HUNTON& WILLIAMS

CORPORATE AND SECURITIES LAW UPDATE

July 2010 Analysis of the Dodd-Frank Wall Street Reform Act

Executive Compensation, Corporate Governance and Enforcement Provisions of the Dodd-Frank Act Affecting Public Companies

On July 15, 2010, the United States Senate approved a comprehensive regulatory reform bill entitled the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The United States House of Representatives approved Dodd-Frank on June 30, 2010. President Obama is expected to sign Dodd-Frank into law on July 21, 2010.

Though the primary focus of Dodd-Frank is on the reduction of systemic risk in financial markets and increased regulation of large financial institutions, Dodd-Frank also contains executive compensation, corporate governance and enforcement provisions that are applicable to most public companies, which are the focus of this client alert.

Most of Dodd-Frank's executive compensation and corporate governance provisions and certain enforcement provisions require further regulatory action to implement. While some provisions specify a deadline for the Securities and Exchange Commission ("SEC") to adopt implementing rules, others do not. The say-on-pay provision will be effective for the 2011 proxy season. It is anticipated that the SEC will move quickly to adopt rules implementing many of the other executive compensation and corporate governance provisions to be effective for the 2011 proxy season as well. It is a priority of SEC Chair Mary Schapiro to adopt proxy access rules that will be effective for the 2011 proxy season.

Corporate Governance and Executive Compensation

Title IX of Dodd-Frank enacts many changes to existing securities laws. Title IX creates new shareholder rights, requires new disclosures by companies and requires changes to compensation practices for executive officers of public companies. Title IX's major changes, as they pertain to public company corporate governance and executive compensation, are discussed below.

Proxy Access

Section 971 of Dodd-Frank amends the Securities Exchange Act of 1934 (the "Exchange Act") to explicitly authorize, but not require, the SEC to issue rules requiring a company to include in its proxy materials shareholder nominees for directors. Dodd-Frank authorizes the SEC to exempt certain companies from any such proxy access requirements and specifically instructs the SEC to consider whether the requirement disproportionately burdens small companies. The authority granted under Dodd-Frank eliminates prior questions as to the SEC's authority to adopt proxy access rules. The SEC proposed proxy access rules in 2009 and, based on comments of SEC Chair Mary Schapiro, is expected to adopt final proxy access rules within a timeframe that would put the rules into effect for the 2011 proxy season.

Although not directly related to its consideration of proposed proxy access rules, the SEC on July 14, 2010, issued a concept release on proxy mechanics. The concept release examines three general areas: (i) accuracy, transparency and efficiency of the voting process; (ii) communications and shareholder participation; and (iii) the relationship between voting power and economic interest. There will be a 90-day public comment period for the concept release after it is published in the *Federal Register*.

Non-Binding "Say-on-Pay" Shareholder Vote on Executive Compensation

Section 951 of Dodd-Frank mandates "say-on-pay" by adding a requirement to the Exchange Act that shareholders receive the opportunity to vote on a non-binding resolution on the compensation of named executive officers[1] at least once every three years. The non-binding resolution must be included in a proxy statement for an annual or other meeting of shareholders for which the SEC's proxy solicitation rules require compensation disclosure. No SEC rulemaking is required to implement this say-on-pay provision. A public company must begin complying starting with its first annual or other meeting occurring more than six months after enactment of Dodd-Frank. The proxy materials for such meeting must contain both the non-binding resolution on compensation and a non-binding resolution to determine whether the say-on-pay vote will occur once every one, two or three years. Following those initial resolutions, shareholders thereafter must vote at least once every six years on the frequency of the say-on-pay shareholder vote. Section 951 grants the SEC authority to exempt companies from these say-on-pay requirements.

Dodd-Frank specifically provides that the non-binding say-on-pay vote will not create or alter any fiduciary duties. Nor will it preclude shareholders' ability to make executive compensation-related proposals. Dodd-Frank requires every institutional investment manager subject to reporting under Section 13(f) of the Exchange Act to report at least annually how it voted on any non-binding shareholder resolution on compensation of named executives. Finally, as noted below, Section 957 codifies the New York Stock Exchange ("NYSE") broker non-vote rule that prevents brokers from exercising voting authority with respect to director elections, executive compensation and any other significant matter, as determined by SEC rulemaking, unless they have received voting instructions from the beneficial owner of the shares.

[1] Named executive officers are those officers for whom executive compensation disclosure is required under Item 402 of the SEC's Regulation S-K, generally the CEO, CFO and the three other most highly compensated executive officers.

Non-Binding "Say-on-Pay" Shareholder Vote on Executive Compensation Relating to Business Combinations ("Golden Parachutes")

Section 951 of Dodd-Frank requires that any proxy solicitation materials for a meeting at which shareholders are asked to approve a business combination or disposition of substantially all of a company's assets must:

(i) contain clear, simple disclosure of any agreements that the soliciting person has with any named executive officer of the company (or the acquiring company, if the company is not the acquiring company) concerning any compensation that relates to the transaction being voted on;

(ii) disclose the aggregate total of all such compensation that may be paid to any named executive officer, and the conditions under which it may be paid; and

(iii) provide for a separate, non-binding shareholder vote to approve any such compensation, unless the agreements or understandings were subject to an earlier non-binding shareholder vote on named executive compensation.

This provision will be applicable to any solicitation occurring more than six months after enactment of Dodd-Frank. The SEC is required to adopt rules describing the type of disclosure required in proxy statements in connection with a shareholder vote on golden parachute compensation. As with the non-binding shareholder votes on named executive compensation, Dodd-Frank specifically provides that (i) the golden parachute vote does not create or change any fiduciary duties; (ii) every institutional investment manager subject to reporting under Section 13(f) of the Exchange Act must report at least annually how it voted on such resolutions; and (iii) the SEC may exempt companies from the vote requirement.

Broker Discretionary Voting

Section 957 of Dodd-Frank requires that national securities exchanges preclude a broker from granting a proxy to vote shares in the case of a vote on the election of directors, executive compensation or any other "significant matter" (as determined in the rules of the SEC), unless the beneficial owner of the shares has specifically instructed the broker how to vote. The NYSE had already eliminated broker discretionary voting for director elections starting with the 2010 proxy season. Any FINRA or AMEX member that is also a NYSE member is already subject to the NYSE rule on broker discretionary voting. Because most large brokerage firms are NYSE member organizations, the prohibition affects companies listed not only on the NYSE but also companies listed on other national exchanges such as NASDAQ. Section 957 of Dodd-Frank will extend the prohibition to say-on-pay votes, among other matters.

Independent Compensation Committee Requirement

Similar to the requirements under the Sarbanes-Oxley Act of 2002 for enhanced audit committee independence, Section 952 of Dodd-Frank requires the SEC to issue rules within 360 days of enactment requiring national securities exchanges to prohibit the listing of any equity security of a company if its board of directors does not have an "independent" compensation committee. In determining the definition of "independent," national securities exchanges must consider (i) the source of director compensation, including any consulting, advisory or other compensatory fee paid to the director by the company, and (ii) whether the director is affiliated with the company or its subsidiaries or affiliates. Section 952's independent compensation committee requirement does not apply to, among other entities, a "controlled company"[2] or a foreign private issuer that provides annual disclosure to shareholders as to why they do not have an independent compensation committee. The SEC may also permit national securities exchanges to create exemptions from the independence requirements, taking into account the potential impact on smaller companies.

Section 952 also requires the SEC to issue rules directing national securities exchanges to adopt listing standards containing explicit authority for compensation committees to engage their own independent advisors. The compensation committee must have direct responsibility for the appointment, compensation and oversight of the compensation consultant, legal counsel or other advisor. Compensation consultants, legal counsel and other advisors need not be independent, but the compensation committee is required to consider factors affecting such advisors' independence, including (i) whether the advisor provides other services to the company, (ii) the amount of fees paid by the company as a percentage of total revenue of the compensation consultant, legal counsel or other advisor, (iii) the policies and procedures of the compensation consultant, legal counsel or other advisor that are designed to prevent conflicts of interest, (iv) whether the advisor has a business or personal relationship with a member of the compensation committee, and (v) any stock of the company owned by the compensation consultant, legal counsel or other advisor. The company's proxy materials for any annual meeting, or special meeting in lieu of an annual meeting, occurring one year after the enactment of Dodd-Frank must disclose whether the compensation committee has retained or obtained the advice of a compensation consultant, whether the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

Additional Compensation Disclosures

Pay for Performance Disclosure. Section 953 of Dodd-Frank directs the SEC to adopt rules that require companies to provide in any proxy statement for an annual meeting disclosure that shows the relationship between executive compensation actually paid by the company and the company's financial performance, which disclosure may be included in a graphic representation.

Internal Pay Ratio Disclosure. Section 953 also directs the SEC to adopt rules that require disclosure of (i) the median total annual compensation of all employees of the company other than the CEO; (ii) the total annual compensation of the company's CEO; and (iii) the ratio of the two amounts.

Dodd-Frank did not specify a timeline for the SEC to adopt these two disclosure rules.

Disclosure of Hedging by Employees and Directors.

Section 955 of Dodd-Frank directs the SEC to amend the proxy rules to require each company to disclose in any proxy statement for an annual meeting whether any employee or director is permitted to purchase financial instruments designed to hedge against or offset any decrease in value of equity securities granted as compensation or otherwise held by the employee or director. Many insider trading policies of public companies already prohibit directors and executive officers and/or all employees from trading in publicly-traded company derivative securities or engaging in short sales with respect to company securities. Dodd-Frank did not specify a timeline for the SEC to adopt these rules.

Disclosure Regarding the Positions of Chairman and CEO

Dodd-Frank does not require companies to have a separate chairman and CEO, but Section 972 requires the SEC to issue rules requiring a company to disclose in its annual

[2] A "controlled company" is a listed company that has more than 50 percent of its voting power held by an individual, a group or another issuer.

proxy statement the reasons why the company chooses to either combine or separate the positions of chairman of the board and CEO. The SEC issued rules effective for the 2010 proxy season, which appear to already cover this disclosure required by Dodd-Frank.

