The Board of Governors of the Federal Reserve Finalizes Interchange Fee Cap and Routing Requirements for Debit Transactions

On June 29, the Board of Governors of the Federal Reserve System (the Board) published the final version of Regulation II, Debit Card Interchange Fees and Routing, which creates a cap on debit card interchange fees, prohibits network exclusivity arrangements, and limits routing restrictions. The regulation aims to bring interchange fees in line with the costs incurred by card issuers to effect an electronic debit transaction. An interchange fee is any fee set by a payment card network (such as Visa or Interlink) and paid to a card issuer (such as a consumer’s bank) by a merchant or a merchant’s bank (known as a merchant acquirer) as compensation for the issuer’s involvement in a debit transaction. The rule, based on a December 2010 proposal and required under section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, finalizes the cap and routing requirements for debit transactions.

1 For more information on the December 2010 proposal, see Banking Legislation and Policy, Volume 29, Number 4.
Protection Act\(^2\) (known as the Durbin Amendment), establishes a standard for determining if the debit interchange fee received by a debit card issuer is “reasonable and proportional to the cost incurred by the issuer with respect to the transaction” as mandated.

**Cap on Interchange Fee**

Merchants who accept debit card payments pay interchange fees, which are established by payment card networks and paid to debit card issuers. In September 2010, the Board surveyed issuers, payment networks, and merchant acquirers to gather information pertinent to the rulemaking. Regulation II, which will be effective on October 1, 2011, sets the maximum interchange fee that an issuer may receive on a debit transaction as the sum of 21 cents and 5 basis points multiplied by the value of the transaction. This standard is based on data collected by the Board from issuers regarding certain allowable costs incurred when effecting a debit transaction. Specifically, the standard accounts for costs related to authorization, clearance, and settlement of a transaction. The allowable costs also include costs associated with network connectivity, network processing fees, and transaction monitoring, as well as costs of software, hardware, equipment, and related labor.\(^3\) Costs that are not incurred in effecting a transaction are not included as allowable costs.\(^4\)

**Exemptions**

The debit interchange fee cap does not apply to issuers that are above and below the asset threshold for exemption in order to facilitate such determination by the payment card networks. Certain prepaid cards for general use and cards issued as part of government-administered programs are also exempt from the cap.

**Fraud Prevention Adjustment**

In addition, the Board issued an interim final rule, effective October 1, 2011, allowing for an upward adjustment to an issuer’s maximum debit interchange fee of up to 1 cent if the issuer implements policies and procedures that comply with certain fraud-prevention standards. The issuer’s plan must be reasonably designed to identify and prevent fraudulent transactions; examine incidents of fraudulent transactions, including losses incurred and subsequent reimbursements received; respond appropriately to suspicious transactions in order to limit current and future fraud losses; and secure debit card and cardholder data. An issuer may receive the fraud-prevention adjustment only if it certifies its eligibility to the payment card networks in which it participates. By combining the interchange fee cap with the fraud-prevention adjustment, an issuer is entitled to a maximum interchange fee of approximately 24 cents\(^5\) for the average transaction (valued at $38.03 according to the Board’s survey). The average interchange fee in 2009 was 44 cents for a debit transaction according to the survey.

**Network Exclusivity and Routing Provisions**

Regulation II prohibits network exclusivity arrangements by requiring that all issuers and networks allow electronic debit transactions to be processed over at least two unaffiliated networks. Additionally, the rule prohibits issuers and networks from interfering with a merchant’s ability to direct the routing of a transaction, provided that

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\(^2\) For more information on the Dodd-Frank Wall Street Reform and Consumer Protection Act, see *Banking Legislation and Policy, Volume 29, Number 2.*

\(^3\) Costs related to customer inquiries and rewards programs are not included.

\(^4\) These excluded costs include costs of corporate overhead, establishment of an account relationship, card production and delivery, marketing, research and development, and network membership fees.

