Most nonfinancial companies are aware of the corporate governance provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act\(^1\) (Dodd-Frank, or “the Act”) that will require near-term changes related to proxy access, executive compensation, and whistleblower protections for all public companies. However, many companies may not have focused on other ways the Act will directly or indirectly impact their operations and strategy. At this early stage of implementation, the key question for many nonfinancial companies is “What is the Act’s potential impact on my business?”—whether in the form of more regulation, increased costs, or having to adapt to new structural features, ways of doing business, and managing risk in the financial markets.

\(^1\) The Dodd-Frank Wall Street Reform and Consumer Protection Act is one of the most comprehensive financial regulatory measures ever passed by Congress. Since the Act is focused primarily on improving regulation and oversight of the US financial system to lessen the chance of future financial crises, large financial institutions are its principal target. That said, the Act covers a lot of ground, reaching from Wall Street to Main Street and encompassing a broad swath of oversight and regulation that may have a significant impact on certain companies outside of the traditional financial services world (nonfinancial companies). The Act is composed of sixteen separate Titles covering everything from financial stability to mortgage reform, and provides for more than 500 rules, 60 studies, and 90 reports over the next 4 years to clarify and implement its requirements.
Some of the key “red-flags” that can indicate a nonfinancial company may be impacted by the Act include:

- Heavy use of derivatives to manage day-to-day business risks or as part of a trading portfolio
- Ownership of a commercial finance or leasing operation
- Operations involving the transfer, clearing, or settling of payments, securities, or other financial transactions among financial institutions, or the provision of IT support or infrastructure to such operations
- Use of securitization transactions involving asset-backed securities
- Ownership of a consumer finance operation where credit is extended to customers and principal risk is retained
- Direct or indirect ownership of a thrift institution, industrial bank, or limited purpose trust company

Companies will also need to consider potential changes in their relationships with financial institutions and credit rating agencies. New regulations will subject the largest financial institutions to more stringent capital requirements and leverage limits, and increase their overall compliance costs. Credit rating agencies will be subject to new internal control, governance, and liability exposures. The impact of these changes will take years to evolve fully, but may result in nonfinancial companies facing higher costs for obtaining funding for their operations and managing financial risks.

This A Closer Look provides context and perspective on areas of the Act of particular concern to nonfinancial companies.

**How to use this A Closer Look**

The corporate governance, executive compensation and over-the-counter derivatives provisions of the Act will impact virtually all companies. Other aspects of the Act will be important for only a limited number of nonfinancial companies with specific types of operations. This A Closer Look publication is organized topically so that readers can focus on those sections that may be relevant to their specific operations:

- Overview of the act
- Over-the-counter derivatives regulation
- Corporate governance and executive compensation
- Potential designation as systemically important to the financial system
- Securitization “skin in the game” regulation
- Consumer finance operations
- Subsidiaries and affiliates that may be subject to direct or increased regulation as financial institutions
- Changing relationships with banks and credit rating agencies
Overview of the act: focusing on the financial system and closing regulatory gaps

The Act embraces the concept of macroprudential regulation\(^2\) to identify and mitigate systemic risk and promote stability of the financial system as a whole. It also expands the regulatory net to include a diverse group of entities that were previously unregulated at the federal level—often called the “shadow financial system.” This group includes hedge and private equity funds; certain providers of payment, clearing, and settlement services; and a diverse group of state-licensed institutions that provide consumer credit and related services. To facilitate this new level of macroprudential supervision and expanded regulatory net, the Act creates two important new governmental entities.

The Financial Stability Oversight Council (FSOC)

The FSOC will designate which US and foreign nonbank financial institutions are considered “systemically important.” The FSOC is also charged with identifying and designating other types of entities that are systemically important to the US financial system, such as so-called financial market utilities (FMUs)—entities involved in a multilateral system for transferring, clearing, or settling payments. The FSOC can also designate payment, clearing, or settlement activities by financial institutions as systemically important. Technology service providers (TSPs)\(^3\) that provide critical IT services to systemically important financial institutions will also find themselves subject to increased regulation and oversight.

The Act contains no definition for systemic risk or systemic importance, so these definitions will largely be left for the FSOC to determine. In testimony before the Senate Banking Committee, Federal Reserve Board Governor Daniel K. Tarullo stated, “[s]ystemic risk refers to the potential for an event or shock triggering a loss of economic value or confidence in a substantial portion of the financial system, with resulting major adverse effects on the real economy. A core characteristic of systemic risk is the potential for contagion effects.”

Designated companies will be required to register with the Federal Reserve Board (FRB), and the FSOC can make recommendations on standards to be applied by the FRB, including risk-based capital, leverage, and liquidity requirements; concentration limits and stress tests; resolution plan and credit exposure requirements; and advance notice of significant nonbank acquisitions, among other considerations.

The Consumer Financial Protection Bureau (CFPB)

The Act seeks to provide more coordinated and effective consumer protection through both structural changes and targeted efforts. Operating as a bureau of the FRB, the CFPB is devoted to the protection of consumers of financial products. It will have the authority to promulgate rules designed to ensure that US consumers receive clear, accurate information to help them evaluate mortgages, credit cards, and other financial products, and to protect them from hidden fees, abusive terms, and deceptive practices.

As further explained below, nonfinancial companies may have operations directly regulated by or indirectly impacted by FSOC and CFPB policies.

Over-the-counter derivatives regulation: stronger oversight of derivatives and the companies that use them

From Fortune 500s on down, nonfinancial companies use derivative instruments to hedge a range of risks, from interest rates and foreign currencies to commodities. Some nonfinancial companies also use derivatives for purely speculative purposes, seeking to profit from price movements. The Act’s objective in relation to over-the-counter (OTC) derivatives is to promote greater transparency and to moderate systemic risks in

\(^2\) Macroprudential regulation is geared to the development of rules and regulations—for example, capital requirements for institutions based on the risks they pose to the US financial system, or new protections for users of financial services and products.