Determination of Beneficial Ownership and Initial Reporting Deadlines

Dodd-Frank amends Sections 13 and 16 of the Exchange Act so that security-based swap positions will give rise to beneficial ownership of a security for the purposes of reporting and short-swing profit disgorgement liability only to the extent that the SEC determines, by rule, that the security-based swap provides "incidents of ownership comparable to direct ownership of the equity security." The SEC's current test for beneficial ownership relates to the power to vote or dispose of a stock.

Section 929R of Dodd-Frank amends Sections 13(d) and 16(a) of the Exchange Act to allow the SEC to establish a period shorter than 10 days for the filing of an initial Section 13(d) beneficial ownership report and for the filing of an initial Section 16(a) statement of beneficial ownership.

Sarbanes-Oxley 404(b) Exemptions for Smaller Companies

Section 989G of Dodd-Frank exempts non-accelerated filers and smaller reporting companies from Section 404(b) of the Sarbanes-Oxley Act, which requires a public company's external auditors to provide an attestation report on the company's internal controls over financial reporting. Dodd-Frank also requires the SEC to study how to reduce the Section 404(b) compliance burden for companies with market capitalizations between $75 million and $250 million, and whether an exemption from or a reduction in the compliance burden imposed by Section 404(b) would encourage more listings on U.S. securities exchanges. Section 989I of Dodd-Frank requires the GAO to study and report to Congress, within three years of enactment, on the impact of the amendments to Section 404 of the Sarbanes-Oxley Act. Among other things, the report must analyze whether the exemption from Section 404(b) changes the frequency of financial statement restatements by affected firms, the cost of capital for affected firms and investor confidence in the integrity of the financial statements of affected firms.

Certain Enforcement Reforms

Incentive Compensation Clawbacks

Section 954 of Dodd-Frank directs the SEC to require national securities exchanges to adopt listing standards so that listed companies must develop and implement policies to "claw back" executive compensation in the event of a financial restatement. The policies must require that, in the event the company is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements under the securities laws, the company will recover from any current or former executive officer who received incentive-based compensation during the three-year period preceding the date on which the company is required to prepare a restatement the amount of such incentive-based compensation that exceeds what would have been paid to the executive officer under the restated financial statements. The Dodd-Frank clawback requirement goes beyond the similar provision in the Sarbanes-Oxley Act, which applies only to a company's CEO and CFO, has only a 12-month look-back and applies only if non-compliance results from misconduct. Dodd-Frank did not specify a timeline for the SEC to adopt these rules.

Enhanced Whistleblower Incentive and Protection

Section 922 of Dodd-Frank adds new Section 21F to the Exchange Act, which requires the SEC, in any action in which it levies sanctions in excess of $1 million, to compensate a whistleblower who provides original, independently derived information that leads to such monetary sanctions with between 10 percent and 30 percent of the amount of the sanctions. Section 922 prohibits the SEC from providing an award to a whistleblower who is convicted of a criminal violation related to the provided information; who gains the information by auditing financial statements as required under the securities laws; who fails to submit information to the SEC as required by an SEC rule; or who is an employee of the Department of Justice or certain other regulatory and law enforcement agencies.

Dodd-Frank prohibits employers from retaliating or otherwise discriminating against a whistleblower because of any lawful act done by the whistleblower. Also, Dodd-Frank provides for a private cause of action by a person who alleges retaliation or discrimination in violation of the above, allowing for relief that includes reinstatement with the same seniority, two times the amount of back pay owed to the individual and compensation for litigation and expert fees.

Dodd-Frank requires the SEC to issue final regulations implementing these whistleblower provisions within 270 days after enactment.

Joint and Several Liability for Control Persons

Section 929P of Dodd-Frank clarifies that the SEC may impose joint and several liability against control persons under Section 20(a) of the Exchange Act.

Liability for Aiding and Abetting Violations of the Securities Act

Section 929O of Dodd-Frank provides the authority for the SEC to impose aiding and abetting liability on persons who “recklessly” provide substantial assistance to someone who violates the Exchange Act. Previously, the SEC was generally required to show that such assistance was provided “knowingly.” In addition, Sections 929M and 929N of Dodd-Frank provide for aiding and abetting liability under the Securities Act of 1933, the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

Impact on Foreign Private Issuers

A number of the provisions of Dodd-Frank apply to foreign private issuers, such as the whistleblower provisions, changes to Section 13 beneficial ownership reporting and changes to broker discretionary voting. However, because foreign private issuers are exempt from U.S. proxy rules, the provisions of Dodd-Frank implemented through the U.S. proxy rules are inapplicable to foreign private issuers, including proxy access, say-on-pay and say-on-golden parachute payments, executive compensation disclosure, hedging disclosure, and chairman and CEO structure disclosure. Also, foreign private issuers that provide annual disclosures to shareholders of the reasons that the foreign private issuer does not have an independent compensation committee are not required to have a fully independent compensation committee.

Conclusion

Many of the specific requirements imposed by Dodd-Frank will depend on the final rules that will be adopted by the SEC and the stock exchanges. Once adopted, however, there will likely be only a small period of time before they become effective for the 2011 proxy season. Thus, companies should begin to consider changes to their corporate governance practices that might be required or advisable, such as confirmation of compensation committee member independence, review of compensation consultant independence and preparation of clawback and employee hedging policies. In particular, companies that will be providing a say-on-pay proposal for the first time should review their current executive compensation practices and consider plans for managing shareholder relations. Finally, given the new whistleblower incentive, companies also should consider whether there is a need to strengthen internal compliance programs and controls.

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OTC Derivatives Reform: Wall Street Transparency and Accountability Act of 2010

I. Introduction

Title VII of H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), substantially alters the regulation of over-the-counter ("OTC") derivatives markets. Financial reform, particularly as it relates to derivatives, had the initial purpose of mitigating systemic risk and interconnection concerns in the financial markets. Congress and regulators, nevertheless, are taking the opportunity in Dodd-Frank to address other perceived issues in the OTC derivatives markets and in the commodities sector.

What every firm using derivatives must do today:

1) Determine whether any of the derivatives they enter into are Swaps;

2) Determine if they are a Swap Dealer or Major Swap Participant;

3) Determine if their Swaps must be centrally cleared or traded on an exchange;

4) Determine what Swaps they must report; and

5) Determine whether or not they or their counterparty must provide margin or meet capital requirements.

The effect of OTC derivatives markets reform legislation will be substantial. However, the true reach of the statute will be unknown until the completion of the extensive mandated rulemakings. Congress delegated to the Commodity Futures Trading Commission (the "CFTC"), the Securities and Exchange Commission (the "SEC") and other regulators the responsibility to fashion many of the material details for implementing the principles contained in Title VII of Dodd-Frank.

II. Jurisdiction

Dodd-Frank maintains the jurisdictional separation between the CFTC and SEC reached in the Shad-Johnson Accord. The SEC will have jurisdiction over markets for Security-Based Swaps, and the CFTC will have jurisdiction over markets for non-security based Swaps. In practice, the SEC will have jurisdiction over a portion of the equity swap market and a portion of the credit default swap ("CDS") market. The CFTC will have jurisdiction over the remainder of the OTC swaps markets, including the markets for commodity swaps, foreign exchange swaps, interest rate swaps, CDS index swaps and equity index swaps.

Dodd-Frank aims to impose similar regulatory requirements on similar instruments. Thus, the CFTC, SEC and other regulators are required under Dodd-Frank to coordinate on portions of the rulemaking required under Title VII. However, the CFTC, SEC and other regulators will only be required to issue joint rules on a small number of definitions.

Title VII of Dodd-Frank also attempts to clarify the relative jurisdictions of the CFTC and the Federal Energy Regulatory Commission ("FERC") over energy markets. The CFTC and FERC are required to enter into a memorandum of understanding regarding their respective jurisdiction over energy markets. In addition, the CFTC is permitted to exempt contracts entered into pursuant to a FERC or state agency tariff or rate schedule from CFTC oversight as Swaps.

III. Swaps and Security-Based Swaps

Dodd-Frank grants the CFTC the authority to regulate OTC Swaps markets. The definition of "Swap" encompasses a wide array of instruments. The definition captures nearly all derivatives except for futures, forwards intended to be physically-settled, foreign exchange and currency derivatives that are not centrally cleared or not exchange traded (if the Secretary of the Treasury chooses to carve out such instruments from the definition of Swap).

Under Dodd-Frank, the SEC has jurisdiction over Security-Based Swaps markets. A “Security-Based Swap” is based on a single security or loan or a narrow-based security index. A narrow-based security index is an index of securities that meets one of the following four requirements: (i) it has nine or fewer components; (ii) one component comprises more than 30 percent of the index weighting; (iii) the five highest-weighted components comprise more than 60 percent of the index weighting; or (iv) the lowest-weighted components, comprising in the aggregate 25 percent of the index’s weighting, have an aggregate dollar value of average daily volume over a six-month period of less than $50 million ($30 million if there are at least 15 component securities).

IV. Swap Dealers and Major Swap Participants

Dodd-Frank imposes most of its regulatory and prudential requirements on two classes of entities: Swap Dealers and Security-based Swap Dealers (together, “Swap Dealers”), and Major Swap Participants and Major Security-based Swap Participants (together, “Major Swap Participants”).

A Swap Dealer is any person who (i) holds themselves out as a dealer in Swaps, (ii) makes a market in Swaps, (iii) regularly enters into Swaps with counterparties as an ordinary course of business for its own account, or (iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in Swaps. An entity can be designated a Swap Dealer for one class of Swaps or for multiple classes of Swaps.

If the third prong of this definition is applied literally, then many frequent users of Swaps could be deemed Swap Dealers including commercial end users who use derivatives primarily for hedging. However, a *de minimis* exception was added to the definition of Swap Dealer during conference, which should partially mitigate this potential issue. Also, a bank cannot be deemed a Swap Dealer solely because it enters into Swaps with customers in connection with the origination of loans.

