advertise mortgage products. The FTC, CFPB, and state attorney generals all have authority to enforce the rule. The rule also imposes a 24-month recordkeeping requirement.

The final rule is effective August 19, 2011.

Commodity Futures Trading Commission

CFTC Begins to Issue Final Rules on Swaps

On July 7, 2011, the CFTC held the first of several planned meetings to adopt final rules that implement the OTC derivatives regulatory provisions in Title VII of the Dodd-Frank Act. The next meetings are scheduled for July 19, August 4, September 8 and September 22, 2011.

At this first meeting, the CFTC issued five final rules that address consumer privacy, anti-fraud and anti-manipulation for swaps, the definition of "agricultural commodity" and large trader reporting for physical commodity swaps. More detail regarding each of these rules appears below.

The final rules provide insight into how the CFTC plans to phase in effective dates for the final rules and require compliance by the entities it has regulated or will regulate under new authority. Entities that were regulated by the CFTC before the Dodd-Frank Act -- e.g., futures commission merchants (FCMs), clearing agencies, commodity pool operators, commodity trading advisors, introducing brokers and retail foreign exchange dealers (existing registrants) -- will become subject to the Dodd-Frank final rules on a faster track than newly regulated entities -- e.g., swap dealers and major swap participants (MSPs) -- which do not yet have core rulemakings in place. For at least one rulemaking (large

trader reporting for physical commodity swaps), the CFTC also authorized its staff to accept non-compliant reports or to further delay compliance for swap dealers and MSPs by up to six months.

The length of waiting period that runs before a final rule becomes effective for existing registrants differs depending on the rule. The consumer privacy rules become effective on September 20, 2011, but compliance is not required for existing registrants until November 21, 2011, which is 120 days after the effective date. Large trader reporting for physical commodity swaps does not have a delayed compliance date. It goes effective and compliance is required for existing registrants -- clearing agencies and clearing members that are not swap dealers or MSPs -- on September 20, 2011. In the latter case, however, the CFTC provided its staff with authority to permit noncompliant reporting for up to six months, if a good faith attempt is made to comply.

For swap dealers and MSPs that will be regulated, but are not yet defined by regulation, the CFTC has tied the effective date for rules applicable to swap dealer/MSPs to the effective date of the yet-to-be issued final rule that contains definitions of swap dealer/MSPs. The

consumer privacy rule will apply to swap dealers and MSPs 60 days after the final rule regarding swap dealer and MSP definitions itself becomes effective. Swap dealers that are not clearing members have to comply with the large trader reporting final rule on the same date that the final rule defining swap dealers/MSPs becomes effective. However, CFTC may extend the compliance date for six months more for certain swap dealer/MSPs.

CFTC Approves Final Anti-Fraud and Anti-Manipulation Rules

On July 7, 2011, the CFTC approved final rules that broadly prohibit fraud and manipulation in connection with swaps, commodities and futures under new authority provided in the Dodd-Frank Act. The final rules are substantially the same as the proposed. However, the CFTC also provided important "clarification and interpretive guidance" in the preamble to these rules that helps explain the scope of these expanded prohibitions. These anti-fraud rules interpret one of the few Dodd-Frank Title VII provisions that became effective for all types of derivatives, including swaps, on July 16, 2011. The final rule becomes effective on August 15, 2011.

There are two subparts to this enforcement and market conduct final rule.

Final Rule 180.1 prohibits fraud and fraud-based manipulations and attempts: (1) by any person (2) acting intentionally or recklessly (3) in connection with (4) any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity (as defined in the CEA)..." Intentional or reckless conduct can qualify as fraud or manipulation. Note that this type of fraud can occur without the intent to commit fraud and without success in creating an artificial price. However, good-faith mistakes or negligence will not constitute a violation of the final rules under any circumstance.

The approach taken in the anti-fraud rules for swaps follows the spirit of longstanding 10b-5 securities fraud jurisprudence. The CFTC plans to be guided by 10b-5 precedent, after taking into account differences between

This approach to effective dates and compliance indicates a willingness by the CFTC to provide longer phase in dates for swap dealer/MSPs that will be newly regulated by the CFTC or the SEC. If the agency continues to tie the effective dates for various rules that impact swap dealer/MSPs to the definition of swap dealer/MSP, this could require a rapid compliance build out once final definitions defining these entities appear.

the securities markets and the derivatives markets. However, this should not be construed as creating new disclosure obligations. The CFTC underscored that this rulemaking does not impose "any new affirmative duties of inquiry, diligence, or disclosure...(except, as provided by section 6(c)(1), as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect)." In other words, silence is not deceptive within the meaning of Rule 180.1, unless there is a pre-existing duty to disclose.