\(^5\) This is calculated as the sum of 21 cents, .05 percent of the average transaction value, and 1 cent for fraud prevention measures.
the merchant routes the transaction to a network enabled on the debit card. Through these requirements, the rule aims to provide merchants with some flexibility to choose a network that offers lower processing costs. Unlike the debit interchange fee cap, the network exclusivity and routing provisions apply to all debit card issuers; they also apply to general-use prepaid cards and cards associated with government-administered programs.

**Federal Reserve’s Ability-to-Repay Proposals for Mortgages**

On April 19, the Board of Governors of the Federal Reserve issued a proposal that would require creditors to assess a consumer’s repayment ability when making mortgage loans. Particularly since 2006, as mortgage delinquency and foreclosure rates have risen, concerns have grown that creditors are originating mortgages without consideration of a borrower’s ability to pay off the loan. The Dodd-Frank Act amends the Truth in Lending Act (TILA) to require a mortgage originator to make a “reasonable and good faith determination” that the consumer has the ability to repay the loan. The proposal, which would revise Regulation Z to implement amendments to TILA, applies to all consumer mortgages and includes four options for satisfying the ability-to-repay requirement, which are outlined below. The Board’s proposal also includes additional steps to protect those with mortgages from predatory lending practices.

**General Ability-to-Repay Standard**

The first option, known as the general ability-to-repay standard, requires a creditor to use widely accepted underwriting standards to consider and verify eight factors when underwriting a mortgage: the borrower’s income or assets that support an ability-to-repay assessment, the borrower’s employment status, the mortgage’s monthly payment, the monthly payment on any concurrent mortgage, the monthly payment for obligations related to a mortgage, and the borrower’s existing debt obligations, residual income, and credit history. In addition, the underwriter must calculate the mortgage payment using substantially equal monthly payments that amortize the loan over its term. For adjustable-rate mortgages, the creditor must also underwrite the loan payment using the fully indexed rate, which is calculated as the sum of the index at the time the loan is made and the maximum applicable margin throughout the loan’s term. If a loan contains an introductory interest rate that is greater than the fully indexed rate, then the introductory rate must be used in the payment calculation. Under this option, there are no restrictions on the mortgage’s features, term, or points and fees, so long as they adhere to the above underwriting standards.

**Qualified Mortgages**

To satisfy the ability-to-repay standard, a creditor may originate a qualified mortgage (QM). The Board is considering two different options for how to define a QM. Alternative 1 identifies a QM as a mortgage for which the borrower’s income or assets are verified and properly documented and the points and fees associated with the loan do not surpass 3 percent of the total loan amount. Additionally, the loan’s underwriting must meet certain standards: It must be based on the maximum interest rate in the first five years, use a payment schedule that fully amortizes the loan within the loan term, and account for any mortgage-related obligations. A mortgage cannot be qualified under this alternative if it contains negative amortization, interest-only payments, balloon payments, or a term over 30 years.

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6 Exceptions include home equity lines of credit, timeshare plans, reverse mortgages, and temporary loans.

7 Residual income is the monthly income remaining after all personal debts, including a mortgage, are paid.
Under *Alternative 2*, a QM must satisfy all of the criteria found in *Alternative 1*. In addition, a creditor must consider the borrower’s employment status, monthly payment on a simultaneous mortgage, existing debt obligations, residual income, and credit history when underwriting a mortgage if it is to be designated a QM loan.

*Alternative 1* and *Alternative 2* also offer differing legal interpretations for QM loans. A QM loan under *Alternative 1* would operate as a legal safe harbor, meaning that a borrower cannot dispute a lender’s compliance with the ability-to-repay standard. A consumer may allege that the ability-to-repay requirement was not satisfied, even when the mortgage is designated as a QM loan, and may present evidence to that effect in a legal proceeding.

First, a creditor must operate in predominantly rural or underserved areas, meaning that at least 50 percent of the creditor’s loans with balloon payments in the previous calendar year are in rural or underserved counties identified by the Board. Additionally, the volume of the creditor’s transactions under this option would be limited in either dollar amount or number of loans in the previous calendar year. The creditor must also keep all balloon loans in portfolio. Finally, the creditor must operate below an annually adjusted asset threshold — $2 billion in 2011.