A Major Swap Participant is any person (i) who is not a Swap Dealer, (ii) who maintains a substantial position (as defined by the CFTC and SEC) in Swaps, excluding positions held for hedging commercial risk and hedge positions maintained by employment benefit plans, (iii) whose outstanding Swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States financial markets, or (iv) who is a highly leveraged financial entity not subject to a federal banking regulator’s capital requirements that maintains a substantial position in outstanding Swaps. An entity can be designated a Major Swap Participant for one class of Swaps or for multiple classes of Swaps. Financing subsidiaries that facilitate the purchase or lease of goods manufactured by their parent and use Swaps to hedge the risk associated with that financing are excluded from the definition of Major Swap Participant.

V. Mandatory Central Clearing

Under Dodd-Frank, both Swap Dealers and Major Swap Participants will be required to clear most or all of their standardized Swaps with a central counterparty.

The determination of which Swaps will be subject to mandatory clearing will be made by the CFTC and SEC for their respective jurisdictions. Derivatives clearing organizations and clearing agencies (together, “Clearing Houses”) will be required to submit all new Swaps that they would seek to accept for clearing to their respective regulators for approval. The appropriate regulator will determine if the Swap will be subject to mandatory clearing. The CFTC and SEC can subject an existing class of Swaps to the mandatory clearing requirement at their own discretion. However, any Swap in existence before the enactment of Dodd-Frank will not be subject to mandatory clearing.

There is an exemption from the mandatory clearing requirement for derivatives end users. If a Swap is subject to the mandatory clearing requirement, but one of the parties to the Swap (i) is not a Financial Entity (defined below), (ii) that party entered into the Swap to hedge or mitigate commercial risk, and (iii) that party informed the CFTC or SEC how it meets its financial obligations associated with uncleared Swaps, then that party may elect to not clear the Swap or may elect to clear the Swap at a Clearing House of its choice. To utilize this exemption, a publicly traded company must first receive approval from an appropriate committee of its board of directors.

A Financial Entity is either a (i) a Swap Dealer or Major Swap Participant, (ii) a commodity pool or private fund, (iii) an employee benefit plan, or (iv) a person predominantly engaged in activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956. Financing subsidiaries that facilitate the purchase or lease of goods manufactured by their parent and use Swaps to hedge the risk associated with that financing are excluded from the definition of "financial entity." In addition, the CFTC and SEC have the authority to exclude small banks and credit unions from the definition of "financial entity."

VI. Exchange Trading

Under Dodd-Frank, counterparties will be required to execute most or all of their standardized Swaps on designated contract markets in the case of Swaps, securities exchanges in the case of Security-Based Swaps, or Swap Execution Facilities[1] (collectively, "Exchanges").

There are two exemptions from mandatory exchange trading: (i) a Swap is not required to be executed on an Exchange if no Exchange will list the Swap for trading; and (ii) a Swap is not required to be executed on an Exchange if a party to the Swap is using the clearing exemption.

VII. Reporting

Dodd-Frank requires all uncleared Swaps to be reported directly to a Swap Data Repository, or if no Swap Data Repository will accept the Swap, the appropriate regulator. If one counterparty to a Swap is a Swap Dealer, then the Swap Dealer is obligated to report the Swap. If a Major Swap Participant enters into a Swap with a party that is neither a Swap Dealer nor Major Swap Participant, then the Major Swap Participant is required to report the Swap. If both counterparties to a Swap are Swap Dealers or if both counterparties are neither a Swap Dealer nor Major Swap Participant, then the counterparties may select which counterparty is responsible for reporting the Swap.

In addition, Dodd-Frank requires that all uncleared Swaps existing prior to enactment be reported to a Swap Data Repository or, if no Swap Data Repository will accept the Swap, the appropriate regulator, within 120 days of enactment of Dodd-Frank.

VIII. Capital and Margin Requirements

Both Swap Dealers and Major Swap Participants will be subject to new prudential capital requirements. If the Swap Dealer or Major Swap Participant is a bank, the capital requirements will be set by its prudential banking regulator. The CFTC and SEC will set capital requirements for non-bank Swap Dealers and non-bank Major Swap Participants under their respective jurisdictions. When setting capital requirements, the regulators may take into account all of an entity's Swap positions, new and existing, regardless of whether the entity is designated a Swap Dealer or Major Swap Participant for a single type of Swap, as well as all other activity that may not be subject to regulation under Title VII of Dodd-Frank.

Swap Dealers and Major Swap Participants will also be subject to new initial and variation margin requirements on uncleared Swaps. If the Swap Dealer or Major Swap Participant is a bank, the margin requirements will be set by its prudential banking regulator. The CFTC and SEC will set margin requirements for all non-bank Swap Dealers and non-bank Major Swap Participants under their respective jurisdictions. Regulators may permit the use of non-cash collateral to satisfy margin requirements as long as it does not pose a systemic risk.

There is no exemption from Title VII's capital and margin requirements. Previous drafts of the bill contained an explicit exemption from the mandatory margin requirements for certain transactions involving end users. However, that exemption was removed during the conference process. While the current margin requirements apply exclusively to Swap Dealers and Major Swap Participants, many end users worry that because of the margin requirements Swap Dealers will either price their cost incurred because of the margin requirement into the Swap or will require their counterparties to post margin as well. In response to these concerns, chairmen Dodd and Lincoln wrote a letter clarifying that Title VII's margin requirement was not intended to impose costs

[1] A Swap Execution Facility is a facility in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants. As currently drafted, a Swap Execution Facility would encompass both electronic trading platforms as well as voice brokerage facilities.

and requirements on derivatives end users and urged regulators to consider the potential cost to end users when drafting the implementing rules. Many market participants expect the CFTC and SEC to clarify when margin requirements apply to Swaps in which one counterparty is an end user.

Dodd-Frank also allows regulators to impose Title VII's margin requirements on Swap Dealers' or Major Swap Participants' existing Swaps. However, Title VII contains legal certainty language that should prevent Swap Dealers and Major Swap Participants from requiring their end user counterparties to post margin on existing Swaps or terminating such Swaps on the basis of a change in law (unless the Swap contract contains an explicit provision addressing derivatives reform).

IX. Position Limits

Dodd-Frank requires the CFTC to implement aggregate position limits for all contracts based on the same underlying commodity. The position limits would apply to an entity's positions on designated contract markets, on Swap Execution Facilities, in OTC significant price discovery contracts and, in certain cases, on foreign boards of trade. The CFTC must also put in place exemptions from the position limits for positions that are *bona fide* hedges. The federal aggregate position limits are in addition to any position limits imposed by individual exchanges, and apply to an entity's aggregate positions across markets.

Under Dodd-Frank, the SEC is authorized, but not required, to adopt position limits for Security-Based Swaps. When applying position limits, the SEC must aggregate an entity's position in Security-Based Swaps with its position in the underlying security. The SEC is also authorized to take Security-Based Swaps into account when determining if an entity is required to report under the Securities Exchange Act's beneficial ownership reporting requirements in Sections 13 and 16.

X. Segregation of Collateral

Under Dodd-Frank, any initial margin proffered in connection with a centrally cleared Swap must be treated as belonging to the customer. In the case of an uncleared Swap (but not Security-Based Swap), a Swap Dealer or Major Swap Participant must notify its counterparty of its right to require the segregation of any initial margin with an independent third-party custodian. If the counterparty does not elect to segregate its initial margin, then the Swap Dealer or Major Swap Participant must submit quarterly reports to the counterparty on the status of the initial margin. Variation margin provided for uncleared Swaps is not subject to a segregation requirement under Dodd-Frank.

XI. Business Conduct Standards

Dodd-Frank authorizes the CFTC and SEC to impose a substantial number of business conduct and compliance requirements on Swap Dealers and Major Swap Participants. However, the CFTC and the SEC cannot impose prudential requirements on an entity that is already subject to prudential regulation by another regulator. Below is a summary of the major business conduct requirements imposed by Dodd-Frank.

Registration

Swap Dealers and Major Swap Participants must register with the CFTC and/or SEC as appropriate. After registering with their respective regulator, Swap Dealers and Major Swap Participants will be required to submit reports to that regulator in a form and at a frequency to be determined by the regulator. A Swap Dealer or Major Swap Participant will be required to disclose to the CFTC or the SEC information on (i) the terms and conditions of its Swaps, (ii) its Swap trading operations, and (iii) its financial integrity protections.

Record Keeping

Swap Dealers and Major Swap Participants must maintain daily trading records and all related documents for all Swaps, including all recorded phone conversations, emails, and instant messages. In addition, Swap Dealers and Major Swap Participants will be required to maintain daily trading records for each counterparty in a manner that is identifiable with each transaction. Finally, each Swap Dealer and Major Swap Participant is responsible for maintaining a complete audit trail for conducting comprehensive trade reconstructions. All records will be required to be maintained for a period of time to be determined by the respective regulator.

Compliance Requirements and Disclosures

A Swap Dealer or Major Swap Participant will be required to conform with business conduct standards prescribed by its respective regulator. The standards will require processes to (i) prevent fraud, manipulation, and other abusive practices; (ii) ensure diligent supervision of operations; and (iii) ensure compliance with position limits.

Swap Dealers and Major Swap Participants will be required to disclose to a counterparty that is not a Swap Dealer or Major Swap Participant (i) the material risks and characteristics of a Swap; (ii) the source and amount of any compensation; (iii) any material incentives or conflicts of interest; (iv) for cleared Swaps, at the request of the counterparty, the clearing house's daily mark; and (v) for uncleared Swaps, the daily mark of the Swap Dealer or Major Swap Participant. The disclosures must be made in good faith and in a fair and balanced manner.

Special Entities and Standards of Care

Swap Dealers and Major Swap Participants who engage in transactions with Special Entities are subject to additional business conduct standards for those transactions. Special Entities are government agencies, municipalities, certain employee benefit plans and endowments.

When a Swap Dealer or Major Swap Participant acts as an adviser to a Special Entity, they have a duty to act in the best interest of the Special Entity and are required to make reasonable efforts to obtain information necessary to determine if a Swap is in the best interest of the Special Entity. In addition, Swap Dealers and Major Swap Participants that enter into a Swap with a Special Entity that is a government agency or municipality counterparty must have a reasonable basis to believe that the Special Entity has an independent adviser that, among other things, (i) has sufficient knowledge to evaluate the transaction; (ii) is independent from the Swap Dealer or Major Swap Participant; (iii) is acting in the counterparty's best interest; and (iv) will provide written representations regarding fair pricing and the appropriateness of the transaction.