\(^3\) Many TSPs are already subject to regulatory examination by the Federal Financial Institutions Examination Council (FFIEC) for compliance with IT systems standards.
order to minimize the recurrence of operational stresses and the excessive risk-taking Congress perceived as having occurred through OTC derivatives activities. The Act provides for comprehensive regulation of the OTC derivatives market by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC).

Nonfinancial companies will be impacted directly if they fall into one of the categories of derivative participants that are regulated directly by the CFTC or SEC, or they may be impacted indirectly via changes to the operating dynamics of the derivatives marketplace that will occur as a result of the Act.

**A sea change in the way the derivatives market operates.** The volume of unregulated OTC derivatives transactions across all industries has grown exponentially over the past decade to an estimated $615 trillion notional value today. Historically, OTC derivatives transactions have been executed privately between companies and their dealer (typically a bank), often taking the form of customized bilateral agreements with no uniformity for margin requirements. Under the Act, that private, customized marketplace is changing dramatically and will be replaced with more standardized products in a “public” market that provides transparency to transactions and pricing. Though this regulation lessens overall credit risk in the system, it will come at a cost to companies in terms of less customization and potentially higher margin and infrastructure costs.

For the first time, OTC derivatives will be regulated by the SEC and the CFTC. The Act broadly defines “swap” to ensure that the term encompasses interest rate swaps, foreign exchange swaps, credit default swaps, and many other derivatives transactions (swaps). The Act:

- Requires central clearing and exchange trading for derivatives that can be cleared, and provides a role for both regulators and clearing houses to determine which contracts should be cleared
- Requires that an OTC derivative that is subject to mandatory clearing and is also accepted for trading on an exchange or “swap execution facility” be executed on such exchange or facility
- Requires data collection and publication through clearing houses or swap data repositories to improve market transparency and provide regulators with important tools for monitoring and responding to risks
- Adds safeguards to the system by ensuring dealers and major swap participants have adequate financial resources to meet their responsibilities
- Provides regulators with the authority to impose capital and margin requirements on swap dealers and major swap participants

The impact of these structural changes cannot be overstated. It represents a sea change in the way the derivatives market operates today.

**What do the proposed changes mean?** By forcing a significant portion of swap transactions onto regulated central clearing houses, the Act concentrates the risk associated with non-performance at the clearing houses. The clearing house will now serve as the counterparty to each of the original parties to a swap. Regulators will be able to impose margin and collateral requirements for certain swaps and participants and will monitor the clearing houses carefully to ensure they are well-managed and well-capitalized. For users of swaps, regulated exchange trading and central clearing means:

- Increased standardization of swap instruments
- Margin and collateral requirements (unless exempted—see discussion below)
- Increased price and transaction transparency
What is central clearing?

While a bilateral trade puts counterparty risk solely on the two parties to the trade, clearing mutualizes risk among clearing members. Client clearing reduces counterparty risk by providing buy-side access to central clearing counterparties (CCPs) for clearing and settlement.

**Bilateral model (existing process)**

Client → Executing broker

Client faces executing broker directly

**Client cleared model**

Client → Clearing member → CCP

Client faces CCP through clearing member and executing dealer faces CCP (instead of client)

Note: CCPs require clearing members to post collateral (initial margin and variation margin) for all cleared trades, and to contribute to a guarantee fund.

**Which swaps must be centrally cleared?** The CFTC and the SEC are charged with reviewing each swap, or any group, category, type, or class of swaps, to determine whether mandatory central clearing is required. Any swap required to be cleared must be executed on a regulated exchange or a swap execution facility (SEF), a facility that accepts bids and offers made by multiple participants. In the case of highly customized swaps that are not suitable for clearing, and in situations where an exchange or SEF is unwilling to list a particular swap, the counterparties will still be required to comply with any relevant CFTC or SEC record-keeping and reporting requirements, as well as applicable capital and margin requirements.

A number of credit and interest rate swaps are currently eligible for central clearing and more are expected to migrate to exchanges as the regulators complete their review. However, debate continues about which swaps should be subject to the central clearing requirement. In early November 2010, the Treasury Department issued a notice seeking public comment on whether foreign exchange swaps and forwards⁴ should be exempt from the regulations being developed by the CFTC.

**Who will be directly regulated in the swaps market?**

**Swap dealers and major swap participants.** The Act focuses most of the regulation and oversight regarding derivatives on the activities of swap dealers and major swap participants (MSPs), a newly defined category of entities. While it is not expected that many nonfinancial companies will be considered dealers or MSPs, the current lack of clarity regarding those definitions raises concerns.

A swap dealer is a market-maker that holds itself out as a dealer in swaps and regularly enters into swaps contracts. An MSP is any entity that is not a swap dealer and meets any of the following criteria:

- Maintains a substantial position in swaps (to be defined by the CFTC and SEC)
- Has a substantial counterparty exposure that could have serious adverse effects on the stability of the US banking system or financial markets

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⁴ The foreign exchange market makes up a very large portion of the total OTC market; the New York Federal Reserve reported there was $675 billion in average daily volume in October 2009. Foreign exchange swaps and forwards are different from other kinds of complex derivatives, and some consider them to be less risky. Unlike currency swaps, in which a payout to a counterparty can change based upon fluctuating currency rates, foreign exchange swaps and forwards entail simply an exchange of currency at a fixed rate agreed upon ahead of time.
• Is a highly leveraged financial entity not subject to the capital requirements of any federal banking regulator and maintains a substantial swaps position

The major swap participant category is comprised of entities that are not swap dealers but whose participation in the swaps market is substantial enough to be relevant to the economy or the financial system as a whole.