Other clarifications of differences between CFTC anti-fraud and securities anti-fraud were provided particularly regarding insider trading. Derivatives market participants may continue to trade on the basis of "lawfully obtained material nonpublic information," unless is so trades in breach of a preexisting duty or obtained the information through fraud or deception.

The CFTC plans to apply its anti-fraud authority broadly over many markets and transactions. This means coverage of "transactions related to the futures or swaps markets, or prices of commodities in interstate commerce, or where the fraud or manipulation has the potential to affect cash commodity, futures, or swaps markets or participants in these markets."

Final Rule 180.2 repeats the statutory standard in Dodd-Frank which states that "[i]t shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity." This

standard requires intent, and reckless conduct does not constitute a violation.

The CFTC will follow the "traditional" four-part test for manipulation that has developed in case law under 6(c) and 9(a)(2) of the Commodity Exchange Act, i.e., "(1)

that the accused had the ability to influence market prices; (2) that the accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand; (3) that artificial prices existed; and (4) that the accused caused the artificial prices."

CFTC Issues Final Rule Defining "Agricultural Commodity"

On July 13, 2011, the CFTC issued a final rule to define the term "agricultural commodity" which provides a basis for bringing agricultural swaps and options into regulation as swaps. The major regulatory impact of this is that eligible agricultural swaps would be subject to: (i) centralized execution, (ii) centralized clearing, and (iii) reporting and recordkeeping requirements. Swap dealers and MSPs that are counterparties to agricultural swaps must follow the enhanced business conduct and other rules applicable to all swaps, as well. Finally, agricultural swaps will be subject to position limits and enforcement provisions.

An agricultural swap is defined as a "swap" in an "agricultural commodity" under Section 723(c)(3) of Dodd Frank. The final rule just issued addresses one part of this two part definition. A separate proposed

joint release by the CFTC and SEC will provide a definition of "swap." This final rule also ties into several other proposed rules on agricultural swaps issued by the CFTC.

The final rule adopts a definition that is "in essentially the same form as originally proposed, subject to a minor revision to the commodity-based index provision." It contains a four part definition of agricultural commodity that, at its most general, covers "all commodities that are, or once were, or are derived from, living organisms, including plant, animal and aquatic life, which are generally fungible, within their respective classes, and are used primarily for human food, shelter, and animal feed or natural fiber," other than onions.

The final rule will become effective on September 12, 2011.

CFTC Adopts Final Rule on Business Affiliate Marketing and Disposal of Consumer Information

On July 7, 2011, the CFTC approved regulations to implement new statutory provisions in Dodd-Frank that require CFTC-regulated entities to provide consumers with the opportunity to prohibit affiliates from using certain information to make marketing solicitations to consumers. They also require CFTC-regulated entities that possess or maintain consumer information in connection with their business activities to develop and implement written policies and procedures for the proper disposal of such information

The rule will apply to futures commission merchants, retail foreign exchange dealers, commodity trading

advisors, commodity pool operators, introducing brokers, swap dealers and major swap participants.

The final rule becomes effective on September 20, 2011, and has staggered compliance dates. Futures commission merchants, commodity pool operators, commodity trading advisors, introducing brokers, and retail foreign exchange dealers must comply with the rule by November 21, 2011. The rules will not become effective for swap dealers or major swap participants until 60 days after the effective date of the final entities definition rulemaking.

CFTC Issues Final Rule on Privacy of Consumer Financial Information

On July 7, 2011, the CFTC approved a final rule that applies certain privacy protections for consumer financial information to existing registrants, such as futures commission merchants (FCMs), and to new registrants, such as swap dealers and major swap participants (MSPs). Swap dealers and MSPs will have to adopt policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information.

The amendments that affect existing CFTC registered entities are minor and will not require that these entities materially alter their compliance programs, according to the CFTC. This part applies only to nonpublic personal information about individuals who obtain financial products or services primarily for personal, family, or household purposes from the institutions listed below. It does not apply to information about companies or about individuals who obtain financial products or

services primarily for business, commercial, or agricultural purposes.