XII. Effective Date

Most provisions of Dodd-Frank become effective one year after its enactment. Many of the implementing rules to be promulgated by the CFTC, SEC and other federal regulators are to become effective at the same time. The notable exception is reporting of existing Swaps that are not centrally cleared. The CFTC and SEC are expected to publish criteria for such reporting within 90-days of the enactment of Dodd-Frank, with reporting to begin 30-days thereafter.

XIII. Conclusion

Dodd-Frank introduces material changes to the OTC derivatives markets. Many of the specific requirements imposed by Dodd-Frank will depend on the final rules adopted by the CFTC and SEC. The year following enactment of Dodd-Frank will see tremendous activity by such federal regulators. Thus, the full impact of Dodd-Frank is yet to be seen. Companies that use OTC derivatives should undergo a thorough compliance review to determine the extent to which they or the derivatives contracts they enter into fall within the new regulatory regime.

If you have any questions about these matters, please contact David McIndoe, Michael Sweeney or your Hunton & Williams LLP contact.

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PRIVATE INVESTMENT FUND UPDATE

July 2010 Analysis of the Dodd-Frank Wall Street Reform Act

Dodd-Frank Act Impacts Private Fund Advisers

On July 15, 2010, the Senate approved the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Act"), previously passed by the House on June 30, 2010. President Obama is expected to sign the Act into law on July 21, 2010. The Act includes expansive financial industry regulatory reforms, including the "Private Fund Investment Advisers Registration Act of 2010" (the "PFIARA").[1] The PFIARA is similar to a prior version of the PFIARA introduced by Sen. Christopher Dodd (D-CT) in the Senate in March and included in H.R. 4173, which was originally passed by the House on December 11, 2009. The PFIARA will have a significant impact on advisers to certain private funds, including hedge funds, private equity funds, venture capital funds and various other investment vehicles, by (1) requiring the registration of certain unregistered advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and (2) imposing additional reporting and disclosure requirements on investment advisers, including those already registered under the Advisers Act. The PFIARA lays out a framework for regulation of private fund advisers, but delegates to the Securities and Exchange Commission ("SEC") rulemaking authority for many of the details concerning the types of advisers that will be facing additional regulatory burden. As a result, private investment fund advisers will need to run their businesses with a renewed focus on compliance.

SEC Registration Requirement; Elimination of Private Adviser Exemption

The PFIARA eliminates the private adviser registration exemption found in Section 203(b)(3) of the Advisers Act (also known as the "15 client" exemption). Many investment advisers to hedge funds, private equity funds, venture capital funds and other investment vehicles rely on the private adviser exemption as well as the client counting rules found in Rule 203(b)(3)-1 to avoid registration under the Advisers Act. Although general partners and managers to private funds are already subject to the antifraud rules of the Advisers Act, once they are required to register as investment advisers, they will become subject to all provisions of the Advisers Act, including its rules relating to client asset custody, record-keeping, advisory contracts, performance fees, ethics and personal trading policies, investment and financial reporting and advertising. In addition, there may be advisers to a number of other types of investment vehicles that may have previously relied on the private adviser exemption that will become subject to the registration and other requirements of the Advisers Act. There also may be other advisers, such as advisers to real estate funds and mortgage REITs, that have relied on the private adviser exemption as an alternative to a more thorough review of available exemptions that will now need to engage in a more in-depth analysis of their business to determine whether registration will be required.

Exemptions from SEC Registration

In place of the broader private adviser exemption, the PFIARA implements several narrower exemptions and reduces the scope of some existing exemptions, which are outlined below.

Private Fund Size Exemption

The PFIARA exempts advisers that advise solely "private funds" and have assets under management in the U.S. of less than $150,000,000. While these investment advisers are exempt from the registration requirements of the Advisers Act, they nonetheless are required to maintain such records and provide to the SEC such reports as the SEC determines necessary or

[1] The PFIARA can be found in Title IV of the Act.

appropriate. The term "private fund" is defined to include any investment fund that relies on the exceptions from investment company status found in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act").

In addition, the PFIARA directs the SEC, when prescribing regulations generally, to take into account the size, governance and investment strategy of "mid-sized private funds." Because Congress did not define the term "mid-sized private fund," it is not clear what advisers will be covered or how the disclosure and other regulations under the Advisers Act will differ for such advisers.

Venture Capital Exemption

The PFIARA exempts advisers that advise solely one or more "venture capital funds" from the registration requirements of the Advisers Act but requires such advisers to maintain such records and provide to the SEC such annual or other reports as the SEC determines necessary or appropriate. Rather than defining the term "venture capital fund" itself, the PFIARA requires the SEC to issue final rules within one year of enactment of the PFIARA to define the term. While it is not clear how the SEC will ultimately define the term "venture capital fund" and whether it will encompass venture capital funds-of-funds, one may assume that the term will be defined based on the size of the fund or a business strategy of investing in small or startup businesses.

Family Office Exemption

The PFIARA excludes "family offices" from the definition of "investment adviser" under Section 202(a)(11) of the Advisers Act. As a result, family offices would be excluded from coverage by the Advisers Act, including the registration, record-keeping and reporting requirements to which they might otherwise be subject upon the elimination of the private adviser exemption. Rather than defining the term "family office" itself, the PFIARA grants the SEC discretion to define the term, but directs the SEC to fashion an exemption that "recognizes the range of organizational structures and management arrangements employed by family offices." Family offices that rely on grandfather provisions will be subject to antifraud provisions of Sections 206(1), (2) and (4) of the Advisers Act.

Limited Exemption for "Foreign Private Advisers"

The PFIARA adds a new limited exemption from registration under the Advisers Act for investment advisers that are "foreign private advisers." A "foreign private adviser" includes any investment adviser that:

- has no place of business in the United States;
- has fewer than 15 clients and investors in the United States in private funds advised by the investment adviser;
- has aggregate assets under management attributable to clients in the United States in private funds advised by the investment adviser of less than $25 million or such higher amount as the SEC may by rule deem appropriate; and
- neither holds itself out generally to the public in the United States as an investment adviser nor acts as an investment adviser to a registered investment company or business development company.

While the statutory language is not completely clear, it appears the foreign private adviser exemption applies to both advisers to private funds and advisers to traditional clients accounts, provided that the total of US investors in private funds advised by such adviser plus other US clients advised by such an adviser is less than 15. Due to the narrow scope and size limitations of the foreign private adviser exemption, many offshore fund advisers will not be able to take advantage of it.

Commodity Trading Exemption

The PFIARA includes an exemption for advisers registered as commodity advisers with the Commodity Futures Trading Commission ("CFTC") and that advise a private fund. The exemption provides, however, that if the business of the adviser becomes predominantly the provision of "securities-related" advice, then such adviser must register with the SEC.

Limited Exemption for SBICs

The PFIARA adds a new limited exemption for investment advisers, other than business development companies, that advise solely (i) small business investment companies licensed under the Small Business Investment Act of 1958, (ii) entities that have received from the Small Business Administration notice to proceed to qualify for a license, or (iii) applicants related to one or more licensed small business investment companies that have applied for another license.

Private Equity Exemption Removed

The PFIARA does not include the exemption from the registration requirements of the Advisers Act for advisers to "private equity funds" that was originally included in the Senate version of the legislation passed on May 20, 2010.

Contraction of Intrastate Exemption

The existing intrastate exemption found in Advisers Act Section 203(b)(1) for investment advisers whose clients are all residents of the state in which the investment adviser maintains its principal place of business remains in place. However, the intrastate exemption has been amended to exclude from its coverage investment advisers to "private funds."

State Law Regulation

The PFIARA increases the threshold for registration under the Advisers Act from $25 million in assets under management to $100 million in assets under management, unless the investment adviser would be required to register with 15 or more states. As a result, any investment adviser with less than $100 million in assets under management will not be subject to federal regulation and the registration requirements under the Advisers Act, but instead will be subject to state investment adviser regulation. Since many of these investment advisers are already registered with the SEC under the federal Advisers Act, this change would require these advisers to de-register with the SEC. For those advisers that are not already registered with the SEC in reliance on the private adviser exemption, this change will require state registration subject to any available state exemptions. In addition, Section 928 of the Act adds a clarification that the Advisers Act Section 205 limitations on performance compensation do not apply to state-registered advisers.

Reporting Requirements

Information Gathering and Sharing

The PFIARA authorizes the SEC to require registered investment advisers to private funds to maintain such records and file such reports regarding the private funds they advise as are necessary or appropriate for the protection of investors or for the assessment of systemic risk by the new Financial Stability Oversight Council ("Council") created under the Act, to consist of the Secretary of the Treasury, the Chairman of the SEC and the heads of various other financial regulatory bodies. The required records and reports for each private fund include a description of:

- the amount of assets under management and use of leverage;
- counterparty credit risk exposures;
- trading and investment positions;
- valuation policies and practices of the fund;
- types of assets held;
- side arrangements or side letters;
- trading practices; and
- such other information as the SEC in consultation with the Council determines necessary or appropriate in the public interest and for the protection of investors for the assessment of systemic risk, which may include the establishment of different reporting requirements for different classes of fund advisers based on the type or size of the private fund being advised.

Records regarding valuation policies and practices of the fund, the types of assets held and side arrangements or side letters will be subject to periodic and special examinations by the SEC. The PFIARA also requires the SEC to share reports, documents, records and information with the Council to the extent the Council deems necessary for the purposes of assessing the systemic risk of a private fund. These additional disclosure requirements likely will facilitate additional SEC scrutiny of potential conflicts of interest, investor disclosures and valuation matters. The additional attention also may bring an increased risk of an enforcement action. Further, the Council may use this information in determining whether an adviser or fund should be subject to additional regulation and prudential supervision under Title I of the Act.

