

Financial Regulation

Worldwide regulatory developments and their implications
for the financial services industry *international*

United States Financial Crisis Commission inquiry report

The Financial Crisis Inquiry Commission (FCIC) published its final report on the *Causes of the Financial and Economic Crisis in the United States* in January 2011[1]. The FCIC was set up the Fraud Enforcement of Recovery Act[2] to examine the causes of the financial and economic crisis with 22 specific points of enquiry. This provides the historical background to the circumstances that brought the US financial system and economy to the precipice of collapse in 2008.

The Report examines the circumstances behind the substantial losses suffered by such key financial institutions as Countrywide Financial, Bear Stearns, Lehman Brothers, American International Group (AIG), Fannie Mae and Freddie Mac, Washington Mutual, Wachovia, Citigroup, Merrill Lynch, Morgan Stanley and Goldman Sachs. The policies adopted by each of the key regulatory authorities were also examined. This included the Federal Reserve Board and Federal Reserve Bank of New York, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Department of Housing and Urban Development (DHUD), the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Agency (FHFA which replaced the OFHEO), the Office of Thrift Supervision (OTS), the Securities and Exchange Commission (SEC) and the Department of Treasury.

The Report intentionally only examines the causes of the crisis and makes no recommendations with regard to regulatory or policy reform. No assessment is made relevant federal laws, including the Troubled Asset Relief Program (TARP) which was separately examined by the Congressional Oversight Panel and the Special Inspector General for the TARP.[3]

The FCIC had ten members with expertise in the housing, economics, finance, regulatory, banking and consumer protection areas. 700 witnesses were examined with millions of pages of documents and 19 days of public hearings. The final report consists of 22 chapters extended to 632 pages with large amounts of additional evidence, data and information made available through its website. The dissenting views of two sets of four members out of the ten individuals on the core panel are also presented in the published report.[4]

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Michael Bleier at Reed Smith LLP provides an analysis of the measures introduced by the US regulator to implement key aspects of the Dodd Frank Act 2010. Copyright retained by Michael Bleier, or words to that effect.

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Structure

The Report breaks the events behind the crisis up into a number of separate stages. Part I examines the 'Crisis on the Horizon' with Chapter 1 on Before Our Very Eyes. Part II is concerned with 'Setting the Stage' and considers 'Shadow Banking', 'Securitization and Derivatives', 'Deregulation Redux' and 'Subprime Lending'. [5] The 'Boom and Bust' period is examined in Part III. This includes six chapters on 'Credit Expansion', 'The Mortgage Machine', 'The CDO Machine', 'All In', 'The Madness' and 'The Bust' [6].

The 'Unravelling' is explained in Part IV. This consists of nine chapters on 'Early 2007: Spreading Subprime Worries', 'Summer 2007: Disruptions in Funding', 'Late 2007 to Early 2008: Billions in Subprime Losses', 'March 2008: The Fall of Bear Stearns', 'March to August 2008: Systemic Risk Concerns', 'September 2008: The Takeover of Fannie Mae and Freddie Mac', 'September 2008: The Bankruptcy of Lehman', 'September 2008: The Bailout of AIG' and 'Crisis and Panic' [7]. The 'Aftershocks' are considered in Part V in two chapters on 'The Economic Fallout' and 'The Foreclosure Crisis' [8]. All of these individual chapters are informative and enlightened.

Overview

The FCIC confirms that the 'financial crisis of 2007 and 2008 was not a single event but a series of crises that rippled through the financial system and, ultimately, the economy' [9]. The vulnerabilities that had created the conditions within which a crisis could occur arose over many years although the more significant failure was the collapse of the housing bubble 'fuelled by low interest rates, easy and available credit, scant regulation and toxic mortgages' which led to 'a full-blown crisis in the fall of 2008' [10]. This led to a loss of almost US\$11trn in household wealth with 26 million losing permanent employment and with four million foreclosures and with possibly another 4.5 million households in danger of foreclosure.

The key triggers are referred to as the failure of Lehman Brothers in September 2008 with the impending collapse of AIG. The Report states that credit markets seized up after that due to a lack of transparency of balance sheet positions, perceived connection and 'too big to fail' [11]. This incorrect to the extent that markets began to freeze a year earlier in August 2007 although the Report correctly states that following the closure of Lehman, '[t]rading ground to a halt. The stock market plummeted. The economy plunged into a deep recession' [12]. The decision to

allow Lehman to fail was the single most important determinative event.

The Report begins by examining relevant opinions and expectations before the crisis as to the potential exposures and vulnerabilities within the financial system. It contrasts the feigned surprise of some bankers and regulators with the apparent inevitability expressed by other commentators. Charles (Chuck) Prince, former Chairman and CEO at Citigroup, referred to the collapse in housing prices as being 'wholly unanticipated' with former Federal Reserve Chairman, Alan Greenspan, claiming that, '[h]istory tells us [regulators] cannot identify the timing of a crisis, or anticipate exactly where it will be located or how large the losses and spill-overs will be' [13]. Richard Breeden, former Chairman of the SEC, claimed that, 'Everybody in the whole world knew that the mortgage bubble was there' and Angelo Mozilo, CEO of Countrywide Financial, described conditions as having created a 'gold rush' mentality [14].

The Report accepts that there were warning signs and specifically that housing prices were inflated, lending practices were out of control, too many homeowners were taking on mortgages and debt they could not afford and the risks to the financial system 'were growing unchecked' [15]. The assets and debt held by the financial sector grew from US\$3trn to US\$36trn between 1978 and 2007 with ten of the largest US commercial banks holding 55% of these by 2005. 25% of all US corporate profits were generated in the financial area [16].

The Report examines the early conditions that created the environment within which the crisis could occur [17]. This included the nature of the shadow banking system, the growth in securitisation and derivatives, regulatory deregulation and the growth of sub-prime lending [18]. The shadow banking system is examined specifically with regard to growth of the commercial paper and repurchase (repo) markets and the earlier savings and loan (S&L) crisis. The shadow banking system had grown to over US\$12trn in the US after 2005 before falling to around US\$8.5trn compared with a traditional banking market of US\$13trn [19]. Legislation was introduced after the Savings & Loan (S&L) crisis to allow banks and savings and loans institutions to deregulate to compete with other market sectors. This included the Depository Institutions Deregulation Monetary Control Act (DIDMCA) 1980 and the Garn-St Germain Act 1982. The crisis in the S&L market allowed Fannie Mae and Freddie Mac to expand substantially especially using

structured finance and then later synthetics tied to credit derivatives[20].

The Report examines the 'boom and bust' period. House prices rose by an average annual rate of 5.2% between 1995 and 2000 and then an astonishing 11.5% between 2000 and 2005[21]. The value of sub-prime loans doubled to US\$310bn between 2001 and 2003 with securitisations rising from 52% to 63%. The market also became increasingly consolidated with the top sub-prime lenders' share of the market increasing from 47% to 93% between 1996 and 2003. Federal authorities reconsidered introducing regulation in the sub-prime area to avoid abuses and predatory lending although insufficient action was taken. Illinois Attorney-General Lisa Madigan stated that: 'The federal regulators' refusal to reform [predatory] practices and products served as an implicit endorsement of their legality'[22]. The Commission concluded that there was 'untrammelled growth in risky mortgages' and that '[u]nsustainable, toxic loans polluted the financial system and fuelled the housing bubble'[23]. Growth in sub-prime lending had been supported by major financial institutions including Citigroup, Lehman and Morgan Stanley which had taken over key sub-prime firms at the same time as provide credit lines, securitisation facilities, purchase guarantees and other financial support. The Federal Reserve was considered to have failed during this period 'to meet its statutory obligation to establish and maintain prudent mortgage lending standards and to protect against predatory lending'[24].

Conclusions and Findings

The Report draws a number of specific conclusions on the key phases in the build up to the crisis at the end of certain key chapters. It also draws six more general findings and identifies three specific triggers with regard to mortgage securitisation, OTC derivatives and credit ratings. Three other important factors are identified, in terms of excess liquidity, Fannie Mae and Freddie Mac and government housing policy, although these are only considered to constitute contributing rather than core causal factors.

The key findings can be summarised in terms of avoidability, supervisory and regulatory failure, risk management and corporate governance defect, leverage, official fall and ethical failure.

(a) Predictability and Containment

The Commission concludes that the crisis was predictable and avoidable. It attributes fault to 'the

result of human action and inaction, not of Mother Nature or computer models gone haywire'[25]. There were a number of warning signs despite contrary statements on Wall Street and in Washington. The Commission considers that the 'tragedy was that they were ignored or discounted'[26]. Relevant factors included the sharp rise in subprime lending and securitisation, unsustainable house price increases, predatory lending, household debt growth and an increase in trading activities, unregulated derivatives and short-term repo lending. Action should have been taken by senior executives in the major financial firms and by the authorities.