The final rule applies to all FCMs, retail foreign exchange dealers, commodity trading advisors, commodity pool operators, introducing brokers, major swap participants and swap dealers that are subject to the jurisdiction of the CFTC, regardless whether they are required to register with the CFTC.

The final rule has staggered effective dates. The rule becomes effective on September 20, 2011. Futures commission merchants, commodity pool operators, commodity trading advisors, introducing brokers, and retail foreign exchange dealers must comply with the rule by November 21, 2011. The rules will not become effective for swap dealers or MSPs until 60 days after the effective date of the final swap dealer/MSP definition rulemaking.

CFTC Approves Final Rule on Large Trader Reporting for Physical Commodity Swaps

Section 730 of the Dodd Frank Act requires a person to submit a large trader report if they have or will enter a swap that the CFTC determines "to perform a significant price discovery function with respect to registered entities" and that exceeds a daily position limit set by the CFTC. Specific books and record keeping requirements also could apply to these positions. This is a general authority to require large trader reporting for swaps.

On July 7, 2011, the CFTC approved a final rule on that requires large trader reports for cleared and uncleared physical commodity swaps. This final rule becomes effective on various dates depending on the regulatory status of the reporting party.

The final rule creates a position visibility reporting regime that is similar to current reporting obligations for large bona fide hedgers. Once effective, it will require position reports for swaps that are economically equivalent to physical futures and options listed on designated contract markets (DCMs) that exceed certain

visibility thresholds. These large trader reports will be required routinely from clearing organizations, clearing members and swap dealers and as warranted from large swap traders. A proposed rule on this matter was issued on November 2, 2011.

The new reporting requirement is described as permitting surveillance of economically equivalent physical commodity futures, options and swaps, to supplement the large trader reports for listed physical commodity futures and options that the CFTC now receives from derivative clearing organizations. It also will serve as a transitional tool for swaps positional data until swap data repositories can collect the same information. The final rule contains a sunset provision that will end the reporting requirement after the SDR for physical commodity swaps are operational and supply data that substitutes for the large trader reports.

The rule will become effective on September 20, 2011.

CFTC Holds Second Final Rulemaking Meeting and Approves Three Final Rules and Two Proposed Rules on Swaps

On July 17, 2011, the CFTC held a public meeting and approved three final rules implementing Title VII of the Dodd-Frank Act, and two proposed rules that were not required by Dodd Frank. The discussion below touches on key aspects of each rulemaking, effective dates and other notable issues arising in the CFTC's hearing on the rules, or in the rulemaking releases.

Process for Review of Swaps for Mandatory Clearing (final rule, effective September 26, 2011).

This rulemaking puts in place the steps that a derivatives clearing organization (DCO) and the CFTC must follow to determine that a swap, group, category, type of class of swap is "required to be cleared." This determination is the trigger for mandatory centralized clearing of swaps, one of the key goals of derivatives regulatory reform. The final rule also creates procedures for determining that a DCO is eligible to clear a swap, although it also states that a DCO is presumed eligible to clear any swap that is within a group, category, type or class of swaps that it already clears.

The timing for action under this regulation was discussed in the release and by the CFTC commissioners at the public meeting. The CFTC plans to conduct DCO eligibility reviews before reviewing the swaps that the DCO plans to accept for clearing. For mandatory clearing determinations, Chairman Gensler suggested that the agency would first review listed swaps that were listed for clearing on July 21, 2010, and therefore were deemed by statute to be submitted for mandatory clearing determinations. He identified these swaps as interest rate swaps and certain broad based index credit default swaps, energy swaps and agricultural swaps. After the CFTC has complete information on a submission, it will have 90 days to make a mandatory clearing determination, although extensions are possible. Assuming the agency stays within these parameters, it is possible, in theory, for the first mandatory clearing determinations for swaps to appear in the next six months. The need for the CFTC to make DCO eligibility determinations before mandatory

clearing decisions seems likely to extend this time frame, however.

After pre-enactment swaps are evaluated, the CFTC plans to review swaps that a DCO commenced clearing after July 21, 2010, or that it wants to begin clearing. It does not plan to initiate review of swaps for mandatory clearing until after these reviews are complete.