Confidentiality of Reports

The PFIARA provides that any "proprietary information" of an investment adviser ascertained by the SEC from any report required to be filed under the Advisers Act shall not be subject to public disclosure and shall be exempt from Freedom of Information Act ("FOIA") disclosure requirements. "Proprietary information" includes sensitive, non-public information regarding:

- the investment or trading strategies of the investment adviser;
- analytical or research methodologies;
- trading data;
- computer hardware or software containing intellectual property; and
- any additional information that the SEC determines to be proprietary.

Many private equity fund advisers will likely want clarification that portfolio-specific information will also be considered proprietary. The SEC may not withhold information from Congress, nor will the SEC be precluded from complying with a request for information from any other federal department or agency or an order of a court of the United States in an action brought by the United States or the SEC.

Disclosure of Client Information

Under the PFIARA, the SEC may require an investment adviser to disclose the identity and investments of clients "for purposes of assessment of potential systemic risk." This represents a significant departure from the current Advisers Act provision, which permits the SEC to require disclosure of client information only in connection with an enforcement proceeding or investigation.

Additional PFIARA Changes

Custody of Client Assets

The PFIARA adds a new provision to the Advisers Act requiring registered investment advisers to take such steps to safeguard client assets over which the adviser has custody, including verification of client assets by independent public accountants and such other client protections as the SEC may prescribe by rule. The SEC issued new final custody rules in December 2009, requiring a registered investment adviser to (1) undergo an annual surprise examination by an independent public accountant to verify client assets, (2) have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients, and (3) unless client assets are maintained by an independent custodian, obtain a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board. Since the SEC adopted its new custody rules prior to the release of the PFIARA, one may assume that Congress expects to see additional rulemaking from the SEC regarding custody safeguards.

Accredited Investor and Qualified Client Standard Adjustment

The PFIARA also directs the SEC to adjust the "accredited investor" standard under the Securities Act of 1933, as amended (the "Securities Act"), (i) to exclude an individual's primary residence from the calculation of the $1 million net worth requirement, (ii) to adjust monetary thresholds to account for inflation, and (iii) to revisit the accredited investor standard every four years going forward. In addition, the PFIARA requires the SEC to update any exemptions in the Advisers Act based on dollar thresholds (such as a net asset threshold or those included in the definition of "qualified client" in Rule 205-3) within one year of enactment and every five years thereafter. These changes will have a greater impact on Section 3(c)(1) funds, because Section 3(c)(7) fund investors must satisfy the higher "qualified purchaser" thresholds.

"Client" Definition

The PFIARA includes a provision that prohibits the SEC from defining the term "client" for purposes of the antifraud rules in Section 206(1) and (2) of the Advisers Act to include the investors in a private fund if the fund has entered into an advisory contract with the investment adviser. This provision may limit the extension of an investment adviser's fiduciary duties to its fund's investors.

Commodity Futures Trading Commission

The PFIARA requires the SEC and the CFTC to jointly promulgate rules regarding reports required to be filed with the SEC and the CFTC by investment advisers that are registered under both the Advisers Act and the Commodity Exchange Act.

GAO Studies

The PFIARA includes a provision requiring a cost study assessing the annual costs to industry members and their investors due to the registration and reporting requirements and requires the Comptroller General to carry out a number of additional studies, including studies assessing:

- costs associated with client custody rules;
- accredited investor standards;

- the feasibility of a self-regulatory organization to oversee private funds; and
- short selling practices.

The inclusion of a requirement for a study regarding a self-regulatory organization to oversee private funds indicates that there is a potential for additional regulation of these types of funds and/or their advisers. The Comptroller General must report the results of such studies to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.

Transition Period and Effective Date

The PFIARA provides that it will be effective one year after enactment, but that investment advisers may register before the effective date.

Other Aspects of the Act Impacting Private Funds

Regulation D

Section 926 of the Act includes a provision prohibiting the offer and sale of securities in Regulation D exempt offerings by felons and other "bad actors," including individuals convicted of misdemeanors in connection with the offer and sale of securities. This provision reflects a significant change from the original Senate version of the Act, which would have increased state regulation of private securities offerings pursuant to Regulation D.

Investment Adviser Incentive Compensation Arrangements

Section 956 of the Act includes a provision relating to enhanced compensation structure reporting by "covered financial institutions," which are defined to include investment advisers and registered broker-dealers. This provision requires that the Federal Reserve, the SEC and other federal regulators jointly prescribe regulations within nine months of enactment to require each covered financial institution to disclose the structures of all incentive-based compensation arrangements offered by that institution sufficient to determine whether the compensation structure provides excessive compensation, fees or benefits to an executive officer, employee, director or principal shareholder of the institution, or could lead to material financial loss to the institution. In addition, the regulators are required to jointly prescribe regulations that prohibit any incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by covered financial institutions by providing excessive compensation, fees or benefits or that could lead to material financial loss to the institution. The provision does not apply to covered financial institutions with assets of less than $1 billion. It is unclear whether this exemption refers to the direct assets of investment advisers or to the assets under management by investment advisers. It is also not yet clear how the incentive allocations and performance fee structures charged by private investment funds will be impacted under the regulations to be promulgated by the federal regulators.

Standards of Conduct Applicable to Retail Customers

Section 913 of the Act includes provisions:

- requiring a study and additional rulemaking potentially impacting any investment adviser providing personalized investment advice to a "retail customer" (including natural persons who receive personalized investment advice and use such advice primarily for personal, family or household purposes);
- permitting the SEC to promulgate rules providing that the standard of conduct of brokers, dealers and investment advisers when providing personalized investment advice to retail customers (and such other customers as the SEC may by rule provide) shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer or investment adviser providing the advice;
- requiring disclosures of any material conflicts of interest and permitting consent by the customer; and
- requiring the SEC to enhance disclosure requirements and examine and promulgate rules prohibiting or restricting certain sales practices, conflicts of interest and compensation schemes for brokers, dealers and investment advisers.

Arbitration

Section 921 of the Act amends Section 205 of the Advisers Act to grant the SEC authority to restrict or condition the use of mandatory arbitration clauses by brokers, dealers or investment advisers.

Whistleblower Incentives

Section 922 of the Act adds a new Section 21F to the Securities Exchange Act of 1934, providing for a reward of 10-30 percent of the total monetary sanctions for whistleblowers in SEC actions under the securities laws that result in monetary sanctions exceeding $1 million. The new provisions not only facilitate the SEC's use of rewards, but also permit their use in a broader range of SEC enforcement actions.

Aiding and Abetting Liability

Section 929N of the Act amends Section 209 of the Advisers Act to include a new provision confirming that any person who knowingly or recklessly has aided or abetted a violation of securities laws is liable to the same extent as the primary actor. This provision represents a significant expansion of liability under the antifraud provisions of the federal securities laws.

Additional SEC Enforcement Powers

Title IX provides the SEC with additional enforcement powers and remedies, including expanded subpoena power, additional flexibility in civil proceedings, additional extraterritorial jurisdiction, and flexibility with respect to collateral bars.

Additional Studies

Title IX of the Act, the "Investor Protection and Securities Reform Act of 2010," requires several additional studies potentially impacting investment advisers, including studies:

- by the SEC regarding the need for enhanced examination and enforcement resources for investment advisers;
- by the SEC regarding the financial literacy of investors;
- by the Comptroller General regarding mutual fund advertising; and
- by the SEC regarding ways to improve investor access to registration information about investment advisers, brokers, dealers and their associated persons.

The inclusion of these studies indicates that there is a potential for additional regulation regarding examination, enforcement and advertising by investment advisers.

Impact

As a result of the PFIARA and subject to additional SEC rulemaking articulating the details of the remaining registration exemptions, it appears that many private investment fund managers with more than $150 million in assets under management in the United States will need to register with the SEC. Many of these firms, particularly the larger ones, have already registered for a variety of reasons, not the least of which is the sense that the limited partner community, particularly ERISA or other fiduciary investors, have a strong preference for investing with registered investment advisers. However, there are likely to be many middle-market fund managers and newer fund managers now needing to register as a result of the PFIARA. In addition, the new Advisers Act regulations will require fund advisers to expand their compliance framework with an eye to enhancing disclosures and the culture of compliance. Registered and unregistered advisers should study the legislation and the forthcoming regulations and consider how they will impact their day-to-day operations. Further, investment advisers should prepare for additional regulatory oversight and — as additional details regarding the proposed reporting and other obligations emerge — develop and refine appropriate compliance policies and procedures.

Further Information

The Hunton & Williams Private Investment Fund practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings, secondary sales and compliance. We will continue to monitor the PFIARA and regulations promulgated thereunder and other relevant trends in private investment fund regulation.

For additional information on financial industry recovery proposals, see our related memoranda, available on huntonfinancialindustryrecovery.com. For additional information on recent proposals relating to regulation of private investment funds and their advisers, see our prior memoranda available on our website at www.hunton.com.

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July 2010 Analysis of the Dodd-Frank Wall Street Reform Act

Volcker Rule Will Impact Private Fund Industry

On July 15, 2010, the Senate approved the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), previously passed by the House on June 30, 2010. President Obama is scheduled to sign the Act into law on July 21, 2010. The Act includes expansive financial industry regulatory reforms, including new restrictions on the private investment fund activities of banking entities and their affiliates, known as the "Volcker Rule."[1] This analysis discusses the Volcker Rule's impact on the private investment fund industry.

The Volcker Rule

Who is covered?

The Volcker Rule applies to any "banking entity," including any insured bank or thrift, a company that controls an insured bank or thrift, a company that is treated as a bank holding company and their affiliates and subsidiaries. Nonbank financial companies supervised by the Federal Reserve engaging in the prohibited activities may also be subject to certain limitations, including additional capital requirements. Since smaller banking entities generally have not focused on private investment funds as a business strategy, such smaller banking entities generally will be less affected by the Volcker Rule than larger banking entities.

What is prohibited?

The Volcker Rule imposes several restrictions on these entities: (1) banking entities are prohibited from engaging in proprietary trading; and (2) banking entities are prohibited from acquiring or retaining any interest in, or sponsoring, a "hedge fund" or "private equity fund," subject to certain limited exemptions. Most notably, banking entities that sponsor or act as investment advisers to hedge funds or private equity funds are prohibited from entering into a "covered transaction" (including loans, purchases of assets or securities, and guarantees) with those funds. The terms "hedge fund" and "private equity fund" are loosely defined in a manner similar to the new "private fund" definition under the Private Fund Investment Advisers Registration Act (included in Title IV of the Act), as any investment fund that relies on the exceptions from investment company status found in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended.