There was 'pervasive permissiveness' with 'little meaningful action [being] taken to quell the threats in a timely manner'[27]. The Federal Reserve was the only authority that could set prudent mortgage-lending standards with its omission being referred to as a 'pivotal failure'[28]. Firms also failed to undertake proper credit assessments and relied on inaccurate credit ratings and short-term borrowing supported by misprice subprime mortgage securities.

(b) Regulatory Failure and Financial Instability

There had been excessive deregulation of US financial markets and an over-reliance on efficient market theories and self-regulatory capability within firms. The Report refers to this having been 'championed' by Alan Greenspan but also others 'supported by successive Administrations and Congresses' and industry lobbying. US\$2.7bn was spent in federal lobbying between 1999 and 2008 with US\$1bn being spent on campaign contributions[29]. This removal of 'key safeguards' was aggravated by the ability of firms to select the 'weakest supervisor' through regulatory arbitrage.

The Commission confirms that the regulatory authorities had the necessary powers to act if they had wished. The SEC could have imposed higher capital requirements and limited higher risk practices within investment firms. The Federal Reserve Bank of New York could have limited 'Citigroup's excesses' and the authorities generally controlled mortgage securitisation more strictly. They failed to carry out their supervisory functions adequately and ignored weaknesses. Where they had inadequate authority, they should have corrected this but often 'lacked the political will – in a political and ideological environment that constrained it – as well as the fortitude to critically challenge the institutions and the entire system they were entrusted to oversee'[30].

(c) Risk Management and Governance Failures

The maintenance of proper risk management failed in many major financial institutions including specifically Wall Street investment firms and bank holding companies. There was an over-reliance on short-term funding, modelling and the use of trading activities to generate returns. Modelling errors meant that '[t]oo often, risk management became risk justification'[31]. A number of firms purchased sub-prime lenders as well as acting as re-packagers and sellers of mortgage-backed securities. Internal compensation systems distorted incentives with a focus on short-term rather than long-term risk management. Normal oversight and governance arrangements failed with 'stunning instances of governance breakdowns and irresponsibility'[32].

(d) Leverage, Risk and Transparency

Excessive liquidity and credit led to excessive debt levels within financial institutions, other firms and households. Leverage ratios in the largest securities firms were around 40:1[33] with Fannie Mae and Freddie Mac having a combined leverage ratio by the end of 2007 of 75:1. Much of this was 'often hidden' through the use of derivatives, off-balance sheet vehicles and managed reporting. Firms and household also increasingly held higher risk instruments[34]. The collapse in confidence and contagion that followed was aggravated by a lack of transparency as to the holdings of this debt.

(e) Official Failure and Inconsistency

Many official agencies had failed to monitor the build up of exposure adequately within the firms they were responsible for overseeing. There had been an over-reliance on self-regulation and an assumed risk spread or diversification within the markets (under an originate-to-distribute model). Many authorities had also failed to predict the ensuing crisis and were unable to deal with the contagion that followed[35]. Inconsistent treatment of major institutions and, in particular, Bear Stearns, Fannie Mae and Freddie Mac with AIG and Lehman also 'increased uncertainty and panic in the market'[36].

(f) Ethical Responsibility

The Report refers to a more general breakdown in responsibility and ethics. Most of the specific examples given relate to federally unregulated mortgage brokers and specialist sub-prime lenders although this also clearly affected the firms carrying out the

securitisations and selling structured products. There had been a 20 times increase in mortgage fraud reports between 1996 and 2000 and a 40-fold increase between 2005 and 2009. Countrywide accepted that the losses on many of its loans could have 'catastrophic consequences' and that specific higher risk loans could result both in foreclosure and 'financial and reputational catastrophe' for the firm[37]. Many borrowers took out loans they knew they would not be able to afford longer term presumably on reliance on an early increase in the value of the property while brokers moved borrowers between products to generate higher undisclosed fees. These failures were then often ignored by the firms securitising or restructuring the mortgages.

The Commission is sufficiently objective to accept that all parties had a responsibility in creating the conditions that led to the crisis although it is particularly critical of financial executives and senior regulatory officials. In commenting on its six core findings, the Commission highlights 'mortal flaws like greed and hubris' although it was 'the failure to account for human weakness' that was more important[38]. The crisis was 'a result of human mistakes, misjudgements and misdeeds that resulted in systemic failures' with 'special responsibility' being attributed to the 'public leaders charged with protecting our financial system, those entrusted to run our regulatory agencies, and the chief executives of companies whose failures drove us to crisis'[39]. The Commission also admits that 'as a nation, we must also accept responsibility for what we permitted to occur' and that '[c]ollectively, but certainly not unanimously, we acquiesced to or embraced a system, a set of policies and actions, that gave rise to our present predicament'[40].

(g) Mortgage-Lending Standards and Securitisation

The Report identifies three further core mechanisms or 'gears' that significantly contributed to the crisis in terms of mortgage securitisation, over-the-counter (OTC) derivatives and credit rating failures. There was a clear and an evident collapse in mortgage processing standards with a 'wilful disregard for a borrower's ability to pay'[41]. The Federal Reserve failed in its mission to protect the safety and soundness of the US banking and financial system with the OCC and OFC being caught up in 'turf wars'[42]. The 'corrosion of mortgage-lending standards' was transmitted through the securitisation pipeline from US issuers to global investors and with everyone in the chain assuming they could 'off-load their risks on a moment's notice to the

next person in line'[43]. The basis for the originate-to-distribute (rather than distribute-to-hold) model was based on an assumed dispersion and spread of risk across the financial system which did to occur (above). Risks were not properly managed and losses adequately transferred with much of this remaining with a limited number of systemically important institutions after underlying mortgage repayment default was transmitted through the securitisation pipeline. The Report refers to the speculators 'who flipped houses' and the mortgage brokers 'who scouted the loans' as well as the lenders who issued the mortgages and the financial firms that created the mortgage-backed securities[44].

Once this system had failed, it was more 'difficult to unwind' with its apparent 'complexity' creating barriers to modifying mortgages to allow households to keep their homes with further uncertainty being created with regard to the condition of the financial and housing markets. The remedy system prevented renegotiation of contracts to avoid foreclosure with the lack of transparency with regard to the losses borne undermining the stability of the financial system more generally and preventing recovery in the housing market.

(h) Financial Derivatives

The deregulation of the OTC derivatives market in the US in 2000 permitted a build-up of uncontrolled leverage, inadequate transparency, capital cover and collateral and with increased speculation, interdependence and concentration of risk. The Report criticises the decision to prevent federal and state governments from regulating the OTC derivatives markets. Credit default swaps (CDSs) were blamed for fuelling the housing bubble and synthetic CDOs for amplifying losses following the collapse of the bubble[45]. AIG had to receive US\$180bn in support to prevent it from collapsing and undermining the global financial system with derivatives creating additional uncertainty and aggravating contagious effects[46].

(i) Credit ratings

The three largest credit rating agencies were criticised as being 'key enablers of the financial meltdown' with it being impossible to market and sell mortgage-related securities without their support[47]. Moody's rated 45,000 mortgage-related securities as AAA between 2000 and 2007 which included 30 securities every day in 2006 but with 83% of these ratings having to be

downgraded subsequently. Moody's was criticised for using flawed computer models, bowing to firm pressure, pursuing market share and allocating insufficient resources despite record earnings and with a larger lack of effective public oversight. The Report refers to investors relying on ratings 'often blindly' with some being 'obligated to use them' or 'regulatory capital standards [being] hinged on them'[48].

(j) Excess Liquidity

The Report considers three other causal factors separately with capital availability and excess liquidity, the role of Fannie Mae and Freddie Mac and US Government housing policy. The credit bubble was created by monetary policy choices keeping interest rates low and with substantial influx of international liquidity invested in US real estate assets. Excess liquidity was nevertheless not the cause of the crisis as such with 'well-priced capital' having created the opportunity for economic expansion and growth[49]. These benefits were undermined by the mortgage and financial market excesses referred to above.

(k) Government Sponsored Entities (GSEs)

Fannie Mae and Freddie Mac had pursued a 'deeply flawed business model' relying on implicit federal support in carrying out an apparently public function. They received US\$151bn in Treasury funding having increased their purchase of high risk mortgages in 2005 and 2006 and successive risk management and corporate governance failures. They were also criticised for spending US\$164m in lobbying between 1999 and 2008 to limit effective regulation and oversight[50]. The FCIC nevertheless accepts the GSE mortgage securities substantially retained their value throughout the crisis and that Fannie Mae and Freddie Mac were not primary causes although they had contributed to the crisis[51].