By July 2011, the SEC and CFTC, in consultation with the FRB, will issue regulations and guidance on such topics as:

• Designation and registration of swap dealers and MSPs
• Minimum capital and initial and variation margin requirements on swap dealers and MSPs that are non-banking entities for all non-cleared swaps
• Business conduct rules for swap dealers and MSPs
• Standards for swap confirmation, processing, valuation, netting, and documentation applicable to all swap dealers and MSPs and their counterparties, unless exempt

Uncertainty about MSP designations. The issue is that the definition of MSP is fairly broad and ambiguous and could scope in any number of entities, from hedge funds to energy and utility companies to global conglomerates. The legislation requires the CFTC and the SEC to define “substantial position” in a way that is prudent for the effective monitoring and supervision of systemically important entities. However, there is little guidance in the Act to indicate how exactly that will be determined. For example, will “substantial position” be determined across affiliated entities or will it be determined on an entity-by-entity basis (e.g., long positions against short positions within a single portfolio)? And what constitutes “substantial counterparty exposure”? These terms are still to be defined, but the Act does state that in making MSP designations, regulators may take into account the value and quality of collateral held against counterparty exposure.

It is important to note that the MSP designation can apply for a certain category of swaps but not for others. For example, it is possible for a given company to be classified as an end-user with respect to commodity swaps, a swap dealer with respect to credit default swaps, and an MSP with respect to interest rate swaps. It appears that determination of whether an entity qualifies as an MSP will have to be made on a case-by-case basis after extensive review and analysis of a particular company's swap activities. Companies across a variety of industry sectors—including energy, technology, and certain industrial product companies—could be vulnerable to MSP designation, particularly if they maintain large swap positions in specific commodities that could potentially move the market for those instruments.

To ensure that a practical process or mechanism will be applied in determining whether a company will be regulated as a swaps dealer or MSP, companies should closely monitor and actively engage in the rulemaking process in the coming months, and work to influence the development of key definitions such as “substantial position” and “substantial counterparty exposure.”.

What will it mean to be designated as a swap dealer or major swap participant?

Capital and margin requirements. Designation as a swap dealer or MSP will mean new (or in some cases additional) minimum capital standards comparable to those applicable to banks. Regulators will have the authority to review all activities of the swap dealers and MSPs, potentially including unregulated activities of affiliates or subsidiaries, when setting those capital requirements.

The CFTC and SEC will also establish initial and variation margin requirements for the swap products, central clearing counterparties, and exchanges that they regulate. Every company designated as a swap dealer or MSP must centrally clear their swaps on a registered exchange (if the swap product has been accepted for listing by an exchange) and collect and post margin for their relevant swap transactions. These margin requirements, in addition to minimum capital standards, mean that dealers and MSPs will necessarily have less operating capital for other business objectives.

Companies may also need to bifurcate their swap portfolios between those that will subject them to clearing and margin requirements as an MSP and those that will be exempted under the commercial end-user
exemption (see discussion below). Companies may also need to have systems and processes in place to determine the fair value of swap positions on a daily basis in order to track and post or receive margin.

**Business conduct and reporting requirements.** In addition to risk exposure regulation, swap dealers and MSPs will also be subject to conduct regulation by the CFTC or SEC, such as disclosure and reporting requirements and business conduct standards. All swap dealers and MSPs will also be required to maintain certain records (daily trading records, recorded communications, audit trails, etc.) and make mandated disclosures to counterparties regarding material risks, incentives, and conflicts of interest associated with a transaction. Maintaining compliance with this level of regulation will require significant record-keeping, administration, and control.

**Impact on commercial end-users of OTC derivatives: the “end-user exemption” and who qualifies**

**Exemption from clearing and exchange trading requirements.** The vast majority of nonfinancial companies use OTC derivatives to mitigate their commercial risks. These commercial end-users have been concerned throughout Dodd-Frank’s development that its objective of requiring more standardized contracts to be cleared and traded on exchanges would result in increased costs due to increased margin and collateral charges. The Act exempts commercial end-users from the mandatory clearing and exchange trading requirements as long as they notify the CFTC or SEC of how they meet their financial obligations associated with non-cleared swaps. The Act also specifies that a public company must obtain the approval of the relevant committee of its board of directors in order to use the exemption.

**Uncertainty regarding definitions.** Commercial firms must keep in mind that the conditions for the exemption could actually pose problems, depending upon how the implementing rules are finalized. For example, to be exempt, a commercial end-user must be hedging or mitigating commercial risk. The Act itself does not define or provide parameters on what constitutes “hedging or mitigating commercial risk,” so there is concern that regulators may interpret it narrowly. The Act also says that any “financial entity” is ineligible for the end-user exemption; therefore, if a company is a financial entity (a definition that includes MSPs), then it cannot be a commercial end-user. Accordingly, it is not enough to simply hedge commercial risk to be exempt; the hedging party must not be a financial entity. How the regulators ultimately define and implement these terms may prevent some companies from availing themselves of the exemption.

Assuming a company qualifies under the end-user exemption, it is not required to use an exchange and centrally clear swap contracts unless it chooses to do so. Its transactions would continue to be executed in a manner similar to today’s market (however, see further discussion of uncertainties below). In contrast, a company using swap transactions for speculative purposes must use central clearing, if available, and comply with the regulator’s margin requirements.

