News Bulletin

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Reconciliation: A Summary Scorecard on Regulatory Reform *(Part II)*

For some weeks now, US Senate and House conferees have been involved in a delicate, but sometimes bare-knuckled, process of reconciliation. The Conference Committee, charged with reconciling differences between the version of the financial regulatory reform bill passed by the House of Representatives in December 2009 and the bill passed in late May 2010 by the Senate, has had to tackle quite a number of controversial, and often arcane, matters. So many issues, in fact, that debate continued into the wee hours of the morning of June 25th.

Yesterday, we shared a brief scorecard on what we regard as some of the most significant issues considered by the Conference Committee—please see Part I at: http://www.mofo.com//files//Uploads/Images/100624Reconciliation.pdf.

The following includes Part II of our scorecard (or, Scorecard on Regulatory Reform, *The Sequel*). Over the course of the next few days, more complete analysis will follow. More information on regulatory reform measures is available from our dedicated webpage at: http://www.mofo.com/resources/regulatory-reform/.

Volcker Rule

The House bill did not contain Volcker Rule provisions, although it did contain certain limitations on permitted activities (for example, the House bill permitted a ban on proprietary trading that poses systemic risk). The Senate bill implemented the Volcker Rule by imposing a prohibition on most proprietary trading by US banks and their affiliates, subject to limited exceptions, and restricting covered institutions from owning, sponsoring or investing in hedge funds or private equity funds. Under the Senate bill, the Financial Stability Oversight Council would be required to study the impact of the rule within six months of enactment, although the Council would have limited opportunity to modify the activity limits contained in the rule. Under the Senate bill, there would have been an approximately two-year phase-in period, subject to limited extensions.

The outcome: Discussions relating to the Volcker Rule were among the most heated. Discussions regarding possible compromise centered on extending the phase-in period for the Volcker Rule and permitting banks to own interests in private funds. The ban on proprietary trading will be included, with exceptions. Covered institutions will be subject to restrictions relating to their activities with hedge funds and private equity funds, although they will have limited leeway to sponsor such funds (up to 3% of Tier 1 capital). Parts of the Merkley-Levin amendment, which had been introduced in the Senate, relating to preventing conflicts of interest at investment banks, would prevent banks that underwrite offerings of asset-backed securities from placing bets against them.

Additional details on the Volcker Rule provisions will follow separately.

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Update on Covered Bonds

Well, they were in, and then they were out.

As we reported yesterday, the Conference Committee had been considering a bill that included a statutory framework for US banks to issue covered bonds. Discussions and debate regarding inclusion in the final bill continued until late in the night. The outcome: no statutory framework for covered bonds (yet). Just one vote short.

Derivatives

Among other things, the Conference Committee dropped a controversial provision from the Senate bill that would have imposed a fiduciary duty on swap dealers and major swap participants when their counterparties are State or local municipalities, Federal agencies, endowments, or pension plans. However, any swap dealer that acts as an adviser to any such counterparty will now have a duty to act in the best interests of the counterparty. Swap dealers and major swap participants must still comply with any duty established by the CFTC or SEC, as applicable, that requires the swap dealer or major swap participant to have a reasonable basis for its determinations with respect to the independence and certain aspects of such a counterparty's representative.

Another noteworthy change from the Senate and House bills is that the Conference Committee extended the effective date for Title VII from 180 days to the later of 360 days after the date of enactment or, to the extent a provision requires rulemaking, no less than 60 days after publication of a final rule or regulation that implements that provision.

Lincoln Provision (or the "Swaps Push-Out" Provision)

Section 716 of the Senate bill, which was fiercely supported by Senator Lincoln, contained an absolute prohibition on the provision of Federal assistance to swaps entities such as swap dealers, major swap participants, exchanges, and clearinghouses. By cutting off access to Federal financial support (*e.g.*, advances from any Federal Reserve credit facility or discount window, FDIC insurance, or guarantees), Section 716 would have forced banks to move their derivatives operations to independently capitalized affiliates. The Conference Committee agreed to a less onerous version of Section 716 by permitting banks to retain derivatives used to hedge their own risk or relating to interest rates, foreign exchange, silver, and gold, among others. Banks will also be permitted to retain trading in certain credit default swaps. A two-year transition period applies to derivatives relating to agricultural commodities, energy, equities, and metals other than gold and silver, among other things. Please note that this is a general summary of Section 716 that may need to be supplemented once the full text of the section is made available to the public.

Conclusion

When it comes to real time commentary on complex legislation that is taking shape in a highly truncated period, there is good reason for caution and humility. It will take some time to assess how the various provisions will operate together, the significance of the proposed provisions that did not make the final cut, and how the legislation, as ultimately adopted, will influence the upcoming, and likely challenging, process of rule-making. And, like many other important initiatives, it will take time to understand the unintended consequences of this legislation.

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Contacts

Contact your Morrison & Foerster lawyer with any questions.

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