**Refinancing of Nonstandard Mortgages**

The proposal includes an exception to the general ability-to-repay standard in cases in which a creditor refinances a nonstandard mortgage into a standard mortgage, lowering the monthly payment on the loan. This option is available only if the borrower has not been delinquent on any payments for the existing nonstandard mortgage to date. In such instances, the creditor can satisfy the repayment ability standard by meeting all underwriting conditions listed in the general ability-to-repay standard except the consideration and verification of the borrower’s income and

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8. For example, in the case of a QM loan under *Alternative 1*, the consumer could not claim that the repayment ability standard was not satisfied because employment status was not verified, since this is not a requirement of a QM loan.

9. A consumer may allege that the ability-to-repay requirement was not satisfied, even when the mortgage is designated as a QM loan, and may present evidence to that effect in a legal proceeding.

10. A balloon payment QM has a term of more than five years, is underwritten using all of the scheduled payments except the balloon payment, and satisfies all other criteria for a QM loan.

11. Specifically, the proposal would prohibit the selling of balloon loans either after the final rule’s effective date or in the current and preceding calendar year.

12. A standard mortgage does not have negative amortization, interest-only payments, balloon payments, or excessive loan fees, among other things. On the other hand, a nonstandard mortgage generally possesses one of these characteristics.
assets. In addition, the underwriter must calculate the mortgage payment for the standard mortgage based on the maximum interest rate applicable in the first five years and substantially equal monthly payments that amortize the loan over its term. The intent of this option is to provide consumers with streamlined refinancing\textsuperscript{13} that lowers monthly payments as well as the risk of default.

\textit{Additional Protections}

The Board’s proposal places certain limits on the penalties creditors are allowed to charge on mortgage prepayments. Prepayment penalties are prohibited except in cases in which a mortgage is a QM, is not a higher-priced mortgage, and has an annual percentage rate that cannot increase. In addition, prepayment penalties must be less than 3 percent in the first year, 2 percent in the second year, 1 percent in the third year, and zero after that. A creditor must always provide an option to the consumer that does not include prepayment penalties when offering a mortgage.

Proposed consumer protections additionally require creditors to keep documentation pertaining to the ability to pay for three years after the loan is made. Creditors are also prohibited from structuring closed-end mortgages covered by the proposal as open-end plans to prevent evasion of the requirements outlined above.

\textit{Final Rulemaking Authority}

Rulemaking authority for TILA transferred to the Consumer Financial Protection Bureau (CFPB) on July 21, 2011. As a result, final rulemaking authority for this proposal will rest with the CFPB, not the Board.

\textbf{Changes to Swap Market Regulation}

The Commodities Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) continue to add new regulation pertaining to swap markets.\textsuperscript{14} Since they are defining a range of new types of participants and instruments, the following abbreviations are useful for understanding the regulation. Generally, an SD (swap dealer) is a market maker for swaps such as a bank or investment bank; an MSP (major swap participant) is an entity with a substantial net position in swaps; an ECP (eligible contract participant) is an entity, such as a financial institution or insurance company, that is permitted to engage in transactions not available to retail customers; an FCM (futures commission merchant) is an entity, such as an investment bank, that handles orders for futures contracts and extends credit to customers in the futures market; and a DCO (derivatives clearing organization) is an entity, such as a clearinghouse, that allows each party in a transaction to substitute the credit of the DCO for the credit of the party. The definitions of these terms are still taking shape; therefore, more time is needed for the classifications to be completely delineated. Additional abbreviations include SBS (security-based swap), TRS (total return swap), SIFI (systemically important financial institution), and BHC (bank holding company).

\textbf{Effective Date for Many Rules Postponed}

The CFTC and the SEC postponed the general effective date of July 16 for much of the proposed swap market regulation prescribed by Title VII of the Dodd-Frank Act until rule-writing and implementation of the swap market regulatory framework are finalized. Swap market participants must observe all anti-fraud and anti-manipulation.

\textsuperscript{13} Streamlined refinancing refers to a consumer’s movement from a risky loan to a more stable mortgage loan requiring little or no documentation.