**Additional uncertainty surrounding margin requirements, costs, and product availability.**

In crafting Dodd-Frank, legislators discussed an exemption from margin requirements for commercial end-users, but such an exemption was not, in fact, included in the final version of the Act. At issue currently is whether the CFTC has the authority to impose margin requirements on end-users even though their swap transactions are not required to be executed on exchanges or cleared through clearing houses. An interpretation of recent comments by CFTC Chairman Gary Gensler indicates that he believes the law grants the authority to impose margin requirements on end-user transactions. This adds another layer of uncertainty surrounding the use of derivatives for commercial risk mitigation and may be causing some companies to set aside funds “just in case” they need to begin posting margin.

Most commercial end-users currently do not have the infrastructure in place to assign fair value to swap positions on a daily basis in order to track and comply with margin posting requirements. If the regulators ultimately require margin posting only by swap dealers and MSPs, it is nonetheless expected that those entities will either pursue corresponding margin posting or otherwise pass their added costs on to their end-user customers, making it more expensive to transact in swaps.

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5 The Act defines a financial entity as any one of the following: a swap dealer or major swap participant, a person predominantly engaged in activities in the banking or financial sectors, a commodity pool or a private fund, or an employee benefit plan.
Another significant uncertainty is the impact that forced exchange trading will have on the standardization and availability of swaps. So, even though commercial end-users will have the option of choosing whether a swap should be centrally cleared, the Act’s required clearing for “standard” swaps may result in less liquidity and thus less competitive pricing for non-cleared, customized swaps.

**Potential accounting implications**

**Increased hedge ineffectiveness.** The changing market dynamics will impact the accounting for derivatives as well. It is unclear at this stage of the Act’s implementation which types of swap transactions will have to be centrally cleared (see discussion above regarding foreign-exchange swaps and forwards) and whether all centrally cleared swaps will be standardized. But for swaps that will be exchange traded, standardization is expected and will likely result in more hedging ineffectiveness, due to likely mismatches between hedged exposures and standardized derivatives, which may increase income statement volatility. For example, today a company can purchase a customized instrument that precisely matches debt maturity dates. In the future, exchanges will only carry standardized instruments which will likely not match the exact cash flows a company is looking to hedge. Companies will need to decide whether to accept the additional ineffectiveness that stems from using a standardized instrument or pay potentially more for a customized swap that minimizes ineffectiveness.

**More difficult to achieve hedge accounting treatment.** The standardization of derivatives may also limit a company’s ability to achieve hedge accounting treatment for certain instruments. For example, it will be less likely that hedging strategies would qualify for the “shortcut” and “matched critical terms” methods currently allowed under US generally accepted accounting principles (GAAP). As a result, companies willing to apply hedge accounting will have to consider implementing “long haul” hedge effectiveness methods. We note that the recent FASB Exposure Draft Accounting for Financial Instruments proposes to eliminate shortcut and matched critical terms methods altogether, so companies may need to switch to long haul methods in the future anyway.

**Changes to fair value measurement.** Any margin required to be posted with counterparties must be taken into consideration when computing the credit valuation adjustment to fair value derivatives. Balance sheet presentation may also be impacted if the requirements for the netting of derivatives and cash margin are not met. And for disclosure purposes, the fair value hierarchy level may change for derivatives that will be exchange traded, depending on the actual trading and pricing mechanisms that are ultimately used.

**What should companies do today?**

Be observant and engaged to influence regulators, and stay nimble to take advantage of changing marketplace dynamics. As rules continue to be debated and rolled out, new competition is entering the market and dealers are jockeying for position and dominance. For example, CME Group Inc., historically one of the largest dealers in commodity-linked derivatives, launched its new interest rate swap clearing service in October, ahead of a rival effort from London-based LCH Clearnet. Increased competition and better transparency may lead to more attractive pricing options for nonfinancial companies, even as product customization and availability potentially decrease.

The recent midterm elections in the US bring even more uncertainty to the table. Leadership changes in the House Financial Services Committee next year may mean further overhaul of the derivatives provisions of the Act, and regulators in the European Union are contemplating similar proposals for their derivatives markets. CFOs and treasurers will need to stay abreast of an evolving, fluid marketplace to manage risks in a cost-effective, capital-efficient manner.

**Corporate governance and executive compensation**

The Act includes a number of provisions related to corporate governance and executive compensation, which apply to all public companies without regard to industry. The provisions reflect the lawmakers’ focus on enhancing corporate accountability, and have the potential to shift significant governing power from boardrooms to shareholders. The new laws (and the associated rulemaking that will be forthcoming) will have a profound impact on the way corporate America structures compensation arrangements, discloses information about those arrangements, and seeks input from shareholders on the terms of executive compensation programs. This section covers the Act’s key provisions in this area.
Whistleblower incentives and protections

The Act’s intent is to increase the reporting of securities laws violations by enhancing existing rewards and protections for whistleblowers. The Act states that a whistleblower providing original information to the SEC that leads to a successful enforcement action resulting in monetary sanctions exceeding $1 million will be eligible for a reward of between 10 percent and 30 percent of the funds collected as sanctions. Whistleblower protections are also enhanced by allowing a whistleblower to sue a retaliating employer directly in federal court. There is a risk, however, that the provisions could create the unintended consequence of encouraging employees to report directly to the SEC rather than through internal channels, potentially undermining the integrity of existing whistleblower programs and making it more challenging for companies to address whistleblower events.

To address corporate concerns, the SEC recently proposed rules that will incent whistleblower employees to report allegations under their company’s internal compliance programs. The proposed rules would provide a 90-day grace period for employees to report under their own company’s compliance program while preserving their “place in line” with the SEC. The proposal also allows the SEC to consider higher percentage rewards for employees who report allegations internally first.