The CFTC has authority to control phase in of the clearing requirement, even after it makes a "required to be cleared" determination. On request from a counterparty or on its own initiative, the CFTC can stay a clearing requirement for 90 days (or longer if the DCO agrees to an extension) in order to complete reviewing the terms of a swap or group, category, type of class of swaps, and the clearing arrangements for that swap.

The CFTC did not directly address several controversial issues regarding the mandatory clearing requirement raised by commenters. These include whether intra-affiliate transactions require mandatory clearing, treatment of swaps submitted for clearing under the clearing requirement but that fail to clear and the extraterritorial reach of the clearing mandate. The CFTC said that these issues are outside the scope of the regulation and will consider how to address them separately.

This rule will become effective on September 26, 2011. At that time, any swap or group, category, type or class of swaps listed for clearing by a DCO shall be deemed submitted to the CFTC for a mandatory clearing determination. A DCO also may request mandatory clearing determinations for other swaps that it plans to accept for clearing.

Provisions Common to Registered Entities (Final rule, effective September 26, 2011)

This rule makes various regulatory changes for registered entities that are often considered market facilitators or infrastructures, i.e., designated contract markets, swap execution facilities, derivatives clearing

organizations (DCOs) and swap data repositories. It provides procedures for registered entities to obtain approval of new contracts, rules or rule amendments. Substantively, it prohibits listing and clearing of war, terrorism or gaming related event contracts. The final rule also provides procedures for systemically important DCOs to adopt risk related rules.

Removal of References to Credit Ratings from Commission Regulations (Final rule, effective September 23, 2011)

This final rule removes references to credit ratings from two regulations and substitutes alternative standards, such as a fixed dollar capital threshold or a new term "credit-worthiness." The final rule will apply to futures commission merchants (FCMs), DCOs and commodity pool operators (CPOs). Highlights include (i) changes to the qualifications that non-U.S. banks must meet before it may take customer funds from an FCM or DCO (regulatory capital exceeds \$1 billion) and (ii) different disclosures by CPOs for use of customer money.

Customer Clearing Documentation and Timing of Acceptance for Clearing (Proposed rule)

Although Dodd-Frank does not require a rulemaking on this topic, the CFTC proposed this rule to address certain customer access and privacy concerns regarding clearing. The rule would prevent FCMs, swap dealers and major swap participants (MSPs) that are clearing members of DCOs from (i) disclosing the identity of a customer's original executing counterparty (CP), (ii) limiting the number of CPs that a customer may trade with, (iii) limiting the overall size of the position that a customer may enter, other than by virtue of an overall credit limit, (iv) impairing a customer's access to trading

on terms that have a "reasonable relationship to best terms available," and (v) preventing compliance with specified time frames for acceptance of trades into clearing. The fact sheet describes this rule and facilitating customer access to clearing and minimizing the time between submission and acceptance or reject of trades for clearing by DCOs and clearing members. It does not require automatic trade processing.

The CFTC staff and commissioners specifically referred to the FIA ISDA clearing agreement when discussing this proposal at the hearing. Commissioners O'Malia and Somers opposed this rulemaking because it is not required by the Dodd-Frank Act.

Clearing Member Risk Management (Proposed rule)

This rulemaking was not required by the Dodd-Frank Act, but was proposed by the CFTC as a corollary to risk management rules for DCOs. It adds risk management standards for FCMs, swap dealers and MSPs that are clearing members of DCOs. These clearing members would have to adopt their own credit and market risk limits for trades that are based on position size, order size, margin requirements or similar factors. Monitoring for compliance with these limits must occur intra-day and overnight, and should permit cancellation of trades that are not compliance. The risk management policies must include stress testing, monitoring its ability to liquidate positions it clears in an orderly manner monthly and testing all lines of credit at least quarterly.

Securities And Exchange Commission

SEC Proposes Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants

On June 29, 2011, the SEC proposed rules that would impose new external business conduct standards on security-based swap dealers (SBS Dealers) and major security-based swap participants (Major SBS Participants) in their dealings with counterparties, including additional standards for counterparties that are "special entities." The proposed rules would implement Section 764 of the Dodd-Frank Act.