\textsuperscript{14} For more information on swap market regulation from previous quarters, see \textit{Banking Legislation and Policy}, Volume 30, Number 1 and \textit{Banking Legislation and Policy}, Volume 29, Number 4.
provisions, as well as any measure in Title VII that had an effective date other than July 16.

The CFTC proposed an order to temporarily exempt compliance with provisions that reference terms needing further definition, such as “swap,” “swap dealer,” “major swap participant,” and “eligible contract participant.” The order also temporarily exempts certain transactions, primarily financial and energy commodities, from CFTC oversight. These exemptions would end on December 31, 2011, or sooner if associated final rules are completed.

Similarly, the SEC’s interim final rules allow offers and sales of security-based swaps to follow the existing legal framework until related final rules are approved. The SEC announced delays pertaining to additional regulation of security-based swaps through an exemptive order and a series of proposed rules.

Final Rules for Swap Market Regulation
The CFTC finalized its anti-manipulation and anti-fraud rules on July 7. Modeled on the SEC’s Rule 10b-5, the final rule prohibits manipulation and fraud “in connection with” swaps, sale contracts for commodities in interstate commerce, contracts for future deliveries, or contracts subject to the rules of a registered entity (for ease of reference, collectively “covered financial instruments”). “In connection with” is interpreted broadly to include a wide range of swap transactions, including purchases, solicitations, and terminations. The broad interpretation includes all obligations arising under a covered financial instrument.

The final rule applies to intentional or unintentional manipulative and deceptive devices, regardless of whether such behavior resulted in an artificial price. Good faith mistakes and negligence will not be considered a violation of the rule; reckless acts will violate the rule.\textsuperscript{15} In the past, the CFTC could prosecute manipulation only if it could prove the intent to create an artificial price, but the new rulemaking closes a significant regulatory gap by expanding the scope of such prosecution to include any reckless use of fraud-based manipulative schemes, according to CFTC Chairman Gary Gensler. The final rule also prohibits price manipulation, even in the absence of fraud, by making it illegal for any person to intend to manipulate the price of any covered financial instrument.

On the same day, the CFTC approved the establishment of a reporting system to collect data on cleared and uncleared swaps from clearing organizations, clearing members, and SDs. The large trader reporting framework will be in effect until swap data repositories, new registered entities that will collect swap market data, are operational.

Proposed Swap Market Terms
On April 27, the SEC and the CFTC jointly proposed more detailed definitions of the terms “swap,” “security-based swap,” and “security-based swap agreement” in an effort to clarify when a transaction will be regulated by one or both agencies (76, Federal Register, pp. 29818-900). Swaps are regulated by the CFTC, security-based swaps are regulated by the SEC, and mixed swaps must abide by both CFTC and SEC regulations. The proposal outlines the criteria used to evaluate how a transaction is classified. In general, instruments based on interest rates would be swaps, while instruments based on the price or value of a debt security, loan, or narrow-based security index\textsuperscript{16}

\textsuperscript{15} For purposes of this rule, recklessness is defined as an act or omission that departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing.

\textsuperscript{16} As defined in the Commodity Exchange Act and the Securities Exchange Act of 1934, a narrow-based security index has fewer than 10 component securities or its components satisfy certain weighting criteria within the index.
would be security-based swaps. A total return swap (TRS) on a single security, loan, or narrow-based security index would be considered a security-based swap. Instruments based on futures and security futures would be swaps and security-based swaps, respectively. Insurance products, forward contracts, consumer and commercial agreements, and loan participations that meet certain criteria would be considered outside the scope of the proposed definitions. The proposal would allow a market participant, the SEC, or the CFTC to formally request the confirmation of a product’s classification.

The Department of the Treasury also weighed in on the scope of the “swaps” definition, issuing a proposed determination that would exempt both foreign exchange swaps and foreign exchange forwards from the “swaps” definition along with related central clearing and exchange trading requirements. The Treasury was granted direct authority over this particular determination by the Dodd-Frank Act.