Corporate governance

Shareholder use of the proxy materials to nominate directors. Bolstered by authority provided in Dodd-Frank, on August 25, 2010, the SEC adopted changes to the federal proxy rules to facilitate the exercise of shareholders’ traditional state law rights to nominate and elect directors to company boards. Under certain circumstances, the new rules will require a company’s proxy materials to provide shareholders with information about, and the ability to vote for, potential directors who have been nominated by significant, longtime shareholders (defined as individuals who’ve owned “at least 3 percent of the company’s shares continuously for at least the prior three years”). This change should significantly lower the cost of nominating a director candidate to run against a nominee proposed by the board.

However, on September 29, 2010, the Business Roundtable and the US Chamber of Commerce challenged the legality of the SEC’s new proxy access rules. Without addressing the merits, the SEC exercised its discretion to defer the new proxy access rules pending resolution of the legal challenge. While the path forward for proxy access has been temporarily blocked, and may change depending on the outcome of the legal proceedings, this new development shines a bright light on the importance of directors strategizing with management on how best to engage their large shareholders on this issue. Directors also can take advantage of the deferral to consider with management whether the company is prepared for a proxy access situation, whether existing director eligibility criteria are appropriate, and if enhancements are needed to director qualifications disclosure in the proxy statement. It is expected that the legal issues will be resolved and the rule will be effective sometime in 2012.

Shareholder “say on pay” voting, including golden parachutes. Companies will be required to include a provision in certain proxy statements for an advisory shareholder vote on the compensation of executives, at least once every three years. Shareholders also will have a separate vote at least every six years on whether they want that “say on pay” vote to occur annually, biennially, or triennially. The proposals also require disclosure of any golden parachute arrangements in any proxy statement to approve a merger, acquisition, consolidation, or business sale. While nonbinding, it is expected that these requirements will apply greater pressure on boards to consider shareholder viewpoints in executive compensation decisions. The SEC issued proposed rules on the say-on-pay provisions on October 18, 2010. Rules are expected to be effective for the 2011 proxy season.

Independence of compensation committees and their advisors. The SEC must direct national securities exchanges to require that each member of a listed company’s compensation committee satisfy a heightened standard of independence, considering factors such as receipt of consulting or advisory fees, similar to the rules currently applicable to audit committee members. Moreover, the compensation committee now must be authorized to retain and oversee compensation consultants and other advisors in fulfilling its duties. Importantly, this oversight explicitly requires compensation committees to consider the independence of any consultants retained, placing additional pressure on boards and management in deciding which advisory firms to use and how to use them. Rules are expected to be adopted in the second quarter of 2011.
Restrictions on the voting of shares by brokers. New York Stock Exchange Rule 452 on broker voting was effective in June 2009 and was originally adopted to prevent brokers from casting their uninstructed votes for management-supported director candidates. The Act incorporates the NYSE rule by requiring national securities exchanges to prohibit member brokers from voting customer shares without first receiving voting instructions from the beneficial owner with respect to director elections, and expands the rule to cover votes on executive compensation and any other “significant matter” determined by the SEC. This will have the effect of reducing the influence of traditionally management-friendly brokers on these matters. Rules are expected to be proposed in the second quarter of 2011.

Executive compensation

Clawback requirements for incentive compensation paid to executives based on misstated financial statements. The SEC must direct national securities exchanges to require each listed company to implement and disclose a “clawback” policy mandating that if a company is required to restate its financial statements due to material noncompliance with relevant reporting requirements, the company must recover from current and former executive officers any excess incentive compensation based on the erroneous data and received during the three-year period preceding the date of the restatement. Rules are expected to be adopted in the second quarter of 2011.

Increased executive compensation disclosures. The SEC must issue rules requiring companies to describe clearly in annual proxy statements the relationship between executive compensation actually paid and the company’s financial performance. Companies will also need to disclose in their Form 10-K (i) the median of the annual total compensation of all the company’s employees except the CEO, (ii) the annual total compensation of the CEO, and (iii) the ratio of (i) to (ii). Disclosure will also be required related to hedging activity by employees or directors intended to offset any decrease in the market value of equity securities granted by the company. Rules are expected to be adopted in the second quarter of 2011.

Implementation challenges. As with most aspects of the Act still subject to rulemaking, many questions are still to be answered, particularly in regard to the executive compensation provisions. For example, will the three-year clawback start from the date the financial restatement is discovered, the date the accounting error was made, the date the restated financial statements are filed with the SEC, or some other date? What definition of “executive officer” will be applied for purposes of the clawback provision? Will the clawback apply to both cash and share-based compensation? Will it apply to annual bonuses where the bonus pool is based on non-GAAP operating performance, or only to longer-term deferred-compensation arrangements?

In computing the median annual total compensation, how should part-time, seasonal, and offshore employee compensation be treated? Should employee costs such as relocation, pension, and other benefits be included? Most companies do not currently have systems or processes in place to easily gather the specified definition of total compensation information for all employees.

Regulators will need to make important clarifications in future rulemaking to make these disclosures practical for companies to apply while still achieving the overall objective of increased transparency. Companies should begin to consider the impact of this additional transparency in terms of comparisons to competitors and the reaction of shareholders, employees, and other stakeholders.

Potential designation as systemically important to the financial system

In regulating systemic risk, the Act is primarily focused on large bank holding companies and other large financial institutions, but it also provides the FSOC with the power to designate other types of entities as systemically important to the financial system—specifically, nonbank financial companies (NFCs); financial market utilities (FMUs); payment, clearing, and settlement services; and technology service providers (TSPs). Companies designated as systemically important will be subject to FRB regulation and enhanced prudential standards in areas such as capital and liquidity.