Is any private fund sponsorship or investment permitted?

The Volcker Rule permits certain de minimis investments in hedge funds and private equity funds, defined as investments that (i) do not exceed 3 percent of the total ownership interests of the fund and (ii) do not represent in aggregate more than 3 percent of the Tier 1 capital of the banking entity. This exception also permits organizing, offering, serving as a general partner or managing member and controlling the management of the fund, provided the banking entity complies with certain conditions, including:

- the banking entity must provide bona fide trust, fiduciary or investment advisory services;
- the fund may be offered only to the banking entity's customers of such services;
- the banking entity must comply with the prohibition on covered transactions;
- the banking entity (including its subsidiaries and affiliates) sponsoring or advising the fund will be subject to Section 23B of the Federal Reserve Act (which requires arm's-length terms in transactions with affiliates) as if

1 The Volcker Rule is found in Section 619 of the Act.

it were a member bank and such fund its affiliate;

- the banking entity may not guarantee, assume or insure the obligations of the fund;
- the banking entity may not share with the fund the same name or variation of its name;
- only those employees of the banking entity who are directly engaged in providing investment advisory or other services to the fund may take or retain an ownership interest in the fund;
- the banking entity must make certain disclosures to investors regarding fund losses;
- the sponsorship or investment must not (i) involve or result in a material "conflict of interest" (yet to be defined) between the banking entity and its clients, customers or counterparties; (ii) result in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (yet to be defined); or (iii) pose a threat to the safety and soundness of such banking entity or a threat to the financial stability of the United States; and
- the banking entity must comply with additional capital requirements and quantitative limitations, including diversification requirements, that may be adopted by federal banking regulators, the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC").

While this 3 percent exemption may initially appear helpful to the industry, it raises a number of questions. For example, what happens if a banking entity relying on this exemption experiences appreciation of fund investments or depreciation of other assets resulting in an over-allocation to hedge and private equity funds? Presumably, these and other important questions will be addressed in the rulemaking process as mandated by the rule.

What is the prohibition on covered transactions?

Compliance with the new prohibition on a banking entity that serves as the investment adviser or sponsor to a hedge fund or private equity fund entering into a "covered transaction" with the fund may be challenging. As a practical matter, "covered transactions" include a number of related party transactions between the fund and affiliated banking entities involving leverage. The Federal Reserve Board may permit an exception for a banking entity to engage in prime brokerage transactions with any hedge fund or private equity fund in which it has taken an ownership interest if it is otherwise in compliance with the conditions described above, its CEO certifies annually as to its compliance, and the Board has determined that the transaction is consistent with safe and sound operation and condition of the banking entity.

What is the timing of implementation?

While the impacts on certain regulated financial institutions may be severe, Congress has allowed substantial time for delayed implementation. The Act requires the new Financial Stability Oversight Council to conduct a study of the Volcker Rule, to be completed within six months of the enactment of the Act. Within nine months of the completion of this study, the appropriate federal banking agencies, the SEC and the CFTC must jointly issue final regulations implementing the Volcker Rule. The Volcker Rule is effective on the earlier of (i) 12 months after the date of issuance of final rules or (ii) two years after the date of enactment, which would be July 2012. The Volcker Rule contemplates a two-year divestiture period for prohibited businesses and investments, which period may be extended one year at a time for not more than an aggregate of three years, provided the divesting party is using good faith to expedite its disposition.

The Act acknowledges that some banking entities may have commitments to continue fund investments at increased ownership levels. Thus it has expressly allowed the Federal Reserve Board to extend for up to five years the period in which a banking entity may take or retain an ownership interest in or provide additional capital to an "illiquid fund" (which is defined as any fund that as of May 1, 2010, was invested or committed to invest principally in illiquid assets such as portfolio companies, real estate investments, and venture capital investments) to the extent necessary to fulfill a contractual obligation in effect on May 1, 2010. In each case the extensions will be subject to the banking entity's complying with additional capital requirements.

Impact

The private equity industry is already planning for compliance with the Volcker Rule. Several banking entities are active limited partners in all variety of funds, in some cases building large portfolios of fund interests. Each of those investors will want to assess whether to sell some investments or whether their portfolios will fall under the de minimis exemption prior to the compliance dates. They should also examine the underlying fund documents for transfer requirements. The markets have seen an increasing volume of secondary sales in 2009 and 2010, and the Volcker Rule should facilitate a continuation of that trend. Other banking entities have become active in the sponsorship of private funds. Each of those entities should undertake a similar assessment. Obviously, planning to dispose of a fund management business will be more involved than a sale of limited partner interests. Further, general partners of private funds will want to understand the impact of the Volcker Rule on their LP base and LP plans to transfer LP interests and/or cease investing in subsequent funds. Finally, other limited partners may see attractive secondary purchase opportunities, whether through rights of first refusal in fund documents or in marketed transactions. These transactions often require prompt action on the part of the buyer, and such LPs would be well advised to plan in advance for these purchase opportunities.

Further Information

The Hunton & Williams Private Investment Fund practice group regularly represents funds, sponsors and a variety of investors, including regulated financial institutions, in all types of private investment fund matters, including structuring, formation, offerings, secondary sales and compliance. We will continue to monitor the study and various regulations implementing the Volcker Rule and other relevant trends in private investment fund regulation.

For additional information on financial industry recovery proposals, see our related memoranda, available on huntonfinancialindustryrecovery.com. For additional information on recent proposals relating to regulation of private investment funds and their advisers, see our prior memoranda available on our website at www.hunton.com.

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FINANCIAL INSTITUTIONS CORPORATE & REGULATORY UPDATE

July 2010

Analysis of the Dodd-Frank Wall Street Reform Act

Impact of the Dodd-Frank Act on Main Street

By: Peter G. Weinstock[1]

On July 15, 2010 the Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which represents the most sweeping change to banking law since Congress adopted the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), if not before. FIRREA was the congressional action designed to "forever prevent" another banking catastrophe. Many statements from the late 1980s, such as the elimination of "too big to fail" ("TBTF"), have echoed in the debate over "systemically important" financial institutions. Hopefully, the Act's Financial Stability Oversight Council and the orderly liquidation authority over nonbanks that pose systemic risk will have more success than the FIRREA tools that were not effectively employed to prevent the subprime bubble.

This client alert does not cover the creation of the Bureau of Consumer Financial Protection, the "Volcker Rule," regulation of private fund investment advisers, derivatives and swaps or other matters that primarily impact the country's biggest banks or nonbank enterprises. These issues are addressed in other Hunton & Williams client alerts. We would be happy to discuss any of those matters. This client alert, however, is limited to issues that should resonate among "main street" bankers.

1. Leveling the Playing Field. The focus of the capital purchase program under the Troubled Asset Relief Program ("TARP") and the Temporary Liquidity Guarantee Program ("TLGP"), as well as numerous other programs provided by the U.S. Treasury ("UST") and the Federal Reserve Board ("Federal Reserve") was to address systemic risk factors that followed in the wake of the bankruptcy of Lehman Brothers. The not-intended consequence of such programs was that consumers and businesses determined that the country's largest banks were TBTF. Consequently, such financial institutions have enjoyed a lower cost of funds than their industry compatriots who are perceived to lack a similar government bulwark. UST Secretary Geithner has commented of the Act that "these reforms will help level the playing field, allowing community banks to compete more fairly with the nation's largest financial firms."

The Act seeks to reduce, although it will not eliminate, this pricing disparity through three steps. First, the Act makes permanent the increase in the FDIC's deposit insurance coverage to $250,000. Second, the Act extends through the end of 2012 the TLGP's protection for transaction account customers whose balances exceed the limit on deposit insurance. Third, the Act now allows financial institutions to pay interest on corporate transaction accounts.

For many community banks, paying interest on corporate deposits will represent a mixture of opportunity and cost. Some financial institutions may focus on their existing corporate transaction accounts and calculate the cost of paying interest as a pure expense item. While the expenses are easy to measure, what is harder to quantify is the opportunity to compete on a more even basis with larger financial institutions. Currently, as businesses grow, they migrate to larger banks that offer sweep accounts and other sophisticated programs that enable corporate treasurers to obtain some yield on their transaction accounts. Now, however, all financial institutions will be able to compete for such business.

2. Interchange Fees. The Act requires fees charged for debit card

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transactions to be both "reasonable and proportional" to the cost incurred by the card issuer. Within nine months of the Act's enactment, the Federal Reserve is to flesh out the meaning of such terms. The Federal Reserve must consider costs incurred by issuers for fraud prevention, but cannot consider other expenses incurred in connection with the authorization, clearance and settlement of electronic debit transactions unless such costs are specific or incremental to the transactions. Any debit card issuer that has, along with its affiliates, fewer than $10 billion of assets will be exempt from the limit on interchange fees.

It is hard to see how exempt institutions will be able to maintain their existing fee structure. First, the competitive market will require that all fees be the same or merchants will migrate away from doing business with customers who hold debit cards issued by smaller issuers. Second, payment networks and issuers may no longer contract that all transactions be handled exclusively on one network. Instead, merchants will be allowed to route their transactions over any network. The Act also overrides issuer restrictions on merchant action to minimize fees paid, such as merchants providing discounts for cash transactions or establishing minimum transaction amounts for using debit cards.

The Act exempts debit or prepaid cards issued as part of federal, state or local government-administered payment programs. One year after the Federal Reserve's regulations become effective, an issuer of such a card may charge overdraft fees and a fee for the first withdrawal per month from an ATM.

Certain financial analysts have estimated that the costs of the changes to the interchange fees will be less than 3 percent of earnings for the TBTF banks and between 4 and 8 percent of earnings for other banks. Such estimates do not assume that financial institutions seek to recoup such revenue from changes in existing fee structures, benefits awarded under reward programs or incentives given to customers who use credit cards rather than debit cards. As Jamie Dimon, JPMorgan Chase & Co. CEO, noted, "If you're a restaurant and you can't charge for the soda, you're going to charge more for the burger."