In her opening remarks at the meeting, Chairman Mary Schapiro stated that the standards proposed are intended to establish a framework that protects investors and also promotes efficiency, competition, and capital formation. They are also intended to take into account the nature of the security-based swap market and existing business conduct requirements applicable for broker-dealers and other market participants. She emphasized that the SEC Staff has worked closely with CFTC staff in consulting with the public and other regulators including the Department of Labor.

Among other things, the Chairman indicated that the proposed rules would require SBS Dealers and Major SBS Participants "to communicate in a fair and balanced manner and to disclose conflicts of interest and material incentives to potential counterparties. Additional requirements would be imposed for dealings with special entities, which include municipalities, pension plans, endowments and similar entities." The Chairman noted in particular, that when acting as counterparty to a special entity, an SBS Dealer or Major SBS Participant would need to have a reasonable basis to believe that the special entity has a qualified independent representative that can help it assess the transaction. If the security-based swap is an employee benefit plan subject to ERISA, the independent representative would also be required to be a fiduciary. In addition, an SBS Dealer that is acting as an advisor to a special entity would need to act in the best interests of the special entity.

Other requirements in the proposal would require SBS Dealer or Major SBS Participants to:

- verify that counterparties are eligible contract participants and identify any special entities;
- disclose, before entering into a security-based swap, to the counterparty information concerning the security-based swap so as to allow the counterparty to assess its material risks and characteristics, material incentives or conflicts of interest;
- provide daily mark of the security-based swap to the counterparty;
- establish, maintain and enforce a system to supervise its business and its associated persons;
- designate a chief compliance officer;
- make reasonable efforts to obtain information (e.g., the special entities' financial and tax status) that is needed to make a reasonable determination that a security-based swap is in the best interest of the special entities;
- make appropriate and timely disclosures to the special entity of material information regarding the security-based swap, and
- provide a written representation regarding fair pricing and the appropriateness of the security-based swap.

Pay to Play

The proposal would prohibit an SBS Dealer from engaging in security-based swap transactions with a "municipal entity" if certain political contributions have been made to officials of the municipal entity. In the context of security-based swaps, the concern is that pay to play practices may result in municipal entities entering into transactions not because of hedging needs or other legitimate purposes, but rather because of campaign contributions given to an official with influence over dealer selection. The proposed rule is meant to create a comparable regulatory framework to that under Advisers Act Rule 206(4)-5 and MSRB Rules G-37 and G-38, as there are no existing federal pay to play restrictions that would apply to all SBS Dealers in their dealings with municipal entities process. The comment period closes on August 29, 2011.

SEC Temporarily Exempts Security-Based Swaps from Exchange Act Requirements

On July 1, 2011, the SEC issued an Order and an interim rule granting temporary exemptions for security-based swaps from numerous Exchange Act requirements and provided additional guidance to clarify which securities laws will apply to security-based swaps as of July 16, 2011, the effective date for many Title VII provisions of Dodd Frank.

The SEC's Order states that a substantial number of the Exchange Act's requirements applicable to securities will not apply to security-based swaps as of the effective date. The Order's temporary exemption will be available to any person who meets the definition of "eligible contract participant" that was in effect as of July 20, 2010, so as to provide relief to persons currently participating in the security-based swap markets.

The SEC Order provides additional guidance regarding the status, as of the effective date, of certain provisions of Title VII that address security-based swaps. The guidance identifies provisions for which compliance will be required on the Effective Date, or if compliance is

predicated upon some other action, such as agency adoption of final rules.

The interim final rules exempt security-based swaps from provisions of the Securities Act of 1933 (Securities Act), the Exchange Act and the Trust Indenture Act of 1939. The SEC's interim final rules grant certain temporary exemptions in order to permit security-based swap transactions with persons who are eligible contract participants (as that term is currently defined), and relating to the operation of trading platforms for security-based swaps to continue.

Security-based swaps would, however, continue to be subject to anti-fraud provisions of the Securities Act.

The Order was effective on July 1, 2011, and the interim final rules were effective on July 11, 2011. Both will remain in effect until the compliance date for final rules the SEC may adopt defining "security-based swap" and "eligible contract participant."

Financial Stability Oversight Counsel

FSOC Adopts Final Rule Regarding Designation of Financial Market Utilities as Systemically Important

The Financial Stability Oversight Council (FSOC) adopted a final rule setting forth the criteria and framework that it will use to determine whether a financial market utility (FMU) should be designated as systemically important, or likely to become systemically important, in accordance with Title VIII of the Dodd-Frank Act. 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." An FMU is systemically important if a "situation where the failure of or 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."