(l) Government Housing Policy

The FCIC also considered the effects of the affordable housing policies adopted by the Department of Housing and Urban Development (HUD) which was supported by many Administrations through incentives, assistance programs and mandates as well as the provision of additional savings and credit facilities under the Community Reinvestment Act (CRA) 1977. Only 6% of high-cost loans were connected with the CRA with many sub-prime lenders not being covered by its provisions. The CRA was not a significant causal factor. The Report also notes the

‘aggressive home ownership goals’ adopted in the US but criticises the Government for failing ‘to ensure that the philosophy of opportunity was being matched by the practical realities on the ground’ with the Federal Reserve and other authorities failing to prevent irresponsibility lending[52].

Commission comment

The Report is remarkably frank and critical of the circumstances that led up to the crisis. It is substantial in its research and study and final content and depth. Significant detail and insight is provided on every factor and institution that contributed to the final crisis in significant causal terms. The continuing use of detailed market data makes it an invaluable reference tool while the repeated use of interviewee quotes still makes it highly readable and informative. This will be used as an invaluable source of factual information for generations to come.

The Report accepts the complexity of the events that led up to the crisis and the extended period of time over which these processes evolved. Underlying conditions are explained in terms of the expansion of the shadow banking system, growth and securitisation and derivatives, regulatory deregulation and the forced growth in sub-prime lending and increasingly high risk mortgage products. Successive governance failures are identified within all of the major financial institutions with regulatory fault in all of the key US authorities. These ‘profound lapses’ led to almost ‘near fatal flaws’ in the US financial system[53]. Specific market failures are noted in terms of collapsing credit standards and mortgage securitisation, expansion of OTC derivatives, especially with CDSs and synthetic CDOs, as well as credit rating failures. Other predictable factors include an over-reliance on short-term funding, risk management and modelling errors, appalling levels of leverage and manipulation of debt reporting through the use of off-balance sheet vehicles, financial derivatives and regulatory reporting adjustments.

A number of the other more general conclusions and findings drawn are even more mature and informed. An over-reliance on market theory and correction is attacked and regulatory authorities savagely criticised for their oversight defects. Failure to take action in many cases also appeared to condone and support further abuse and malpractice. The Report is scathing of the Federal Reserve’s ‘pivotal failure’ and statutory derogation of duty[54]. Any excuse or explanation in terms of lack of power is rejected with authorities being under a duty to monitor and correct any

statutory or legal gaps. Reference is repeatedly made to officials not being prepared to deal with the crisis which would extend to both their earlier oversight and subsequent market support initiatives. The inconsistent treatment of a number of specific institutions including, in particular, Bear Stearns, Fannie Mae and Freddie Mac and AIG with Lehman is also highlighted[55].

The larger and possibly even more significant findings uncovered relate to the predictability and avoidability of the crisis. Blame for this is firmly placed in human action and error. This nevertheless extends from ‘flipping’ house buyers and fraudulent mortgage applicants to unregulated brokers as well as uncritical lenders and unscrupulous re-packagers and sellers of mortgage-backed debt to naive investors and other careless professional counterparties. Special responsibility is nevertheless placed on public leaders, regulatory agencies and financial chief executives[56]. The Commission is also blunt in its admission that the US nation as a whole must accept responsibility for what occurred and attacks collective acquiescence and inaction. It also stresses ‘collective responsibility’ in learning the necessary lessons and the need to take ‘different choices if we want different results’[57]. Much of this is clearly equally applicable in other countries where the authorities allowed similar housing and asset price bubbles to expand and then explode but possibly without some of the same underlying abusive and predatory mortgage practices as occurred in the US.

With collective failure, brings collective responsibility and the need for a collective response and commitment. The final Report is modest in its aims and makes no attempt, and has no authority, to issue specific recommendations for regulatory correction. Much of this is nevertheless clearly implied in the criticisms made throughout. One surprising aspect of this is possibly the apparent disconnect between the Commission’s investigative work and other regulatory reforms undertaken especially with regard to the negotiation and final drafting and agreement on the Dodd-Frank Act in 2010. The legislative and regulatory authorities in the US have started to take forward a large number of corrective initiatives to deal with all of the apparent failures identified in the US financial system for which they are to be commended. It may nevertheless take another separate report to determine whether all of the findings of the FCIC have been dealt with appropriately in terms of legislative and regulatory change.

Underlying the FCIC work and final Report is nevertheless a fundamental faith in financial markets and a desire to rebuild an effective capital allocation system. The Report refers to this as providing the ‘foundation for a new era of broadly shared prosperity’.

This is a noble but highly ambitious objective and agenda. The Report certainly represents an important step in this rebuilding process.

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Endnotes

1. Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (January 2011). Available at www.fcic.gov/.
2. Public Law 111-21 of May 2009.
3. www.treasury.gov/initiatives/financial-stability/about/Oversight/Pages/oversight.aspx.
4. These consist of Keith Hennessey, Douglas Holtz-Eakin, and Bill Thomas FCIC Report (n1) 413-439; and Peter J. Wallison and Arthur F Burns (n 1) 443-538.
5. FCIC Report, Chs.1 and 2-5.
6. FCIC Report, Chs.6-11.
7. FCIC Report, Chs.12-20.
8. FCIC Report, Chs.21-22.
9. FCIC Report 27.
10. FCIC Report (n) xvi.
11. xvi.
12. xvi.
13. FCIC Report, ‘Before Our Very Eyes’ Report, ch.1, 3.
14. FCIC Report 4 and 5.
15. FCIC Report 3.
16. xvii.
17. FCIC Report, Part II, Setting the Stage, 27-82.
18. FCIC Report, Chs.2-5. (n 5) above.
19. FCIC Report, figure 2.1.
20. The Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). FCIC, ‘Securitisation and Derivatives’ Report, ch.3. [Federal National Mortgage Association. Federal Home Mortgage Corporation].
21. ‘Credit expansion’ ch.6.
22. 97.
23. 101.
24. 101. See also (n 28) below.
25. xvii.
26. xvii.
27. xvii.
28. xvii. See also (n 24) above and (n 42) below.
29. xviii.
30. xviii.
31. xix.
32. Senior managers in AIG were ignorant of the terms and risk of its US\$79bn derivatives exposure to mortgage-backed securities. The senior management at Merrill Lynch were unaware that it held US\$55bn in ‘super-senior debt’. xix. In commenting on Citigroup’s failure to monitor its securities positions, the Commission stated that ‘too big to fail meant too big to manage’. xix.
33. The Report states that the leverage ratios of Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley and Goldman Sachs were 40:1. Bear Stearns specifically only had US\$11.8bn in equity capital against US\$383.6bn in liabilities with up to US\$70bn being borrowed in the overnight market. xix-xx. Average mortgage debt per household rose by 33% from US\$91,500 to US\$149,500 between 2001 and 2007.
34. With Lehman holding US\$111bn or four times its equity in property related securities and one in ten households having an ‘option ARM’ loan. xx.
35. The Federal Reserve and Treasury were both criticised for offering ‘public assurances that the turmoil in the subprime mortgage markets would be contained’ and the SEC for overstating the ‘capital cushions’ within the largest investment firms after the collapse of Bear Stearns which was described as being ‘relatively unique’. xxi.
36. xxi.
37. xxii.
38. xxiii.
39. xxiii.
40. xxiii.
41. xxiii. Almost one quarter of mortgages at the beginning of 2005 were interest-only with 68% of ‘option ARM’ mortgages issued by Countywide and Washington Mutual having low or no documentation conditions.
42. xxiii. The Report considered that the Federal Reserve failed in its mission ‘to ensure the safety and soundness of the nation’s banking and financial system and to protect the credit rights of consumers’. See also (nn 24 and 28) above.
43. xxii and xxiv.
44. xxiv.
45. Goldman Sachs sold US\$73bn in synthetic CDOs between 1 July 2004 and 31 May 2007 referenced

- to 3,400 mortgage securities with 610 of them being referenced, at least, twice. xxiv.
46. xxv.
 47. xxv.
 48. xxv.
 49. xxvi.
 50. xxvi.
 51. Only 6.2% of GSE mortgages were seriously delinquent as against 28.3% of non-GSE securitised mortgages. The non-GSE mortgage-backed market was driven by the Wall Street firms with GSE purchases only rising from 10.5% in 2001 to 40% in 2004 and then declining to 28% by 2008. Credit assessment standards were lowered to meet growth targets and retain market share and support compensation payment. xxvi.
 52. xxvii.
 53. xxviii.
 54. xxvii and 101. (nn 24, 28 and 42) above.
 55. xxvi.
 56. xxviii.
 57. xxviii.

Dodd-Frank implementation: what's happened?