**Business Conduct Standards for Security-Based Swap Entities**

On June 29, the SEC proposed business conduct standards for security-based swap dealers and major security-based swap participants (collectively referred to as SBS entities) in an effort to increase transparency and protect investors. SBS entities would be required to verify that a counterparty meets the standards to be an eligible contract participant (ECP) prior to the transaction, unless traded on a registered national securities exchange or swap execution facility; SBS entities would need to determine whether a counterparty is a “special entity” at that time as well. The special entity designation includes federal agencies, state and political subdivisions, employee benefit plans, governmental plans, and endowments. The proposal encourages fair and balanced communication with counterparties and requires SBS entities to disclose material information, information concerning the daily mark, and clearing requirements of the security-based swap. SBS dealers would be required to make suitable recommendations to counterparties, maintain records of the attributes of each known counterparty, and comply with pay-to-play restrictions, which deter the awarding of government contracts in exchange for campaign contributions or other payments. SBS entities that act as an adviser to a special entity would be required to act in the best interest of the special entity and ensure that the counterparty has an independent representative that meets certain qualifications.

**Capital Requirements for Swap Entities**

On May 12, the CFTC proposed rules regarding capital requirements for SDs and MSPs that are not subject to oversight by any other prudential regulator or designated as a systemically important financial institution (SIFI). Any SD or MSP that is also registered as a futures commission merchant (FCM) would be required to hold a minimum of $20 million in adjusted net capital and meet existing FCM requirements. SDs and MSPs that are not FCMs but are nonbank subsidiaries of U.S. BHCs would be treated as if they are BHCs. All other SDs and MSPs would be required to hold tangible net equity equal to $20 million plus additional amounts that would depend on certain risk measures.

**Proposed Protection of Cleared Swaps Customer Collateral**

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17 A futures commission merchant is a registered intermediary that solicits or accepts orders for futures or options traded on or subject to the rules of an exchange, using the client’s money or credit to secure the trades.

18 A firm’s tangible net equity is based on net equity as determined by U.S. generally accepted accounting principles (GAAP), minus intangibles such as goodwill.
On June 9, the CFTC proposed rules that protect FCM customers by ensuring that collateral supporting cleared swaps is isolated from other business activities (76, Federal Register, pp. 33818-78). The proposed Complete Legal Segregation Model would require derivatives clearing organizations (DCOs) and FCMs to hold their own assets and customers’ collateral in separate accounts. If an FCM and one or more of its customers default, a DCO would have recourse against the FCM and the collateral of defaulting customers only. The same investment rules governing the collateral of futures customers, Commission Regulation 1.25, would apply to the collateral of cleared swaps customers.

Federal Legislation
Proposed Legislation

Two alternative pieces of legislation were proposed to wind down the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. The Housing Finance Reform Act of 2011, introduced by Representative John Campbell (R-Calif.) and Representative Gary Peters (D-Mich.), would replace the GSEs with a collection of smaller, privately funded housing finance guarantee associations, whose sole purpose would be to securitize conventional 30-year fixed-rate mortgages guaranteed by the federal government (H.R. 1859). The Secondary Market Facility for Residential Mortgages Act of 2011, sponsored by Representative Gary Miller (R-Calif.) and Representative Carolyn McCarthy (D-N.Y.), would merge the GSEs into a not-for-profit mortgage financing utility operated by the government (H.R. 2413). The mortgage financing utility would purchase, package, and sell home loans as government-backed securities but would be funded in part by fees charged to lenders and investors. The focus in this second proposal is on eliminating the moral hazard that arises when the private sector benefits from a government guarantee.

The House Financial Services Committee and the Agriculture Committee passed a bill that would delay implementation of a large portion of the swaps market reform for 14 months (H.R. 1573). The deadline for the majority of swaps market rulemaking by the SEC and the CFTC was July 21, 2011. The bill, which is sponsored by Representative Spencer Bachus (R-Ala.), Representative Frank Lucas (R-Okla.), and others, will now be considered by the entire House of Representatives.