FSOC intends to use a two-stage process for evaluating FMUs prior to a vote of proposed designation. The first stage will consist of a primarily data-driven process for FSOC to identify a preliminary set of FMUs. In the second stage, the FMUs identified through the first stage of review will be subject to a more in-depth review, with a focus on qualitative factors. Those FMUs that advance to stage two will receive confidential written notification from FSOC that they are under consideration for

designation as systemically important. An FMU may voluntarily submit written materials in response and may request a hearing within 30 days of receiving FSOC's notice.

In determining whether an FMU should be designated as systemically important, the final rule provides that FSOC must consider, among other things: (1) the aggregate monetary value of transactions processed by the FMU; (2) the aggregate exposure of the FMU to its counterparties; (3) the relationship, interdependencies or other interactions of the FMU with other FMUs or payment, clearing or settlement activities; (4) the effect

that the failure of the FMU would have on critical markets or the broader financial system. Upon consideration of the above factors, FSOC must approve by a two-thirds vote whether to designate an FMU as systemically important. FSOC must then provide the FMU with written notice of its final determination.

The rule is effective on August 26, 2011, and applies only to the designation of FMUs. FSOC plans to address the designation of payment, clearing or settlement activities as systemically important in a separate rulemaking.

Government Accountability Office

GAO Report on Volcker Rule Proprietary Trading Ban -- A Challenge to Implement

On July 13, 2011, the Government Accountability Office (GAO) issued a report on proprietary trading by U.S. bank holding companies as required by the Dodd Frank Act. The report answers two questions: (1) what is known about the risks associated with proprietary trading and the potential effects of the Volcker restrictions and (2) how can do regulators oversee such activities. This report provides insight into how regulators might enforce the Volcker Rule ban on proprietary trading in all but certain types of instruments by conducted by banks and their affiliates, and through investments in hedge funds or private funds that pursue certain investment strategies.

The GAO analyzed data on stand-alone proprietary trading desks at the six largest U.S. bank holding companies from June 2006 through December 2010. It concludes that, compared to overall revenues, the stand-alone proprietary trading desks produced small revenues in most quarters and some larger losses during the financial crisis. Within this set of data, outsized single quarter gains and losses arose at one institution in particular.

The responses by GAO to these questions were fairly straightforward: (i) at stand-alone proprietary trading desks, the biggest risk is that you can lose more money

than you make and (ii) there are concerns among the largest banking organizations that restrictions on proprietary trading could reduce the ability of banks to reduce risks in other areas, harm the global competitive position of US banks, and reduce the amount of liquidity in markets. The GAO considered these possibilities and could find no information that would validate those concerns. As for the regulators, the GAO found they faced a number of "challenges" in drawing lines between prohibited proprietary trading and permitted market-making, underwriting, hedging and customer driven activities. The biggest part of the challenge is the regulators getting comprehensive information necessary to monitor compliance.

Highlights of Findings

While the GAO's report is essentially neutral in tone, it has some interesting information regarding the performance of stand-alone trading desks and on improvements in risk management at banking organizations. However on the key regulatory issue -- how to distinguish proprietary trading from market-making -- it acknowledges the challenge, but adds little to the debate for a solution.

- With respect to proprietary trading data, the GAO limited its analysis to that collected on stand-alone trading desks because firms did not separately maintain records of broader trading activity outside of these desks. From June 2006 through December 2010, the six largest bank holding companies that were studied had a combined net loss of about \$221 million. The GAO found that such amount was not significant when compared to losses in other areas during the crisis and quotes the FDIC as indicating they were not aware of any bank failures that had resulted from stand-alone proprietary trading. To paraphrase Shakespeare, much ado about not much.
- In reviewing how regulators supervised trading activities and how banking organizations managed their risks, the GAO noted that losses during the financial crisis have prompted banking organizations to improve their management of trading risks. The GAO noted that representatives of the bank holding companies indicated they now use VaR measures with longer time horizons that include a fuller range of economic cycles to increase their models' accuracy and consistency. Some are working to incorporate more complicated often illiquid,

assets into their VaR measures. Another institution had instituted a new policy to incorporate the warehousing risk from CDOs that arises during the period that an organization is accumulating the underlying securities per quarter per firm.