Introduction

It has now been eight months since the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173, 111th Congress) ('Dodd-Frank') became law July 21, 2010. As we opined in our overview presentation of July 27, 2010, much needed to be done by the regulators before we could better understand the implications of Dodd-Frank. Since that time, the federal bank regulatory agencies ('Agencies')[1] have been putting out proposed rulemakings for comment, studies, reports and final rules. This alert will cover the steps that have been taken to date, primarily by the Financial Stability Oversight Council ('FSOC'), the Board, and the FDIC in implementing Titles I, II, III and VI.

The Agencies have approached the implementation of Dodd-Frank in a fairly methodical and triaged manner. They appear to be working their way through the statutory implementation requirements, first doing those with the most current deadline to those furthest out on the timeline.

Titles I and II are intended to address the overriding concerns of Too Big To Fail and 'moral hazard', and which financial services companies will be wearing the dubious crown of a Systemically Important Financial Institution ('SIFI'). Title III focuses on a restructuring of the regulatory world by (i) the absorption by the OCC of the OTS, (ii) the parent thrift holding companies becoming supervised by the Board, and (iii) the FDIC being afforded the means to replenish the Deposit Insurance Fund ('DIF'). Title VI's focus is on the Volcker Rule and the statutorily mandated 'improvements' to the regulation of banks and their parent holding companies.

Title I

Under Title I, most of the future rulemakings are to be undertaken by the Board and completed by January 2012.

The rulemakings are to focus on setting standards for risk-based capital requirements, leverage limits, use of contingent capital, creation of acceptable resolution plans or living wills (the latter along with the FDIC), credit exposure limits, limits on debt, early remediation, intermediate holding companies, and limits thereon (Section 165).

The Board has recently proposed criteria for determining when a company is 'predominantly engaged' in financial activities, as well as the questions of what a 'significant bank holding company' ('BHC') is and what a 'significant nonbank financial company' is. Comments are due by March 30, 2011 (Sections 102(a)(7), 112 and 113).[2]

The proposed principal test for 'predominantly engaged' in financial activities is whether 85% or more of a company's consolidated annual gross revenues or consolidated total assets during either of its two most recently completed fiscal years (under the accounting standard the company uses in the ordinary course of its business) are in financial activities as defined under the Bank Holding Company Act (ie, financial in nature or incidental to such financial activity, or complementary to a financial activity).

A significant non-bank financial company is one supervised by the Board and any other bank holding company that had \$50bn or more in assets as of its last completed fiscal year.

FSOC has put out an Advanced Notice of Proposed

Rulemaking ('ANPR') for comment on the criteria that it should consider in designating what organization should be identified as a SIFI (Section 102(a)(7), 113).[3]

Comments were received from 50 persons by November 5, and as a result, FSOC has now put out a Notice of Proposed Rulemaking ('NPR') describing the criteria that it will use and the process it will follow in designating nonbanks as SIFIs. The NPR indicates that determinations should be based on a combination of quantitative and qualitative factors with significant weight given to size, leverage and the type of leverage (secured versus unsecured, long-term versus short-term, and operational versus financial), liquidity risk, interconnectedness, degree of primary regulation, and substitutability. The criteria track the considerations set out in s113 of Dodd-Frank.[4]

FSOC's determinations will be based on whether the firm's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness or mix of its activities, could pose a threat to the financial stability of the United States. The standards will be adjusted for a particular industry sector and business model.

To date, no specific firm has been identified by FSOC. There has been a Bloomberg report that an 80-page memo is circulating at Treasury that suggests some large hedge funds, private equity firms and insurers pose a systemic risk under certain scenarios. I am certain that report was intended only for internal Treasury Department circulation.

With respect to the requirement in s171 (Collins Amendment) for a minimum risk-based capital floor for large banking organizations that is at least the same as the banks, on December 15 the Agencies requested comments on a proposed rule that would amend the advanced-approaches capital-adequacy framework, to meet on an ongoing basis, the higher of the generally applicable and the advanced-approaches minimum risk-based capital standards.[5]

Section 616 of Dodd-Frank states that a countercyclical capital component is to be added.

On March 18, 2011, the Board issued a report on its comprehensive supervisory review of the capital planning process of 19 large complex BHCs and their planned capital actions under stress scenarios. The scenarios include Basel III's capital requirements. While the institution-specific results will not be made public, those BHCs that proposed increased capital distributions in 2011 (whether dividends or share buy-backs) will be advised of the Board's non-objection position no later than March 21, 2011.[6]

FSOC issued an ANPR December 21, 2010 as to the framework to be applied for designating Financial Market Utilities ('FMUs'). On March 17, 2011, FSOC issued an NPR describing the criteria and analytical framework that it will apply in designating FMUs. Comments are due by May 27, 2011 (ss112, 804, 809 and 810).[7]

In November 2010, the Board and the FDIC held a roundtable with industry executives to discuss the purpose, goals, key elements, and potential effects of the resolution plan or living will requirements of s165. Both the Board and the FDIC must agree on how the living will rule will be implemented.

On March 29, 2011, the FDIC issued a notice of proposed rulemaking outlining what information should be in a living will and the ongoing reporting requirements. The Board is expected to act very soon. There is a 60-day public comment period. A final rule must be in place by January 21, 2012.

This will be one of the most difficult rules to implement. This provision imposes an extra burden on a SIFI acquirer who must court its target and almost simultaneously have discussions on how it will divest of the target in the event of 'material financial distress or failure'.

Title II

FDIC has filed an NPR on what its initial rules should be for the orderly liquidation of an SIFI (in implementing ss204(a), 206, 209 and 210). The proposal outlined how the FDIC will carry out its role as liquidator of a nonbank SIFI.[8]

Shareholders and creditors will bear much of the losses, and management and other involved parties will be held accountable. The FDIC also will have the ability to create a bridge financial company to guard against a disorderly collapse.

After having received 27 comments and having held two meetings with industry representatives and trade associations, the FDIC decided to issue an interim final rule (effective January 25, 2011) that took from both the Bankruptcy Code and the FDIC Act.[9]

Because many of the comments related to matters beyond the scope of the original October 19, 2010 NPR, and the FDIC wanted to provide additional time for comments, the comment period was extended to March 28, 2011.

A key point in the revised rule was to make it clear that all collateral will be valued at Fair Market Value as of the date the FDIC was made receiver. A number of other technical provisions are covered by this

rulemaking, including (i) the payment of similarly situated creditors, (ii) the honoring of personal service contracts, (iii) the treatment of any remaining shareholder value in the case of a covered financial company that is a subsidiary of an insurance company, and (iv) limitations on liens the FDIC may take on the assets of a covered financial company that is an insurance company or covered subsidiary.

On March 15, 2011, the FDIC issued a new proposed rule further amplifying on its orderly liquidation process while focusing on the rights of creditors in Title II receiverships. For example: (i) defining the priorities of payment for creditors, (ii) detailing the priority of set-off claims, (iii) specifying how post-insolvency interest will be paid, (iv) specifying the process for initial determination of claims, and (v) outlining the steps necessary to seek a judicial decision on any disallowed claims. Comments are due by May 23, 2011.[10]

The proposed rule also (i) helps define what ‘financial company’ is subject to this resolution process, (ii) helps define how compensation can be clawed back up to two years from covered senior executives and directors, and (iii) clarifies the application of the receiver’s powers to avoid fraudulent and preferential transfers (Sections 201 and 210).

Title III

Title III grants the FDIC much greater discretion to manage the DIF through economic cycles, to achieve moderate, steady assessment rates, and to maintain a positive fund balance.

It includes changing the assessment base from the traditional bank deposits to the new average consolidated total assets minus tangible equity (Tier 1 capital). The new base may also be adjusted for bankers’ banks and custodial banks (Section 331).[11]

FDIC is afforded much more flexibility in deciding when and how to raise DIF funding. A new rule also changes the assessment rate for large banks (those with at least \$10 billion in assets) using a scorecard based on institution performance and financial measures, with a separate and more complex scorecard for ‘highly complex’ institutions that have more than \$50bn in assets and are controlled by a parent to intermediate holding company with more than \$500bn in total assets. FDIC also established a Designated Reserve Ratio at 2% (§334).[12]

Early on, the FDIC issued a final rule raising its deposit insurance coverage to \$250,000 per account (Section 335).[13]

FDIC also issued a final rule implementing until December 31, 2012, unlimited deposit insurance coverage for non-interest-bearing transaction accounts (§343).[14]

Agencies have submitted a joint implementation plan to the House Financial Services Committee, the Senate Banking Committee, and the Agencies’ Inspector Generals describing actions taken to date for implementation of Title III’s consolidation of the OTS into the OCC, and about the thrifts’ parent holding companies becoming subject to Board supervision (§327).[15]

This integration process actually started with a February 3, 2011, interagency change to the current OTS reporting requirements for savings associations and Savings and Loan Holding Companies (‘SLHCs’) by requiring thrifts to file bank Call Reports beginning with the March 31, 2012, reporting period in lieu of Thrift Call Reports, and for SLHCs to start making bank holding company form filings starting with their First Quarter March 31, 2012, reporting period.[16]

It will be interesting to see what the Board will do with the thrifts that have subsidiaries engaged in real estate development activities, an impermissible activity as far as the Board is concerned.