It is important to note that any systemic importance designation will depend on the specifics of the economic environment at the time of assessment by the FSOC, and the status of potential candidates for designation could change over time in light of external economic events or a company’s internal strategic changes. Accordingly, the possibility of being designated as systemically important never ceases. Nonfinancial
companies may have subsidiaries, affiliates, or operations that fall into one or more of the categories discussed below.

**Nonbank financial companies**

**NFC criteria: which companies are at risk?** In order to be designated as systemically important, an NFC must derive 85 percent or more of its consolidated assets or revenues from certain financial activities. While a commercial or industrial entity would generally not meet this definition, a commercial or other finance company subsidiary may. The Act sets forth a number of nonexclusive factors to be considered by the FSOC in deciding systemic designation for NFCs, including size, importance to a particular industry, lack of a ready substitute, interconnectedness to major financial institutions, degree of leverage, and the specific NFC’s types of activities, interrelationships, and off-balance-sheet exposures.

Expectations are that the FSOC, in designating systemically important NFCs, will focus on large financial institutions not subject to consolidated supervision by federal banking regulators, large hedge funds, large mutual fund complexes, and other financial companies with a major footprint in financial markets (e.g., large, multinational insurance companies, credit card companies). However, it is possible that a financial subsidiary of a nonfinancial company could be designated if it were large, had a dominant position in a financial market for which there are no ready substitutes, or was interconnected through extensive derivatives or other activities with major financial institutions (e.g., the finance subsidiary of a global manufacturing conglomerate with a significant footprint in the commercial equipment lending and leasing market could be designated because it provides essential liquidity to a significant segment of the economy).

**What does it mean to be a systemically important NFC?** As a general rule, systemically important NFCs will have to comply with more stringent prudential standards, as determined by the FRB or the FSOC. The standards must cover risk-based capital requirements and leverage limits as well as liquidity requirements, risk management, resolution plan, and credit exposure reporting and concentration limits, among other considerations.

**Financial market utilities and payment, clearing, and settlement activities**

**Criteria for FMUs and payment, clearing, and settlement services: which companies are at risk?** FMUs are entities involved in the multilateral processing, clearing, settlement, and payment of transactions within the financial markets. They facilitate and otherwise execute transactions and play a critical role in mitigating settlement risk (the risk that trades will not be settled or completed as expected). The Depository Trust and Clearing Corporation is an example of an FMU, providing clearing, settlement, and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments, and OTC derivatives. Nonfinancial companies (for example, in the technology or financial media sectors) may operate similar trade and settlement facilities that could qualify as FMUs.

For FMUs, some of the factors to be considered in a systemically important designation include:

- The aggregate monetary value of transactions processed by the FMU
- The aggregate exposure of the FMU to counterparties
- The relationships or other interdependencies of the FMU’s activities
- The effect that a failure would have on critical markets or financial institutions

Regulators will likely focus on the potential for a failure or disruption to threaten the stability of the financial system and also on the potential impacts of the FMU’s activities.

**What does it mean to be designated as a systemically important FMU?** Designated FMUs may be subjected to enhanced risk management policies and standards, including margin or collateral requirements, capital and financial resource requirements, counterparty default policies and procedures, and timely settlement and clearance requirements (i.e., increased standards to ensure that the FMU is able to sustain operations or quickly recover in the event of severe financial market conditions or other internal/external stresses).
Technology service providers

**Which companies are at risk?** Many financial institutions outsource critical IT processing functions to a TSP. A financial institution’s use of a TSP does not diminish its responsibility to ensure that these activities are conducted in a safe and sound manner and in compliance with applicable banking regulations. Federal banking regulators have the legal authority to supervise all the activities and records of financial institutions, whether performed and generated directly by the institution or by a third party. Accordingly, TSPs may already be subject to examination and supervision by one of the Federal banking agencies—for example, to regulatory examination by the Federal Financial Institutions Examination Council (FFIEC) for compliance with IT systems standards.

However, the Act potentially expands that regulatory scope. Systemically important banks, NFCs, and FMUs will be subjected to enhanced supervision and regulation under the Act, and such enhanced requirements will likely include risk management over critical IT systems and other functions, whether managed in-house or outsourced to a TSP. Nonfinancial companies in the technology, IT outsourcing, or financial media sectors that perform or service critical functions of the financial markets may therefore be at risk for designation as TSPs to systemically important entities, subjecting them to new levels of supervision and examination that will include IT hardware and software development protocols, disaster recovery and going-concern plans, etc.

**What should companies do today?**

The Act clearly does not intend a “one size fits all” approach to the regulation of systemically important entities. The FSOC and FRB are provided with a great deal of discretion to differentiate among companies, not only based on the types of firms but also on the basis of factors of risk. The regulators’ primary focus will be large financial institutions. Rulemaking over the process and criteria for designating NFCs and FMUs is expected to be completed by Q2 2011, followed by period of formal designations and rulemaking on prudential standards which will extend into 2012. Companies at risk for designation should monitor and engage in the rulemaking over the next year and begin to examine their operations to identify factors that may be considered by regulators as placing the financial system at risk.

**Securitization “skin in the game” regulation**

The Act requires the SEC and the federal banking agencies to jointly develop new rules and regulations to address the perceived problem that asset-backed originators, securitizers, and underwriters have not performed adequate due diligence and other loan-assessment functions, leading to bad loans being originated, packaged, and sold to unsuspecting buyers.

**Which companies are at risk?** The securitization provisions of the Act apply to all asset-backed securities (ABS). The Act amends the Securities Exchange Act of 1934 to define the term “asset-backed security” as “fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset.”