On the live issues of how to distinguish proprietary trading from market-making, the GAO indicated that its review had revealed that some institutions have pursued strategies that were a combination of client focused transactions and proprietary positioning that could be considered impermissible proprietary trading if not properly monitored. These transactions were described as one firm allowing its desk traders to hold inventory positions exceeding the amount necessary to facilitate client trades when the traders had a particular view on the direction of the market. But some may argue that such activities are market-making. This latter example underlines the broader point made by GAO that "regulations that further define what are and are not permitted activities, could significantly impact the scope of the new restrictions."

GAO Report on Mortgage Reform: Potential Impact of Dodd Frank on Homebuyers and the Mortgage Market

The Dodd Frank Act seeks to reform residential mortgage lending and securitization practices by various mechanisms. It provides minimum standards for mortgages which require lenders to determine that a consumer has a "reasonable ability to repay" at origination. A lender that issues a "qualified mortgage" is presumed to meet this requirement and receives some protection from liability. The Dodd Frank Act identifies nine criteria for defining a qualified mortgage. Dodd-Frank also requires loan securitizers to keep "skin in the game" or retain at least 5% of the credit risk of any securitized residential mortgages that are not qualified residential mortgages which fall within a category of lower risk of default.

The Dodd Frank Act requires the GAO to assess the potential impact of these mortgage provisions. The GAO examined mortgages originated from 2001 through 2010 to see which would have met five of the nine qualified

mortgage criteria, i.e., payment of loan principal, length of the mortgage term, scheduled lump-sum payments, documentation of borrower resources and borrower debt burden. There was insufficient data to examine the other four criteria.

The GAO generally found that most mortgages would have met the five qualified mortgage criteria. It noted that some consumer group suggest that the criteria could increase the cost and restrict the availability of mortgages for some borrower groups, including lower-income and minority borrowers.

The review of securitization noted that key regulatory decisions remain outstanding. Undecided factors such as which mortgages are exempted from risk retention, the forms of risk retention and amount required, could affect the availability and cost of mortgage credit and the viability of a private mortgage securitization market, it concluded.

GAO Report on Bankruptcy: Complex Financial Institutions and International Coordination Pose Challenges

On July 19, 2011, the GAO released a report on the effectiveness of the US Bankruptcy Code (Code) and current mechanisms for international coordination in bankruptcy cases as required by the Dodd Frank Act. The report addresses (1) the effectiveness of Chapters 7 and 11 of the Code for facilitating orderly resolutions of failed financial institutions; (2) proposals for improving the effectiveness of liquidations and reorganizations under the Code; and (3) existing mechanisms that facilitate international coordination under the Code and barriers to coordination of financial institution bankruptcies.

The GAO found that the effectiveness of the Code in resolving failed complex financial institutions is unclear for several reasons, including that criteria are not well-developed, data is lacking and financial institutions have complex activities and organizational structures. Experts agreed that maximizing asset values and minimizing systemic impacts are potential criteria for judging effectiveness, but the Code does not directly address systemic factors in bankruptcies.

Further the GAO found that even if criteria were established, few complex financial institutions have filed for bankruptcy. Those institutions that have filed for bankruptcy have only done so recently, which makes measuring effectiveness difficult. However, the report found that experts generally agreed that certain attributes of financial institutions complicated bankruptcy proceedings, such as highly liquid funding sources, use of derivatives, complicated legal structures that do not correspond to integrated, interconnected operating structures and international scope of operations.

The GAO's report also examined efforts to improve international coordination and found that the existing mechanisms are not comprehensive, and international coordination generally is limited, often because national interests can play a determining role in resolution outcomes.

GAO Report on Agency Resources for Implementing Dodd Frank Regulatory Reform

On July 14, 2011, the GAO released a report containing its testimony before the House Subcommittee on Oversight and Investigations, Committee of Financial Services, to report on eleven federal agencies' funding and staff resources associated with implementing Dodd-Frank in 2010, 2011 and 2012. The testimony focuses on (1) the agencies' funding estimates and the sources of funds associated with implementing the Act, (2) agencies' estimates of the number of new entities that will be created and the full-time equivalents (FTEs) they anticipate needing to carry out new responsibilities, and (3) challenges that the agencies faced in developing these estimates.