Title VI

On January 18, FSOC issued its 79-page Study and Recommendations on Section 619’s Volcker Rule. The Volcker Rule prohibits banking entities from engaging in proprietary trading and from investing in or sponsoring hedge funds and private equity funds, subject to certain exceptions.[17]

These exceptions are, in a very general sense, certain types of market making related activities, risk-mitigating hedging activities, asset management, underwriting, transactions in government securities, and other transactions on behalf of customers.

Permitted activities are subject to a prudential ‘backstop’ that prohibits an activity if it would result in (i) a material conflict of interest, (ii) material exposure to high-risk assets or high-risk trading strategies, (iii) a threat to the safety and soundness of the banking entity, or (iv) a threat to the financial stability of the United States.

Many of these activities often evidence outwardly similar characteristics to proprietary trading. It will be difficult for the Agencies, the SEC and the CFTC to not come out with a very prescriptive rule.

The Study has 10 upfront recommendations (at page 3), and sets out a four-part implementation and

supervisory framework built around: (i) strong internal controls and a programmatic compliance regime with extensive monitoring, recordkeeping, reporting and testing, (ii) a detailed set of metrics, (iii) extensive supervisory review and oversight, and (iv) strong enforcement procedures for violations, which includes termination of the impermissible activities, reductions in risk limits, increased capital charges or monetary penalties.

The next required step is for the Board to come out with proposed rules as to how it will implement Section 619 of Dodd-Frank that are to be finalized within nine months of the FSOC study, or by October 18, 2011.

The Board has issued a final rule (effective April 1, 2011) establishing the conformance period for banking entities and nonbank financial companies supervised by the Board; in effect, when BHCs with more than \$50 billion in assets and non-bank financial companies deemed to be SIFIs must bring their proprietary trading, hedge fund and private equity fund activities, and investments into compliance with the Volcker Rule.[18]

The prohibitions in the Volcker Rule become effective on the earlier of July 21, 2012 (two years after Dodd-Frank) or one year after the adoption of final Agency rules. That can be extended an additional three years (one year at a time) if the extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest.

In the case of illiquid funds, they could have an additional five years or maybe less (up to the Board's discretion).

The final rule clarifies a fund as illiquid only if at least 75% of its consolidated total assets are, or are expected to be, comprised of illiquid assets.

The conformance period can be two years after a non-bank financial company is designated by FSOC for Board supervision. Requests for extension can be made as late as 180 days before the conformance deadline.

There is no final Volcker Rule, as it requires interagency action by the Agencies and the SEC and CFTC. Also, the Board will likely need to issue its own rulemaking before it will issue a final rule, and will likely set out definitions such as 'hedge funds,' 'private equity funds,' and investments and activities. The Board will review this conformance rule after completion of the interagency rulemaking.

Under s622, the FSOC completed its study and made recommendations on how to implement the new

concentration limits on large financial companies, which need not be BHCs.[19]

It was anticipated the concentration limit will help deal with Too Big To Fail and moral hazard, and the study makes recommendations consistent with the statutory limit of 10% of aggregate consolidated liabilities (or total risk-weighted assets less total regulatory capital for risk-based capital rules, ie Basel III). It was felt that this aggregate limit would be more comprehensive than the 10 %of nationwide deposit limit in Riegle-Neal.

Note that US-based firms are treated differently from foreign-based firms because the concentration limit for US-headquartered firms is based on global liabilities. In the case of foreign firms, only their US operations are considered.

Future Regulatory Actions

The Board has a very large number of anticipated rulemakings. Among those it has indicated it may issue by mid-year 2011 are the following proposed rules under Title I:

- Propose the reporting forms and information requirements for nonbank SIFIs that must register with the Board (Sections 114 and 604);
- A rule to implement the requirement that it must consider whether the foreign bank's home country has a financial regulatory system that mitigates risk the foreign bank may present to the United States, before it acts on a foreign bank application to establish a U.S. office or whether to terminate its U.S. office (Section 173(a) and (b));
- Final rules defining 'predominantly engaged', 'significant nonbank financial company', and 'significant BHC';
- Prior notice requirement for SIFIs to acquire a nonbank with \$10 billion or more in assets (Section 163(b));
- Final rule that will make Regulation L applicable to nonbank SIFIs (Section 164); and
- Board is to issue a series of proposed stricter prudential rules applicable to BHCs with total consolidated assets of \$50 billion or greater in the following areas:
 - Risk-based capital and leverage requirements (Section 165(b)(i)(A)(i));
 - Liquidity requirements (Section 165(b)(i)(A)(ii));
 - Risk-management requirements (Section 165(b)(i)(A)(iii));
 - Credit exposure limits (Section 165(e));
 - Risk committee requirements (for all BHCs with

\$10 billion or more in assets) (Section 165(h));

- Stress tests, both internal and examiner conducted (Section 165(i)); and
- New preemptive Prompt Corrective Action measures (Section 166).

The proposed rules under Title VI are the following:

- Limits on asset purchases or sales with insiders (Section 615);
- Requirement that the parent bank holding company, in addition to its depository subsidiaries, be well capitalised and well managed in order for the parent holding company to qualify as a financial holding company (Section 606);
- Agencies will seek comments on Volcker Rule's 10% of liabilities concentration limit, which is in lieu of Riegle-Neal's 10% of countrywide deposit cap (Section 622(b)); and
- Board will issue a final rule indicating that among the factors it must consider in passing on bank acquisitions or mergers is the impact on the stability of the US banking or financial system (Section 604(d) and (f)).

Board is to undertake joint or coordinated rulemakings with the Agencies in the following areas:

- Resolution Plan or Living Will requirements with the FDIC (Section 165(d));
- For nonbanks supervised by the Board and BHCs with \$50 billion or more in assets, a new reporting requirement to the Board, FSOC and FDIC on credit exposures between these several companies and other 'significant' nonbanks and BHCs (Section 165(d));
- For banks, thrifts and their holding companies with total consolidated assets of more than \$10 billion, a rule regarding requirements for self-administered stress tests – to be done in a coordinated manner along with the Federal Insurance Office (Section 165(i)(2)); and
- Final joint rulemakings by the Board and other Agencies implementing the Volcker Rule's proprietary trading restrictions.

As the above suggests, the rulemaking process for Dodd-Frank is quite extensive and it will be quite a while before the true impact of Dodd-Frank can be ascertained. There is also the need to be mindful of Congressional action that might delay, modify, or nullify not just the various provisions in Dodd-Frank, but also implementing actions by the financial services regulators.

Michael Bleier is a partner in Reed Smith's Financial Industry Group and a member of the firm's internal task force following the Dodd-Frank Act. The task force includes partners from various practice groups across the firm, including Mark Oesterle (former Chief Counsel to the Senate Banking Committee and a key drafter of Dodd-Frank) and Bill Mutterperl (former Vice Chairman of The PNC Financial Services Group and General Counsel of Fleet Financial Company). These partners, along with others on our task force, have extensive backgrounds and unique insights when it comes to financial services and the ever-changing regulatory environment.

The lawyers at Reed Smith have been closely following the developments of Dodd-Frank since its inception and have been holding a series of webinars on Dodd-Frank and populating a dedicated website focused on all things Dodd-Frank. The site (www.reedsmith.com/doddfrank) includes articles and client alerts related to Dodd-Frank and its impact on the financial services industry. In addition, the site houses recordings and materials related to our teleseminars focusing on Dodd-Frank.

Our Financial Industry Group is comprised of more than 220 lawyers organized on a cross-border, cross-discipline basis and dedicated to representing clients involved in the financial sector, advising most of the top financial institutions in the world. As well as being authorities in their areas of law, FIG lawyers have a particular understanding of the financial services industry sector, enabling the practice to evaluate risks, and to anticipate and identify the legal support needed by clients. Lawyers in the group advise on transactional finance covering the full spectrum of financial products, litigation, commercial restructuring, bankruptcy, investment management, consumer compliance, legislation and bank regulation, including all aspects of regulatory issues, such as examinations, enforcement and expansion proposals. For more information, visit www.reedsmith.com/fig.