3. Assessments. The Act changes the basis for assessments from a tax based on deposits to one based on assets. The assessment base will be based on average consolidated total assets of the financial institution minus its tangible equity. In the case of custodial banks and bankers' banks, the FDIC must determine a consistent formula.

The minimum reserve ratio has been increased from 1.15 percent to 1.35 percent of deposits. The Deposit Insurance Fund ("DIF") is to reach this ratio by September 30, 2020. Currently, the FDIC expects the DIF to reach 1.15 percent by March 31, 2017.

The Act places the burden of the assessments needed (to reach the required threshold) on institutions with total assets above $10 billion. It is unclear whether the assets of sister banks of the same holding company will be aggregated for the purpose of calculating what institutions are subject to such higher assessments.

The FDIC was required by law to pay dividends if the DIF exceeded 1.15 percent. This requirement arguably was counter-cyclical. The Act now removes this requirement. Going forward, the FDIC will have discretion of whether or not to pay dividends.

4. The Office of Thrift Supervision ("OTS"). It seems fair to say that few countries, if they were starting from scratch, would design a system of bank regulation that had as its end result our country's myriad of federal bank regulatory agencies with overlapping authority over the same financial institutions. As discussed below, in the Act, Congress actually further expands regulatory duplication. The last remnant of the Obama administration's original proposal to streamline and make more efficient jurisdiction over financial institutions that made it through the Congressional meat grinder concerns the fate of the OTS.

The Act provides for the elimination of the OTS as a separate regulatory body. The OTS is to be merged into the Office of the Comptroller of the Currency (the "OCC"). The Act establishes a deputy comptroller for federal savings banks. In contrast, the House bill had proposed a Division of Thrift Supervision housed within the OCC and a senior deputy comptroller.

The Act provides that all employees of the OTS would become employees of the OCC and the other federal bank regulator agencies, as the case may be, with similar seniority and positions to the extent available. The OCC would have the authority to adopt rules and regulations governing federal savings banks and will have the same jurisdiction over federal thrifts that the OTS now possesses.

All orders, resolutions, determinations, agreements, regulations, interpretive rules, other interpretations, guidelines, procedures and other advisory materials that have been issued by the OTS will continue in effect after the date of transfer of authority and the demise of the OTS. The OCC and the other federal bank regulatory agencies, as the case may be, however, are to publish no later than the transfer date, the regulations of the OTS that each such agency intends to continue.

The Federal Deposit Insurance Corporation (the "FDIC") will continue to regulate and supervise state savings banks. The OCC, Federal Reserve and FDIC will consult with one another to discuss changes to OTS regulations, staffing and other matters. The federal bank regulatory authorities must publish any proposed changes to the OTS regulations by the transfer date.

The effective date for such transfers of authority would be one year after the date of enactment of the statute. The Secretary of Treasury, however, in consultation with the other federal bank regulatory authorities, including the OTS, can extend the time period for the transfer of authority, but not by more than 18 months after the date of enactment. Ninety days after the transfer date, the OTS and the position of director of the OTS are to be abolished.

5. The Fate of the Federal Savings Bank Charter and Thrift Holding Companies. The Act prohibits the OCC from granting any additional federal savings bank charters. The existing 757 federal savings bank charters (at March 31, 2010) are grandfathered.

The Act continues the qualified thrift lender ("QTL") test. Unlike the current lax consideration given to the QTL test by the OTS, the Act strengthens enforcement. There will be dividend restrictions in the event a savings bank is not in compliance with the QTL test. Moreover, the failure to comply may be subject to civil money penalties, administrative action and other sanctions. The provisions of the House bill that proposed forcing a federal savings bank to convert to a national bank if it failed the QTL test were not adopted.

The Federal Reserve will regulate thrift holding companies and their nonbank subsidiaries. The 10(l) election under the Home Owners' Loan Act ("HOLA") that currently authorizes holding companies over state savings banks to elect to be regulated either by the OTS or the Federal Reserve is eliminated.

For the first time, thrift holding companies will now be subject to regulations related to capital requirements. In contrast, under existing law, thrift holding companies are not subject to any quantitative capital requirements or leverage limitations. The Federal Reserve's leverage and risk-based capital requirements, however, will not become applicable for five years. This delayed effectiveness is intended to enable thrift holding companies to deleverage as need be.

6. Financial Holding Companies. For thrift holding companies that are engaged in activities that are financial in nature under the authority created by the Gramm-Leach-Bliley Act, the Act permits the Federal Reserve to require that such activities be contained in an intermediate thrift holding company. Such intermediate holding companies, as well as financial holding companies (and not just their financial institution subsidiaries), will now be subject to the Federal Reserve's capital and management requirements.

7. Capital. Senator Collins proposed an amendment (the "Collins Amendment") that was incorporated into the Act requiring bank regulators to establish for holding companies minimum capital levels that are at least of the same nature as those applicable to financial institutions. In doing so, however, the Act requires that the Federal Reserve seek to make any capital requirements counter-cyclical, "so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the company."

All trust preferred securities ("TRUPs") issued by bank or thrift holding companies prior to December 31, 2009 (or mutual holding companies prior to May 19, 2010) continue to count as Tier I capital for holding companies with assets under $15 billion at December 31, 2009. Starting on January 1, 2013, holding companies with assets above the $15 billion threshold will deduct one-third of TRUPs a year for the following three years from Tier I capital. (The TRUPs will become Tier II capital.) Within 18 months, the GAO is to conduct a study of hybrid capital elements.

Holding companies that received funding under TARP will continue to be able to count such securities as Tier

I capital. The $500 million Regulation Y small bank holding company exemption has been preserved.[2]

8. Source-of-Strength. The Act codifies the Federal Reserve's Source-of-Strength Policy Statement. Interestingly, while the Federal Reserve requires holding companies to serve as a source of financial and *managerial* strength, the statute only requires a holding company to serve as a source of financial strength to its subsidiary financial institutions. Thrift holding companies, as well as bank holding companies, are subject to the source-of-strength requirement. Commercial firms that own ILCs[3] also are subject to the source-of-strength requirement.

9. Branching. The Act generally provides for the possibility of unlimited nationwide branching for all financial institutions, not just federal savings banks. Under the Act, national and state banks can branch into states on a de novo basis. As long as a bank domiciled in the host state would be allowed to branch, then an out-of-state financial institution could establish that branch. Once in a state, an out-of-state financial institution may establish additional branches within a state to the same extent as a commercial bank chartered in such state can do so.

The Act also fixes a quirk of the Riegle-Neal Act, by making it clear that a federal savings bank that becomes a commercial bank may continue to operate any branch that it operated immediately before becoming a bank.

10. Transactions with Affiliates. The Act provides that the borrowing or lending of securities (including a guaranty, acceptance, or letter of credit issued on behalf of a securities borrowing or lending transaction) will be a "covered transaction" under the Affiliates Act and Regulation W to the extent it causes a financial institution to have credit exposure to the affiliate. Similarly, a derivative transaction will be subject to restrictions on transactions with affiliates if it creates a credit exposure for the bank. The Federal Reserve may issue regulations or interpretations considering the effect of a netting agreement on the amounts outstanding and collateral coverage requirements. Exceptions for transactions with financial subsidiaries have been eliminated. All of these changes would take effect one year from the enactment of the Act.

11. Insider Transactions. The Act also requires a majority of a financial institution's disinterested directors to approve in advance of the purchase or sale of any asset to or from any Insider (as defined by Regulation O) if the amount of the transaction exceeds 10 percent of the financial institution's capital. The transaction also must be on an arm's-length basis. The Federal Reserve is to adopt regulations further fleshing out this requirement. It can be expected that the Federal Reserve will exclude from the "disinterested director" definition members of management and likely will exclude directors who represent institutional investors.

12. Holding Company Supervision. The Act provides that the Federal Reserve examine nonbank subsidiaries of a bank or thrift holding company. To the extent possible, the Federal Reserve should rely on other agencies' examination reports and seek to avoid duplication of other agencies' examination activities. In addition, the Federal Reserve is to give notice to and consult with such agencies, including regulators of functionally regulated subsidiaries. The primary federal regulator of a financial institution is now entitled, under certain circumstances, to examine the holding company and its nonbank subsidiaries to the extent the Federal Reserve fails to do so. The primary regulator, however, must recommend any enforcement action to the Federal Reserve. Sheila Bair has said that the FDIC's back-up authority over holding companies will augment its back-up authority over financial institutions. Such back-up authority may assist in limited circumstances when one regulator fails to uphold its responsibilities. In most cases, however, rather than streamlining existing federal agency jurisdiction, the Act oftentimes adds to the clutter.

13. Preemption. The Act weakens the authority of the federal bank regulatory agencies to preempt state law rules and regulations. Essentially, Congress is rolling back federal preemption rules to that which existed before the bank regulatory agencies, at the behest of the industry, became more aggressive in finding preemption, and the Supreme Court backed up such findings. Congress does so by reinstituting the standard embodied in the *Barnett Bank of Marion County, N.A. vs. Nelson* decision. Essentially, the OCC would need to determine

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[2] For a discussion of sources of available capital, see the client alert that I co-authored with Mike Keeley dated March, 2009.

[3] The Act preserves for the time being the ILC charter. The Federal Reserve is to study commercial ownership of ILCs. While the fate of the ILC is debated, ILCs owned by commercial firms are subject to limitations on their activities.

that there is substantial evidence of a conflict between the federal rule and the state rule, and that the OCC has previously adopted a substantive standard intended to address the activity in question. We separately will provide information regarding that standard. Subsidiaries of national banks will not be able to rely on preemption.

14. Deposit Cap. The Act includes savings associations and ILCs, as well as banks, in the nationwide deposit limitation. Thus, no acquisition of any financial institution, not just a commercial bank, can be approved if the effect of the acquisition would be to increase the acquiror's nationwide deposits to more than 10 percent of all deposits.

15. SARBOX. The Act exempts companies with less than $75 million in market capitalization from the requirement to comply with the auditor attestation requirement for internal controls required by Section 404 of the Sarbanes-Oxley Act ("SARBOX").