The amount of new funding the agencies reported as associated with implementing the Act varied significantly. For example, new funding resources related to Dodd-Frank responsibilities during the years 2011-2012 ranged from a low of \$0 for Federal Trade Commission (FTC) to a high of around \$329 million for Consumer Financial Protection Bureau (CFPB). Funding resources accounted for at least 25 percent of nine of the agencies' budgets. The GAO further found that, excluding the three agencies that Act created (CFPB, FSOC, and OFR), the CFTC devoted the highest share of total agency resources (25 percent) to implementing the Dodd-Frank provisions. The agencies reported to GAO that most of the costs related to implementing the provisions will be recurring.

The agencies are relying on a variety of sources to fund the implementation costs for the new provisions, including assessments and revenues, appropriations, offsetting collections, and transfers from other agencies. Six of the 11 agencies reported that their funding would be fully or partly met by assessments imposed on regulated institutions or revenues from their operations. Three others reported that they would have to rely at least partly on appropriations.

Nearly all the agencies plan to have some staff work specifically on responsibilities related to the Act.

Agencies can hire new staff, redirect staff from other areas, or use staff transferred from other agencies. According to data from the agencies, FTEs related to implementing the Dodd-Frank provisions for the years 2011-2012 ranged from a low of 0 for FTC to a high of 1,225 for CFPB. Beyond the normal challenges associated with estimating resource needs in the future, agencies told the GAO that pending and evolving implementation actions, such as interagency transfers (e.g., from OTS to the OCC) and establishing new offices required by the Act, makes these estimates particularly uncertain and subject to change.

GAO Report on Private Fund Advisers and Self-Regulatory Organizations

On July 11, 2011, the GAO released a report that examines the feasibility of forming a self-regulatory organization (SRO) to provide primary oversight of private fund advisers. The report concludes that it is feasible to form a private fund adviser SRO, as evidenced by the creation and existence of other SROs. However, the GAO found that the formation of a private fund adviser SRO would require legislation and would not be without challenges.

Creating a private fund adviser SRO would involve advantages and disadvantages. The GAO concurred with a conclusion reached in an SEC study of private funds, namely that the SEC likely will not have sufficient capacity to effectively examine registered investment

advisers with adequate frequency without additional resources. The GAO found that a private fund adviser SRO could supplement SEC's oversight of investment advisers and help address SEC's capacity challenges.

The GAO also found, however, that an SRO would oversee only a fraction of all registered investment advisers. The SEC still would need to maintain the staff and resources necessary to examine the majority of investment advisers that do not advise private funds and to oversee the private fund adviser SRO, among other things. Furthermore, by fragmenting regulation between advisers that advise private funds and those that do not, a private fund adviser SRO could lead to regulatory gaps, duplication, and inconsistencies.

International Organizations

FSB Issues Consultative Document on Effective Resolution for SIFIs

On July 19, 2011, the Financial Stability Board (FSB) released a consultative document that proposes policies and timelines for the effective resolution of systemically important financial institutions (SIFIs). The FSB seeks comment on the following proposed recommendations:

- **Effective resolution regimes.** A national resolution regime should provide authorities with the ability to intervene safely and quickly to ensure

the firm can continue to perform its systemically important functions.

- **Bail-in powers.** Bail-in powers are elements of statutory powers within a special resolution procedure and possible contractual provisions to achieve resolution of the systemically vital functions of an ailing financial institution. Resolution authorities should have bail-in powers as part of their regime.

- **Cross-border cooperation.** Bilateral or multilateral cooperation agreements setting out how jurisdictions will cooperate over the resolution of individual firms are needed.
- **Resolvability assessments.** Resolvability assessments of each SIFI are needed to identify the changes needed to regimes, legal powers and individual firms.
- **Recovery and resolution plans (RRPs).** RRP should set out in advance the measures, in event of a crisis, that a firm could take to recover as a going concern or else that the authorities could take to resolve it an orderly way.
- **Improving resolvability.** Firms should, among other things, have procedures to install information systems that provide them and regulatory authorities with comprehensive information on an aggregate and entity level, enter into service level agreements with third party service providers that include provisions that prevent termination of the agreement in times of crisis, and streamline global payment operations.

The FSB also seeks comment on its proposed timeline for implementation of the above recommendations

Additional Information

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