Endnotes

1. Federal Deposit Insurance Corporation ('FDIC'), Federal Reserve Board ('Board'), Office of the Comptroller of the Currency ('OCC') and Office of Thrift Supervision ('OTS').
2. 76 Federal Register 7731.
3. 75 Federal Register 61653.
4. 76 Federal Register 4555.
5. 75 Federal Register 82317.
6. Board of Governors of the Federal Reserve System, Comprehensive Capital Analysis and Review: Objectives and Overview (March 18, 2011), www.federalreserve.gov/newsevents/press/bcreg/20110318a.htm.
7. 75 Federal Register 79922 and 76 Federal Register 17047.
8. 75 Federal Register 64173.
9. 76 Federal Register 4207.
10. 76 Federal Register 16324.
11. 75 Federal Register 66272, 75 Federal Register 72582 and 75 Federal Register 72612.
12. 75 Federal Register 79286.
13. 75 Federal Register 49363.
14. 76 Federal Register 4813.
15. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, Joint Implementation Plan, 301-326 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (January 2011).
16. 76 Federal Register 7082.

17. Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds, Completed Pursuant to Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (January 2011).
18. 76 Federal Register 8265.
19. Financial Stability Oversight Council, Study & Recommendations Regarding Concentration Limits on Large Financial Companies, Completed Pursuant to Section 622 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (January 2011).

Does 'Dodd-Frank' allow for federal liquidator of an insurance company?

The short answer to the title question is 'No'. However, under the Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank' or the 'Act'), the Federal Deposit Insurance Corporation ('FDIC') has limited 'backup' authority to place into liquidation an insurance company that (i) meets certain criteria as respects the nature of its business and (ii) is essentially 'too big to fail'. This liquidation proceeding would, however, still be under the relevant state insurance liquidation laws.[1]

We outline below what is required for the FDIC to exercise this 'backup authority' and will touch on some novel issues raised by this possible federal entry into the area of insurance company liquidations.

1. An Insurance Company Would First Have To Be A 'Financial Company' Under 'Title II' Of Dodd-Frank

Title II of Dodd-Frank, providing for the liquidation of certain financial companies, has application to insurance companies that constitute a 'financial company' under Title II. An insurance company is considered a financial company if it is incorporated or organised under any provision of federal or state law and has 'predominantly engaged in activities that the Board of Governors [of the Federal Reserve System] has determined are financial in nature or incidental thereto for purposes of section 1843(k) of this title [12 USC § 1843(k)] ...' (12 USC § 5381(a)(11)(A) and (B)(iii).)

Title II further provides that:

... no company shall be deemed to be predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 1834(k) of this title, if the consolidated revenues of such company from such activities constitute less than 85 percent of the total consolidated revenues of the such company, as the [FDIC], in consultation with the Secretary [of Treasury], shall establish by regulation.

While the meaning of 'financial company' under Title II still needs to be further defined by regulations promulgated by the FDIC, 12 USC § 1843(k) provides that the following activity shall be considered 'financial' in nature: 'insuring, guaranteeing, or indemnifying against loss, harm, damage, and acting as principal, agent or broker for purposes of the foregoing, in any State' (12 USC §1843(k)(4)(B)). (This activity is considered a 'financial activity' as part of the determination by the Board of Governors of the Federal Reserve System as respects whether a financial holding company can engage in the activity under the Bank Holding Company Act as amended by the Gramm-Leach-Bliley Act of 1999.)

2. An Insurance Company That Is Deemed A Financial Company Would Have To Pose A Systemic Risk Under Title II

The second requirement before the FDIC can act is a determination that the relevant insurer poses a systemic risk if it were to be in default or in danger of default (12 USC §5383). This determination is made on the recommendation of the Director of the Federal Insurance Office ('FIO') and the Board of Governors of the Federal Reserve System, either on their own initiative or at the request of the Secretary of Treasury. A recommendation of systemic risk has to be approved by a two-thirds vote of the Board of Governors and additionally has to be approved by the Director of FIO in consultation with the FDIC (12 USC §5383(a)(1)(C)). These procedures also apply to an insurer that is a subsidiary of a financial company where the insurer is the largest subsidiary of the financial company as measured by total assets as of the end of the previous calendar quarter (12 USC §5383).

The factors that shall be considered in making such a systemic risk determination for an insurer include the following: (i) the insurer is in default or in danger of

default; (ii) the failure of the insurer would have serious adverse effects on financial stability in the United States; (iii) no viable private sector alternative to liquidation is available; (iv) the effect of liquidation on the claims of creditors, counterparties or shareholders of the financial company; (v) and whether liquidation would mitigate the adverse effects, including potential adverse effects on financial stability in the United States (12 USC §5383(b)).[2] Obviously, for there to be a systemic risk determination under this section, an insurer would have to be a very large entity whose default or possible default would have an adverse effect on the United States economy (12 USC §5383(a)(2)).

3. The FDIC Can Only Act Where The Insurance Department With Supervisory Authority Does Not Act Within 60 Days Of The Systemic Risk Determination

While other financial companies would be liquidated under the provisions of Title II, the receivership of an insurer (including an insurer that is a subsidiary of a financial company) would still be conducted under the applicable state law (12 USC § 5383(e)(1)). The State insurance regulator could still institute the proceeding, either rehabilitation or liquidation, but the FDIC is authorised to act in the insurance department's stead where:

'if after the end of the 60-day period beginning on the date on which a [systemic risk] determination is made ... the appropriate regulatory agency has not filed the appropriate judicial action in the appropriate State court to place such company into orderly liquidation under the laws and requirements of the State, the [FDIC] shall have the authority to stand in the place of the appropriate regulatory agency and file the appropriate judicial action in the appropriate State court to place such company into orderly liquidation under the laws and requirements of the State.' (12 USC §5383(e)(3).)

Under this provision, the FDIC can act where the insurance department does not do so within the 60-day time frame, but the FDIC can only seek to place the company into liquidation, not rehabilitation. In contrast, an insurance department has the discretion to place the insurer into either rehabilitation or liquidation under 12 USC §5383(e)(1). Presumably, once the FDIC has instituted the proceeding, the liquidation would then proceed under the state law as if the insurance department had instituted the

proceeding, with the insurance commissioner acting as the liquidator.

The Limited Authority Of The FDIC Opens A Pandora's Box Of Potential Issues

The limited authority of the FDIC raises a number of unprecedented potential issues: First, the FDIC must define with greater precision when an insurance company would be deemed a 'financial company' for purposes of Title II.

Second, it is not clear how the FDIC would interact with State insurance regulators who may have a much different view on whether liquidation is necessary. Under Title II, the FDIC can only place the insurer into liquidation, not rehabilitation. State insurance departments, however, often prefer to place a company into rehabilitation, at least initially, or to exercise supervision regarding a financially troubled insurer.

Third, no one can predict the effect of an FDIC-initiated liquidation on the state guaranty funds which would likely be triggered, and which would face a large strain, since an insurer that is 'too big to fail' would surely be a large institution with millions of policyholders nationwide. Because the assessments which insurers pay to guaranty funds are taxdeductible in many states, an FDIC decision to liquidate an insurer likely would also have major implications for state tax revenues.

All of these issues will hopefully cause the FDIC to be judicious in exercising its authority to seek the liquidation of insurance companies that it does not regulate. We note in this context that Congress directed the FDIC to engage in extensive consultation with insurance regulators in exercising its authority under Title II, 12 USC §5384(c), and those consultations will be key to avoiding possible confusion and disruption.

Conclusion

We may never know (and hope not to learn) how this aspect of Dodd-Frank will work in practice, as it would require the default or danger of default of a major insurer, which would then pose the risk of serious adverse effects on the financial stability of the United States. Regardless, the limited authority afforded to the FDIC does present the possibility of increased federal oversight of insurance companies.

(Additional aspects of Dodd-Frank that may apply to insurance companies were addressed in a previous *NewsWire* article in the November 10, 2010 issue, authored by Richard Liskov: *Federal Financial Regulatory Reform: What Congress Has Done In Respect Of (Re) insurance (So Far).*)

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Endnotes

1. Insurance companies are not subject to the United States Bankruptcy Code and any receivership of an insurance company is under state law, usually the state law of the domicile or home state of the insurer. 11 USC § 109(b)(2).

2. Under Title II,

... a financial company shall be considered to be in default or in danger of default if

(A) a case has been, or likely will promptly be, commenced

with respect to the financial company under the Bankruptcy Code;

(B) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion;

(C) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or

(D) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.

12 USC § 5383 (C)(4) *(emphasis added)*.

UK Bribery Act in force from July: Ministry of Justice finally publishes guidance on adequate bribery-prevention procedures

On 30 March 2011 the UK Government's Ministry of Justice announced that the implementation of the Bribery Act 2010 (Bribery Act) will now proceed, so that the Bribery Act will come into effect on 1 July, 2011. At the same time, the Ministry published long-awaited guidance (Guidance) on 'adequate' bribery-prevention procedures that can provide a defence to the new corporate offence of failing to prevent bribery.

Organisations can now complete their preparations for the new regime, and those that have delayed development of their compliance programs must make haste to have these in place. Early action by investigation and prosecuting authorities is considered likely and, only last week, the FSA's 2011-12 Business Plan highlighted, as a priority, addressing regulated firms' financial crime 'systems and controls issues through enforcement activity and increasingly intensive, ongoing supervision'.