This new definition has the effect of expanding the categories of securitizations and structured products that were not previously subject to registration. The definition will now include collateralized mortgage obligations, collateralized debt obligations, collateralized bond obligations, and any other securities that the SEC determines are ABS—but will exclude any securities issued by a finance subsidiary that issues securities only to its affiliates. This regulation applies to more than just mortgage lenders and other financial institutions. The ABS market cuts across nonfinancial sectors as well. Asset-backed bonds have been fairly common in the auto sector, but ABS market activity has recently increased to include other industries as well. For example, recent issuances have included bonds backed by advertising revenue from billboards and bonds backed by aircraft equipment.

The Act mandates a rulemaking process to require that “securitizers” and collateral originators retain at least a 5 percent economic interest in a portion of the credit risk in each asset held in a securitization—the so-called “skin in the game” provision. The Act also requires the FRB to conduct a study on the effect of the new risk retention requirements and interaction with the relevant accounting standards. That study, completed in October, concluded that simple credit risk retention rules, applied uniformly across all asset types, are unlikely to achieve the objectives of the Act. Accordingly, the FRB recommended rulemakers consider crafting
credit risk retention requirements that are tailored to each major class of securitized assets. Such an approach could recognize differences in market practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized. Asset class-specific requirements could also more directly address differences in the fundamental incentive problems characteristic of securitizations of each asset type. The scale and form of the required retention is expected to vary based on the characteristics and perceived credit risk of the underlying collateral, and the structural attributes of the securitization may also affect retention parameters.

What should companies do today?

Nonfinancial companies may be considered issuers, sponsors, or originators of asset-backed securities under this new definition. While much of the rulemaking in this area still needs to be completed (rules on risk retention are expected to be finalized in Q2 2011) and the effective date for ABS other than those backed by residential mortgages is May 2013, companies involved in securitization transactions should begin examining their arrangements now to determine whether they could be scoped in under the new ABS definition. Affected companies may encounter significant changes to the accounting for existing securitization structures and may be subject to the Act’s disclosure and reporting requirements.

Consumer finance operations

The new CFPB will serve as the primary regulatory authority over consumer financial products and services and nearly every federal consumer protection statute related to financial services. This includes rulemaking, supervisory, and examination, but the extent to which a company is subject to each CFPB authority differs by the type of products it offers, the market it serves, the size of the business, and its legal entity type.

Until the creation of the CFPB, federal financial services consumer protection fell within the mandate of several different regulators and enforcement agencies, which combined financial services consumer protection with other priorities. This new, singular focal point for financial services consumer protection, along with the general post–financial crisis zeitgeist, will lead to stricter compliance requirements and enforcement activities for any company involved in providing financing to consumers.

Rulemaking and enforcement authority. The CFPB will assume rulemaking and enforcement authority over most federal financial consumer protection laws. Prior to its creation, such rulemaking was vested in a wide variety of agencies, including federal bank, thrift, and credit union regulators; the Federal Trade Commission (FTC); and the Department of Housing and Urban Development (HUD).

Unless clearly exempted under the Act (e.g., charities, auto dealers, professional services firms, etc.) most providers of consumer financial services are potentially covered under CFPB rules. Specifically, the CFPB will have the authority to expand the coverage of existing rules or adopt new rules to regulate “covered persons” offering “consumer financial product or service[s].” Though there have been notable exceptions, most existing consumer protection regulations have focused on banks, thrifts, and credit unions. The Act, however, grants the CFPB rulemaking authority over any “covered person,” a very broad category that includes “any person that engages in offering or providing a consumer financial product or service” and “any affiliate of [such person] if such affiliate acts as a service provider to such person.”

The CFPB will also enforce existing rules concerning unfair or deceptive practices, and will have the authority to define new acts as unfair, deceptive, or abusive. The CFPB needs only a “reasonable basis” to conclude that a practice is “unfair” or “abusive.”

Supervision. Just because a company is covered by CFPB rules, this does not necessarily mean that the company will be subject to CFPB supervision and examination.

Specifically, the CFPB will routinely supervise and examine larger banks (e.g., those with assets of at least $10 billion) for compliance with federal financial consumer protection laws. Smaller banks and credit unions will continue to be examined by their current federal financial supervisor.

The CFPB will also supervise and examine certain nonbanking financial companies (including mortgage-related businesses, payday lenders, student lenders, debt collectors, and consumer reporting agencies) for compliance with federal financial consumer protection laws. It is unclear how the CFPB will supervise and
examine such a large population of companies. It is possible that the CFPB will use a model similar to that of the FTC, which examines companies based upon receipt of a certain number of complaints.

The Act further gives the CFPB supervisory and examination authority over “larger participant[s]” in the market for consumer financial products or services. The Act does not define what a larger participant is, but industry commentators believe that this category would include large captive finance companies.

**Which nonfinancial companies are at risk?** Many nonfinancial companies, particularly in the retail and technology sectors, have financial subsidiaries or operations that may be subject to new regulation under the Act as a “covered person” that offers or provides a consumer financial product or service, such as the extension of retail credit to consumers. “Consumer” financial products and services are those offered or provided for use primarily for personal, family, or household purposes. The definition of a “financial product or service” under the Act is fairly broad and covers a range of areas from loan servicing and other extensions of credit to real estate settlement services.

**Uncertainty regarding definition of “consumer financial products and services.”** Retail and other consumer-facing companies use a wide variety of loyalty programs to facilitate customer sales, including store-branded credit cards, extension of in-house credit, deferred-payment plans, and “rent to own” programs. It is unclear at this stage of rulemaking how broadly the CFPB definitions will be applied.