16. Regulation D. Regulation D is most often used by smaller holding companies to raise capital in private placements. The issuance of securities is exempt from federal registration with the Securities and Exchange Commission ("SEC") if the offering is limited to 35 sophisticated purchasers and an unlimited number of "accredited investors." Accredited investors are either high earners or have net worths of a million dollars or more. The Act carves out the value of a home from the net-worth test. Moreover, the SEC is charged with evaluating whether to increase the income or net-worth thresholds over time and whether other changes are needed to protect investors. The effect of such changes could be to limit a holding company's ability to raise capital quickly and without the cost of a SEC registration.

17. Restrictions on Conversions of Troubled Banks. A financial institution may not convert its charter to the extent it has an existing administrative action unless:

- notice is provided to the financial institution's current regulator;
- the current regulator does not object to the conversion or the plan to address the significant supervisory matters;
- the new regulator ensures the plan is implemented; and
- in the case of an enforcement action issued by a State Attorney General, the financial institution commits to comply with such action.

18. Legal Lending Limit. Congress had considered applying the lending limit applicable to national banks to state banks. In other words, state banks would be subject to a lending limit of 15 percent of capital and reserves as the base rule applicable to any loans to one borrower. This provision did not make its way into the Act.

19. Excessive Compensation. The Act provides that the "appropriate federal regulators" must establish standards prohibiting, as an unsafe and unsound practice, any compensation plan of a bank holding company or other "covered financial institution" that provides an Insider or other employee with "excessive compensation" (undefined) or could lead to a material financial loss to such firm. A "covered financial institution" includes investment advisers, broker dealers, credit unions and any other entity that the appropriate federal regulators jointly deem to be covered. The appropriate "federal regulators" are all federal bank regulatory agencies plus the National Credit Union Administration board, the SEC and the Federal Housing Finance Agency.

In establishing such standards, the appropriate federal regulators will consider the safety and soundness standards regarding compensation that the FDIC issued in response to the Federal Deposit Insurance Corporation Improvement Act of 1991. The Federal Reserve has previously had the authority to regulate compensation at the holding company level. This authority was eliminated by the Riegle-Neal Act. The Act now provides even more such authority.

The Act requires companies with securities listed on national securities exchanges to require that all boards have compensation committees composed of members independent of the issuer. Certainly, most compensation committees are currently so populated under the best practices that arose following SARBOX. It is likely that the national securities exchanges will mandate independence tests for compensation committee members similar to existing tests for audit committee members, which tests are more strict than the overall requirements for a determination of board independence.

The Act furthermore requires the compensation committee to consider whether committee advisers are independent. These advisors include not just compensation consultants, but also legal counsel and accountants.

The Act also requires national securities exchanges to prohibit the listing of company equity securities if the company's compensation policies do not include "claw back" provisions if compensation were paid that should not have been in light of information subsequently uncovered. Although these compensation provisions govern firms listed on national security exchanges, it is highly likely that the bank regulatory authorities will adopt them either as best practices or as compensation standards in regulation for all financial institutions.[4]

20. Fair Lending; Regulatory Burden. The Act contains numerous provisions that will enhance the regulatory burden and challenge the compliance officers of financial institutions. For instance, the federal bank regulatory agencies have already ramped up enforcement of fair lending laws.[5] The Act requires financial institutions to inquire whether a small business loan applicant is a woman-owned or minority-owned enterprise. The financial institution will be required to retain for three years information such as the number of the application, the date on which the application was received, the type and purpose of the loan, the amount of credit applied for, the type of action taken, the applicant's census track, the gross annual revenue of the applicant, and the race, sex and ethnicity of the principal owners of the applicant. The purpose for such data collection is "to facilitate enforcement of fair lending laws." Accordingly, financial institutions should consider developing pricing models to ensure that there is clearly no disparate pricing or approval of such credits.

The work of the federal regulatory agencies will result in future further substantive changes. The Act provides for literally hundreds of regulations, studies and reports. Nonetheless, this summary will provide a good foundation of the current key topics primarily of concern to "main street" financial institutions and their holding companies.

[4] Other compensation provisions of the Act are discussed in separate Hunton & Williams client alerts.

[5] See my client alert dated June, 2010.

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Hunton Employment & Labor Law Perspectives

Posted at 1:05 PM on July 28, 2010 by Hunton & Williams LLP

Financial Reform: What Employers Can Expect

The Dodd-Frank Wall Street Reform and Consumer Protection Act just signed into law by President Obama, H.R. 4173, 111th Cong. (2010) ("Dodd-Frank"), creates new statutory rights and incentives for whistleblowers and also expands already existing rights, such as under the Sarbanes-Oxley Act ("SOX"). Now more than ever, clear policies and procedures backed by strong audit, compliance and investigatory functions are critical to managing the anticipated increase of regulatory enforcement and private party whistleblower litigation that this expansive legislation likely will create.

Here are the highlights:

- Dodd-Frank incentivizes individuals to aggregate and then report information that leads to a successful enforcement action of the Securities Exchange Commission ("SEC"), the Department of Justice ("DOJ") or other arms of government, by entitling an individual to between 10% and 30% of monetary sanctions exceeding $1 million as a result of "original information" provided by the individual;
- Dodd-Frank creates new whistleblower protections by prohibiting retaliation against an individual who provides information related to violations of securities laws to the SEC, who participates in any related SEC action, or who makes required disclosures under the Securities Exchange Act, SOX, or any law or regulation within the SEC's jurisdiction;
- Dodd-Frank entitles an individual to bring a private whistleblower action directly in federal court where he or she may be entitled to reinstatement and two times back pay;
- Dodd-Frank incentivizes plaintiffs' counsel to pursue whistleblower actions through lengthy limitations periods and allows for reimbursement of costs and attorneys' fees to a prevailing plaintiff;
- Dodd-Frank gives the SEC the authority to restrict pre-dispute arbitration agreements between customers or clients of brokers, dealers, or municipal securities dealers, so long as the SEC views the limitations as being in the public interest or to protect investors;
- Dodd-Frank creates a new private whistleblower action for alleged retaliation for any individual who provides information to the SEC; initiates or participates in any investigation or judicial or administrative action of the SEC; or makes disclosures as otherwise required under a variety of Federal laws including SOX and believes they were retaliated against as a result;
- Dodd-Frank amends SOX to expand coverage of the SOX whistleblower provisions to now include both publicly-traded companies and "any subsidiary or affiliate whose financial information is included in the consolidated financial statements of such" publicly-traded company;

- Dodd-Frank amends SOX to expand the time an individual has to bring a SOX whistleblower claim from 90 days after a violation occurs, to within 180 days of the aggrieved individual learning of the violation;
- Dodd-Frank amends SOX to allow a jury trial of whistleblower claims; and
- Dodd-Frank declares void any pre-dispute arbitration agreements waiving rights and remedies provided by SOX.

Although the regulations implementing and related to this legislation have not yet been written, an individual who submits information will still be entitled to the statutory protections the legislation affords. Just as individual whistleblowers and their lawyers will not wait around for this legislation to ripen, companies subject to securities laws need to address the Dodd-Frank Act immediately and thoughtfully in a coordinated and deliberate fashion. As the regulations are drafted and this enormous piece of legislation gains traction in the coming days, weeks and months, please consult the Hunton Employment & Labor Perspectives Blog for related in-depth analyses and updates.

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Dodd-Frank Corporate Governance and Executive Compensation Provisions Application to Public Companies

Enactment—effective immediately:

- SEC is authorized to enact proxy access rules
- Pursuant to final rules to be adopted by the national securities exchanges, brokers cannot vote uninstructed shares on (a) director elections (though a similar NYSE rule is already in place), (b) executive compensation proposals and (c) other "significant matters" as determined by the SEC
- Non-accelerated issuers are exempt from Section 404(b) of Sarbanes-Oxley
- SEC is authorized to amend the definition of beneficial ownership in Section 13(d) and shorten the timeframe in which an initial Schedule 13D must be filed (currently ten days)

July 21, 2010*

6 months after enactment

- Say-on-Pay:
  - All proxy statements must contain non-binding say-on-pay proposals on executive compensation (including a proposal on whether the say-on-pay proposal shall be held every 1, 2, or 3 years)
  - All proxy statements relating to mergers or other business combinations must include a say-on-pay proposal relating to golden parachutes
  - Institutional investment mangers subject to Section 13(f) of the Exchange Act must disclose annually how they voted on say-on-pay proposals

January 17, 2011

180 days after enactment

- Chairman/CEO Disclosure: Issuers must disclose the reasons for their current leadership structure, though comparable SEC rules are already in place

January 22, 2011

April 17, 2011

270 days after enactment

- Final whistleblower rules must be implemented

July 16, 2011

360 days after enactment

- Compensation Committees:
  - Members' Independence: Members must be "independent" as defined by the applicable national securities exchange
  - Advisors: Committee must have authority to retain and compensate advisors and must exercise oversight of its advisors' work
  - Advisors' Independence: Committee must consider its advisors' independence in light of various factors such as whether the advisor provides other services to the company and the amount of the advisor's fees from the company as a percentage of its total revenue

July 21, 2011

1 year after enactment

- Compensation Consultant Disclosure: Each issuer must disclose whether its compensation committee retained a compensation consultant and whether the work of the consultant raised any conflict and, if so, the nature of the conflict and how it is being addressed
- SEC and CFTC rules must be issued addressing clearance requirements for swap transactions. An "appropriate committee" of the board of directors must approve any "swap transactions" that rely on the "commercial end-user" exemptions

No Timeframe for New Requirements

- Claw-Back Policies: Implementation and disclosure of claw-back policies to recover incentive-based compensation awarded to all executive officers during the three-year period prior to a restatement of financial statements
- Disclosure of Hedging Policies: Disclosure of whether an issuer's employees or directors are permitted to hedge against the issuer's securities
- Executive Compensation Disclosure: Each issuer must disclose (a) the relationship between executive compensation actually paid and the issuer's financial performance and (b) the ratio of the median total compensation of all employees (except its CEO) with the annual total compensation of its CEO

*Certain dates in this timeline are deadlines by which final rules must be adopted