Most businesses will consider the final Guidance a marked improvement over the draft guidance (Draft Guidance) that the Ministry of Justice issued for consultation last September. The Draft Guidance related to Section 7 of the Bribery Act and set out principles to assess the adequacy of an organisation's

procedures to prevent bribery and corruption. The final Guidance was expected at the end of January 2011 in advance of the Bribery Act coming into effect on April 2011.

Publication of the Draft Guidance was followed by vociferous protest and a vigorous campaign for clearer guidance in areas such as corporate hospitality and a less stringent approach to facilitation payments, liability for subsidiaries, joint venture partners and other associated persons, and foreign companies listed in the UK but having no business presence in the country. In light of this, the Government delayed publication of the final Guidance (which had been expected in January) and the previously scheduled April 2011 implementation date for the Bribery Act itself.

Despite the further consultations and drafting, there remain concerns with the Guidance as we highlight below – see 'Key changes and issues in the final Guidance'.

Bribery Act – Section 7

Section 7(1) of the Bribery Act provides for a new corporate offence, whereby commercial organisations incorporated or formed in the UK, or that carry on

business in the UK, will be guilty of an offence if they fail to prevent bribery by an associated person.

A relevant organisation will have a defence, however, if it can demonstrate that it has implemented adequate bribery prevention procedures. Section 9 of the Bribery Act requires the UK Government to publish guidance about procedures that relevant organisations can put in place.

For further information on the Bribery Act, see Dewey & LeBoeuf Client Alert UK Bribery Act – Implications for Corporates.

Guidance on Adequate Procedures to Prevent Bribery (Guidance)

The purpose of the Guidance is to help relevant commercial organisations prepare for the introduction of the new offence. At the heart of the Guidance are six general principles designed to be of general applicability across all sectors and a number of illustrative scenarios. It also provides a description and some interpretation of the Bribery Act

The six principles as set out in the Guidance are:

Principle 1: Proportionate Procedures

A commercial organisation's procedures to prevent bribery by persons associated with it are proportionate to the bribery risk it faces and to the nature, scale and complexity of the commercial organisation's activities. They are also clear, practical, accessible, effectively implemented and enforced.

Principle 2: Top Level Commitment

The top level management of a commercial organisation (be it a board of directors, the owners or any other equivalent body or person) are committed to preventing bribery by persons associated with it. They foster a culture within the organisation in which bribery is never acceptable.

Principle 3: Risk Assessment

The commercial organisation assesses the nature and extent of its exposure to potential external and internal risks of bribery on its behalf by persons associated with it. The assessment is periodic, informed and documented.

Principle 4: Due Diligence

The commercial organisation applies due diligence policies and procedures, taking a proportionate and risk based approach, in respect of persons who perform or will perform services for or on behalf of the

organisation, in order to mitigate identified bribery risks.

Principle 5: Communication (including training)

The commercial organisation seeks to ensure that its bribery prevention policies and procedures are embedded and understood throughout the organisation through internal and external communication, including training, that is proportionate to the risks it faces.

Principle 6: Monitoring and Review

The commercial organisation monitors and reviews procedures designed to prevent bribery by persons associated with it and makes improvements where necessary.

Key Changes and Issues in the Final Guidance

Both the format and content of the Guidance have improved substantially from the Draft Guidance. It is more user-friendly. The principles have been re-ordered and in some cases renamed, and there's more emphasis on a proportionate and risk-based approach to bribery prevention. There are more case studies (technically not part of the Guidance) and these are more focused on action points rather than questions to consider. And, in response to the pressure from business interests, the document goes beyond the confines of the guidance required by Section 9 to express the Government's policy in relation to the Bribery Act and to interpret some of its provisions.

Particular points and issues to note include:

- Hospitality: the approach in the Guidance would allow much more flexibility than many feared;
- Joint ventures and agents: the Government's interpretation of various provisions may provide some comfort, but the Guidance emphasises the fact-specific nature of these arrangements;
- Foreign companies: the Government believes that a company would not qualify as carrying on business in the UK for the purposes of the Bribery Act merely by having its securities admitted to listing in the UK (an interpretation that has caused considerable concern amongst certain institutional investors and other interests) nor merely by having a UK subsidiary (which might act independently of its parent and affiliates).
- Facilitation payments: the Government has refused to backtrack on this issue, and in practice had little room for manoeuvre other than to highlight the limited defence of duress and the availability of

prosecutorial discretion and public interest considerations relevant to the exercise of such discretion.

Other Guidelines

The Guidance is stated to complement other forms of bribery prevention guidelines published by industry and sector representative bodies and also rules and informal guidance set by the Financial Services Authority for the financial services industry. The Ministry of Justice has also published a 'quick start' guide to the Bribery Act, intended for small and medium-sized enterprises.

Although the final Ministry of Justice Guidance appears to provide reassurance about the scope of the legislation and the risks of prosecution in certain areas, it acknowledges that the courts are the final arbiter on interpretation and that prosecuting authorities have substantial discretion whether to prosecute in any particular circumstances. As expected, the Director of Public Prosecutions and the Director of the Serious Fraud Office have also published guidance today, focusing on public interest considerations in deciding whether to prosecute, and identifying factors which tend in favour or against prosecution. These must be taken into account in developing and implementing compliance programs.

Comment

All commercial organisations should be reviewing their operations and procedures, in light of the Bribery Act, to assess and address the risks that they or their 'associated persons' might commit offences, and particularly to avoid potential exposure under Section 7. At a minimum, companies should review their compliance programs, third party agreements, internal policies and procedures and code of ethics. A glossy brochure, or a detailed manual gathering dust on employees' shelves, will simply not suffice. Bribery Act compliance is an on-going project, and includes also training, monitoring and other elements inherent in any effective compliance program. It must be done and be seen to be done.

Although a program designed for compliance with the US Foreign Corrupt Practices Act (FCPA) may provide a good foundation for a Bribery Act compliance program, there are key differences between the two regimes. Because the Bribery Act is wider in important ways, FCPA compliance is not in itself sufficient to avoid Section 7 liability for failure to prevent bribery, nor to protect staff, agents and others who provide services for an organisation, and businesses must take into account the extraterritorial application of both regimes.

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Financial Services Europe and International Update

Regulatory developments

This article summarises recent regulatory developments in the EU and the UK in the investment funds and assets management sector.

EU and International Regulatory Developments

Prospectus Directive: ESMA Call for Evidence on Request for Technical Advice

The European Securities and Markets Authority ('ESMA') issued a request for interested parties to submit views on aspects or areas that it should consider in its advice to the European Commission on possible delegated acts concerning the Prospectus Directive (2003/71/EC) (as amended by Directive 2010/73) towards the end of January 2011. ESMA has been asked

to deliver certain parts of the requested advice on 30 September 2011. To enable it to fulfil the request for advice, ESMA has set up a Prospectus Level 2 Task Force. The advice requested by the European Commission included the following matters:

- the format of final terms to a base prospectus;
- the format of the summary and content and format requirements of the key information to be included in the summary of a prospectus;
- the proportionate disclosure regime in relation to certain rights issue prospectuses and prospectuses in relation to issues by SMEs, companies with reduced market capitalisation and certain issues of non-equity securities by credit institutions;
- the criteria for assessing equivalence of the regulatory framework of third country markets in connection with the extended employee offer exemption from

- the requirement for a prospectus; and
- the consent requirements in connection with the use of a prospectus in a retail cascade.

The Commission has also asked ESMA to consider certain amendments to the disclosure requirements in the Prospectus Regulation, including in relation to:

- the information on taxes on income from securities withheld at source;
- the requirement for an independent report for a profit forecast or estimate; and
- the period covered by the audited financial information.

Responses to this initial call for evidence should have been received by 25 February 2011 (ESMA intends to publish a consultation paper in July 2011). Thereafter, the advice to the European Commission is expected to be signed off by ESMA in September 2011 and the Commission will then prepare the delegated acts from October to December 2011, with adoption of the delegated acts by the Commission expected in late December 2011. March and June 2012 will be the end of the objection period for the Parliament and Council and the transposition period for the implementing directive will end on 1 July 2012.

Commodity Markets: European Commission Communication

The European Commission presented earlier this month an integrated strategic vision to tackle challenges in commodity markets and on raw materials. The Communication includes measures to improve the transparency of financial and commodity markets. (The report has been delayed after the French President Nicolas Sarkozy criticised an earlier version, which said it had found no evidence of 'a correlation between the substantial increase in index fund positions and commodity futures prices'. In the final version the section has been removed. Instead, the Commission said that 'while it is clear that there is a strong correlation between positions on derivatives markets and spot prices, it is still difficult to assess fully the interactions and the impact of movements in the derivative markets on the volatility of the underlying physical markets'.)