**As of the date of this publication, the CFPB has been slow to organize.** A director to lead its efforts still needs to be selected by the president and confirmed by the Senate, and experienced staff will likely need to be reallocated from other regulatory bodies. Much rulemaking remains to be completed in this area. The secretary of the Treasury announced July 21, 2011, as the “designated transfer date” upon which the CFPB will assume responsibility for consumer protection and fair housing laws. One year later, on July 21, 2012, the CFPB will be required to define the term “non-depository covered person.” Full implementation could take as long as three and a half years.

**What should companies do today?**

While financial institutions have long been subject to extensive regulation and supervision with respect to consumer protection laws, the stronger impact of CFPB will likely be felt by nonfinancial companies that provide consumer finance services who, over time, may become subject to considerable additional regulatory burdens such as federal registration requirements, federal examinations, disclosure requirements, and extensive new recordkeeping and reporting requirements.

Potentially affected companies may wish to engage in the regulation-setting process by keeping abreast of developments and providing formal comments on proposed rules. Working with well-established trade associations may be an effective mechanism for influencing the direction of regulation. Although full implementation of CFPB oversight may seem to be following a lengthy timeline, companies should begin planning now. Nonfinancial companies and potential “larger participants” will likely need to enhance or build new consumer compliance programs for new regulations and be prepared to assess the strategic business and operational impacts of new rules.

**Subsidiaries and affiliates that may be subject to direct or increased regulation as financial institutions**

A key focus of the Act is to close significant gaps in the financial regulatory web and extend that web over previously unregulated or lightly regulated companies. Nonfinancial companies may have subsidiaries or affiliates that will be subject to new oversight or increased regulation. While not common among nonfinancial companies, the key categories to be aware of include the following.

- **Savings and loan holding companies and thrifts.** While nonfinancial companies generally cannot own banks or thrifts, certain companies acquired a single thrift institution and became savings and loan holding companies before the enactment of the Gramm-Leach-Bliley Act in 1999, and were grandfathered in under that legislation. These nonfinancial owners of thrifts have been subject to fairly light supervision and regulation at the parent holding company level by the Office of Thrift Supervision (OTS). However, the Act abolishes the OTS in one year, at which point parent holding companies of thrifts will become regulated by the Federal Reserve Board (FRB). Such holding companies will have to serve as a source of
strength for their thrift subsidiaries, and in five years will be subject to bank capital requirements. For many nonfinancial company owners of thrifts, this may lead to a reassessment of the strategic reasons for continuing to own a thrift.

- **Industrial banks and trust subsidiaries.** Some nonfinancial companies own so-called industrial banks or limited purpose trust companies that are exempt from the definition of “bank” in the Bank Holding Company Act and whose parent companies are thus not regulated as bank holding companies. The nonfinancial owners of industrial banks and limited purpose trust companies face no immediate regulation, but the Act includes a three-year moratorium on any new such charters for commercial firms and requires a study by the GAO on whether these institutions should continue to be exempted from the definition of “bank,” and their parent companies exempted from bank holding company regulation. The outcome of that study is uncertain, and owners of industrial banks and limited purpose trust companies may face the prospect of future regulation that could make ownership of these institutions less desirable.

### Changing relationships with banks and credit rating agencies

**Higher cost structures for banks.** The Act will increase many costs for covered institutions, including, importantly, system costs related to structural changes, and substantial new compliance and reporting costs. Financial costs for systemically important institutions are also likely to increase for the same reasons. But the Act cannot be viewed in a vacuum. Also to be considered are costs associated with new Basel III capital and liquidity requirements, changes in product markets, accounting changes, and other considerations. How these costs may ultimately be passed on to corporate clients remains to be seen, but some banking executives have indicated that they expect client pricing to increase due to modest returns on current credit pricing and higher funding costs. The impact is expected to differ dramatically by client and type of product.

The Act’s impact on the cost structures of financial institutions and the availability and pricing of their products and services will take years to evolve fully. But companies will need to be ready to assess and adapt to alternative sources of capital than found in today’s marketplace.

**Increased liability and transparency for credit rating agencies.** The changes to the credit ratings industry under the Act are significant and will have important implications for nonfinancial companies who issue corporate debt. The Act establishes an independent office within the SEC called the Office of Credit Ratings, with a mandate to promote accuracy of credit ratings and prevent conflicts of interest. The legislation subjects credit rating agencies (CRAs) to significant private litigation by removing “safe harbor over forward-looking statements” protection, and exposes CRAs to “expert liability” for credit ratings provided in an SEC registration statement. This is a very significant increase in liability for CRAs, and will likely cause dramatic changes in the way the industry approaches ratings. In fact, shortly after the Act was signed into law, the three major CRAs refused to give permission for their ratings to be included in registration statements—in essence freezing some new issuance of bonds since some types of assets (notably asset-backed securities) are required to include a rating. The SEC has addressed this issue by extending indefinitely a ‘no action’ letter that will allow issuers to omit credit ratings from registration statements filed under Regulation AB.

The Act also imposes new restrictions and requirements on a CRA’s corporate governance, internal controls, transparency, conflicts of interest, and liability exposure under the securities laws. And CRAs will be required to internally separate their credit rating activities from sales and marketing activities.

These requirements impose a new and more formal regime for producing ratings and add transparency to a process that, until the Act’s passage, was largely invisible to investors. Companies may find that ratings for their existing and future debt securities differ significantly from today’s expectations, potentially impacting pricing and liquidity.
While Dodd-Frank will have impact on nonfinancial companies, many implementation issues are currently unclear and are subject to the SEC’s and other agencies’ rulemaking processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will be available at www.pwcregulatory.com.

**Additional information**

If you would like additional information about the matters discussed in this *A Closer Look*, please contact:

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