The Fighting Fraud in Bankruptcy Act of 2011, introduced by Senator Patrick Leahy (D-Vt.), would reinforce the U.S. bankruptcy trustee’s powers to protect homeowners from fraud by creditors in bankruptcy court (S.1054). The bill was referred to the Judiciary Committee.

On June 23, the House Appropriations Committee approved a financial services appropriations bill for fiscal year 2012 that would cap the Federal Reserve’s funding of the CFPB at $200 million. The Dodd-Frank Act previously capped the funding at an estimated $500 million. In addition, the bill would place authority over the CFPB’s budget within the congressional appropriations process effective in fiscal year 2013.

Federal Regulation
Board of Governors of the Federal Reserve System
Adopted Rule for S-Corps and Mutual Bank Holding Companies

The Board of Governors of the Federal Reserve System (the Board) adopted a final rule that permits any bank holding company (BHC), organized as an S-Corp or in mutual form, to include debt issued as part of the
Capital Purchase Program (CPP) in its measure of tier 1 capital. The CPP, one component of the Troubled Asset Relief Program (TARP), injected capital into many financial institutions through purchases of preferred stock, which can be included in tier 1 capital. S-Corps and mutual BHCs, however, are not allowed to issue preferred stock; therefore, the capital relief they received as part of the CPP was through purchases of subordinated debt securities. This rule aligns across institutions the treatment of TARP relief in capital adequacy standards by designating subordinated debt from the CPP as part of tier 1 capital.

Proposal for Annual Capital Plan Reviews
On June 10, the Board issued a proposed rule that would require large U.S. BHCs\(^{19}\) to submit annual capital plans to the Federal Reserve. The capital plan review of an institution aims to ensure continued operations during periods of economic and financial stress while accounting for a firm’s unique risks. Specifically, an institution’s plan must provide for sufficient capital to continue household and business lending under adverse conditions. The Dodd-Frank Act directs regulators to develop enhanced prudential standards and requires internal stress tests for large firms. The proposal builds on the Comprehensive Capital Analysis and Review (CCAR),\(^{20}\) completed in March, to implement these directives.

As part of the capital plan review, the Federal Reserve would examine an institution’s proposed dividend adjustments and stock repurchases. Firms whose capital plans are rejected by the Federal Reserve would need approval prior to making such capital distributions. An institution’s capital plan, which requires annual approval by its board of directors, would likely include company-run stress tests.

Proposed Rule on Protections Related to Remittance Transfers
On May 12, the Board proposed new consumer protections for senders of remittance transfers. The term remittance transfer refers to a transaction in which a consumer sends funds to a relative or other individual in a foreign country. The proposal applies only to electronic remittance transfers enacted through an intermediary (such as a bank). Transfer providers must give senders pre-payment disclosures and receipts of payment that include information regarding fees and the exchange rate applied, as well as the currency amount obtained by the recipient of the transfer. In addition, the proposal gives senders certain error resolution and cancellation rights. The rule is proposed under Regulation E and implements requirements outlined in the Dodd-Frank Act.

Federal Deposit Insurance Corporation
Final Rule on Retail Foreign Exchange Transactions
The Federal Deposit Insurance Corporation (FDIC) issued a final rule, pursuant to section 742 of the Dodd-Frank Act, to protect small businesses and individual consumers engaging in retail foreign exchange (retail forex) transactions.\(^{21}\) Retail customers often use these transactions to bet or speculate on foreign currency, but the majority of retail forex transactions are unprofitable. Among other things, the rule details disclosure, recordkeeping, and capital and margin requirements. For example, an institution must inform customers of the

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\(^{19}\) Large BHCs are identified here as those BHCs with over $50 billion in consolidated assets. As of March 31, there are approximately 35 of these firms in the United States.

\(^{20}\) The CCAR provided a forward-looking analysis of capital plans at 19 of the largest U.S. BHCs.

\(^{21}\) Retail forex transactions include foreign currency futures, options, options on futures, and those transactions that are functionally or economically similar (e.g., a rolling spot transaction).
percentage of retail forex accounts that have been profitable in the last year. The new requirements do not apply to traditional forward and spot contracts. Although this rule affects only FDIC-supervised institutions, other regulators have introduced analogous regulations, including a proposal from the Office of the Comptroller of the Currency in April.