In its Communication the Commission presents an overview of developments in financial and physical markets and proposes a series of measures which include improving the integrity, transparency and stability of commodity derivatives markets, inter alia through a review of the Market Abuse Directive and MiFID.

The Commission's Communication also notes that further work is necessary to understand fully the interlink between physical and financial markets, and it

intends to continue working on this in the framework of the G20-debate taking place at the global level.

IOSCO Final Report on Point of Sale Disclosure Principles for Collective Investment Schemes

The International Organisation of Securities Commissions ('IOSCO') published its final report on point of sale ('POS') disclosure principles for collective investment schemes ('CISs') on 2 February 2011.

In the report, IOSCO explains that transparency in the market place, particularly the disclosure of information to investors, has always been a high priority and the goal of regulators in seeking to ensure that markets run efficiently and with integrity. The financial crisis highlighted the critical role that accurate, understandable and meaningful disclosure can play.

The report considers issues arising from requiring key information disclosures to be made to retail investors relating to CISs and their distribution prior to the POS, setting out principles for the disclosure of key information relating to CISs prior to the POS. The principles are designed to help markets and regulators when they are considering POS disclosure requirements. Key points made in the report are that:

- no matter what POS disclosures are required, they will not have the intended effect if the investor does not read or understand the information provided and as a result, regulators should consider steps to improve retail investor education;
- new POS disclosure requirements should not be imposed without the benefit of consumer testing or assessment, to help to determine the likely effectiveness of any new requirements; and
- the principles in the report may also be applicable to non-retail investors.

IOSCO is aware that some members of the CIS industry believe that if CIS products are subject to enhanced POS disclosure requirements, this may place them at a competitive disadvantage in relation to other financial products; however, IOSCO has not considered the merits of this argument in great detail in the report, due partly to the difficulty in identifying truly comparable products that are as popular with retail investors.

The report does not consider issues relating to the suitability of CISs. Also, it does not purport to describe or address all intermediary disclosure obligations. Although the report, and the principles, apply to CISs, IOSCO encourages regulators to consider how the principles could be adopted for similar products.

CRD 4: Commission Consultation on Counterparty Credit Risk

As part of its work on developing a wholesale revision of

the Capital Requirements Directive ('CRD') to reflect the Basel 3 concordat, the European Commission is currently seeking views on different aspects of the revision. It has already consulted on counter-cyclical buffers and is expected to publish its proposed amendments to CRD in July 2011. Basel 3 also introduces capital requirements for exposures to CCPs, which previously were set at zero if certain conditions were met, and at the same time, in line with the G20, OTC derivatives that are not cleared are to be subject to higher capital charges to reflect the increased perceived risk.

The Commission recently launched a public consultation on counterparty credit risk generated by derivatives, repo and securities financing activities. It addresses two specific questions:

- capital requirements for exposures to CCPs; and
- treatment of incurred credit valuation adjustments.

The objective is stated as ensuring higher capital charges to encourage the clearing of OTC derivatives. The CCPs themselves would be divided between 'qualifying' CCPs, which meet international standards and the Commission suggests also EU regulations, to which modest capital requirements would apply, and 'non-qualifying' ones that would face higher charges.

Responses were required by 9 March 2011. The full formal proposals to amend the CRD are then expected in July 2011. Part of the revision is likely to see some aspects of the CRD transformed into Regulations.

UK Regulatory Developments

FSA Consultation on Product Disclosure

The FSA published a consultation on product disclosure for retail investments (CP11/3) on 2 February 2011.

CP11/3 brings together a number of product disclosure issues and proposals to:

- amend the key features illustrations ('KFIs') firms are required to provide to clients in respect of advised sales of retail investment products (which includes individual personal pensions) and group personal pensions; this is to reflect the Retail Distribution Review (the 'RDR') ban on commission, and product providers will need to amend their KFIs to reflect these requirements by the end of 2012;
- introduce new KFI disclosure requirements in respect of personal pension schemes marketed as self-invested personal pensions ('SIPPs') by clarifying the nature of a SIPP and improving the quality and usefulness of personal pension scheme disclosure; (however, the FSA is not proposing any disclosure

rule changes for other packaged products in view of the European Commission's consultation on packaged retail products (PRIPs) and intention to put forward detailed proposals in the context of its reviews of MiFID (2004/39/EC) (MiFID) and the Insurance Mediation Directive (2002/92/EC); and

- potentially amend pension KFIs to replace monetary projections with inflation-adjusted projections for personal and stakeholder pensions (both individual and group).

The FSA intends to publish a policy statement, including feedback on its CP 11/3 proposals, in the second half of 2011 and any final rules in relation to the RDR adviser and consultancy charging requirements will come into force on 31 December 2012 and any final rules on pension scheme disclosures will come into force on 6 April 2012.

AIC Guidance for Investment Company Boards on Managing Custody Risk

The Association of Investment Companies (the 'AIC') published guidance for boards of investment companies on managing custody risk on 4 February 2011.

Custody risk is described as the risk that an investment company's assets which are held in custody are lost, or access to them is compromised, as a result of the custodian's misuse of assets, fraud, poor administration or inadequate record-keeping. The guidance paper notes that the custody market is dominated by a smaller number of global institutions, including major banks, which hold a wide range of assets, including equities, government and corporate bonds, warrants and derivatives.

The guidance note covers the following areas:

- the role of an investment company's board;
- board review of custodial arrangements; and
- reporting to shareholders.

The potential for counterparty failure has become more apparent in recent years, particularly in view of the collapse of Lehman Brothers in 2008. This has resulted in new regulation and legislation designed to clarify depositaries' responsibilities and set higher standards. In this respect, the guidance note draws attention to the provisions in the AIFM Directive relating to depositary arrangements, which will come into effect in 2013.

The guidance paper also refers to proposed new depositary rules for UCITS funds (under the European Commission review of the UCITS Directive (2009/65/EC)), which may have wider implications for the products and services offered by custody service

providers in other sectors of the market. (In Spring 2011, the European Commission intends to present a legislative proposal (known as 'UCITS V') which will update the current framework applicable to UCITS depositaries and introduce new provisions on the remuneration of UCITS managers).

Since the nature of custody provision is likely to undergo significant change over the coming years, the AIC is encouraging investment company boards to review their existing custody arrangements and consider, as far as possible, whether current arrangements will be sufficient to meet future regulatory and legislative changes.

FSA Policy Statement on Implementing the 2nd Electronic Money Directive

The FSA published a policy statement on 10 February 2011 on implementing the second Electronic Money Directive (2009/110/EC) ("2EMD") (PS11/2) which reports on the feedback the FSA has received to its October 2010 consultation paper on implementing 2EMD (CP10/25) and its October 2010 consultation paper on regulatory fees and levies (CP10/24). PS11/2 includes confirmation of the following issues:

- **Perimeter guidance:** the FSA will publish amended guidance in the FSA's Perimeter Guidance manual (PERG) about the scope of the Electronic Money Regulations 2011 (SI 2011/99) and intends to publish an e-money approach document by the end of February 2011;
- **Reporting requirements:** the FSA intends electronic money institutions ('EMIs') to report on their e-money and payment services business using manual returns, details being contained in chapter 16 of the Supervision Manual (SUP);
- **Dispute resolution:** the FSA's proposals are being

implemented unchanged from its consultation in CP10/25 (which means that the compulsory jurisdiction of the Financial Ombudsman Service will cover all e-money issuers within the scope of 2EMD for disputes concerning the issuance and redeemability of e-money and related payment services);

- **Enforcement:** the FSA will take enforcement action consistent with its stated enforcement policies in the Decision Procedure and Penalties manual (DEPP) and the Enforcement Guide (EG); and
- **Application Fees:** the FSA has also confirmed which e-money issuers will be exempt from paying application fees and the level of fees authorised EMIs and small EMIs will need to pay, the fees being finalised in the FSA's consolidated fees policy statement which is due to be published in May 2011.

Changes to the FSA Handbook to implement the new rules and guidance are set out in the Electronic Money and Payment Services Instrument 2011 (FSA 2011/7), included in Appendix 1 to PS11/2. (Different parts of the instrument will come into force on three dates: 10 February 2011, 30 April 2011 and 30 April 2012.)

Bank Levy for 2011

HM Treasury announced on 8 February 2011 that the full bank levy rates (0.075% for short-term liabilities and 0.0375% for long-term equity and liabilities) are to apply for the calendar year 2011. However, because reduced rates were set for January and February 2011 (0.05% for short-term liabilities and 0.025% for long-term equity and liabilities), the rates for March and April 2011 are increased to take account of the shortfall (0.1% for short-term liabilities and 0.05% for long-term equity and liabilities).

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