Department of the Treasury

Final Rule for Designation of Systemically Important Financial Market Utilities

On July 18, the Financial Stability Oversight Council (FSOC) issued a final rule on its authority to designate financial market utilities (FMUs) as systemically important financial institutions (SIFIs). In general, an FMU is an entity that operates a multilateral system for transferring, clearing, or settling payments, securities, or other transactions among financial institutions or between financial institutions and the entity. A systemically important designation indicates that the institution could create or increase the risk of contagion of significant liquidity or credit problems that would threaten the stability of the U.S. financial system. The final criteria for SIFI determination is identical to the proposal of March 2011; the FSOC will consider the size of the FMU, aggregate exposure of the FMU to its counterparties, interdependencies with other FMUs, the effect of an FMU’s failure on the broader financial system, and any other appropriate factors. The final rule allows an FMU to contest an SIFI designation by the FSOC. Systemically important FMUs would be required to adhere to stronger risk management standards, additional reporting requirements, and enforcement actions determined by the Federal Reserve Board, the CFTC, and the SEC.

Securities and Exchange Commission

Final Rules to Strengthen Oversight of Investment Advisers

On June 22, the SEC approved a final rule regarding the registration and reporting requirements for private fund and hedge fund advisers. The final rules are substantially similar to the original proposal in November 2010. Starting March 30, 2012, the advisers will be subject to the same registration requirements, regulatory oversight, and other rules that govern SEC-registered investment advisers. The rule also shifts regulatory authority for medium-size advisers, with managed assets between $25 and $100 million, from the SEC to state securities authorities. Advisers solely to venture capital funds and advisers solely to private funds with less than $150 million in assets, as well as certain foreign advisers without a place of business in the U.S., are exempt from the registration requirement but are required to report certain information to the SEC. The final rule also strengthens the SEC’s pay-to-play restrictions, which are designed to prevent an adviser from gaining government contracts through political contributions.

Additionally, the SEC adopted a rule to define “family offices” that are exempt from the Investment Advisers Act’s definition of “investment adviser” (76, Federal Register, pp. 37983-96). Family offices are established by wealthy families to manage their wealth and other financial services to family members. A family office can take advantage of the exemption if it is wholly owned by family clients (in general, family members, family-funded causes and trusts, and certain key employees), serves only certain family clients, and does not publicize itself as an investment adviser. Family offices that do not meet the criteria will be required to register with the SEC and comply with the Investment Adviser’s Act by March 30, 2012.

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22 The definition of an FMU specifically excludes certain designated contract markets and national securities exchanges.
23 For more information, see Banking Legislation and Policy, Volume 30, Number 1.
24 For more information, see Banking Legislation and Policy, Volume 29, Number 4.
Proposed Rule to Strengthen Audits and Reporting of Broker-Dealers
On June 15, the SEC proposed amendments to the broker-dealer financial reporting rule under the Securities Exchange Act of 1934 in order to strengthen the audits of broker-dealers and protect investors. Those broker-dealers who maintain custody of customer securities and cash would be audited by a registered public accounting firm to ensure compliance with certain segregation requirements. These requirements are designed to protect customer assets by isolating them from other business activities so that they can be recovered if the broker-dealer fails. A broker-dealer that does not maintain customer assets could obtain an exemption from segregation requirements through an independent public accountant. The proposal would require a quarterly report on the maintenance of customer accounts and require brokers to make audit information available to regulators.

Final Rule to Establish Whistleblower Program
On May 25, the SEC adopted rules to create a whistleblower program to reward individuals who voluntarily provide specific and original information to the SEC that leads to successful enforcement actions.

Proposed Rules to Address Extraordinary Market Volatility
On April 5, the SEC proposed rules for a one-year pilot of a limit up-limit down mechanism, replacing the existing single stock circuit breakers approved in 2010 (set to expire in August 2011), in order to counter extraordinary market volatility in U.S. equity markets. These regulatory steps are a direct result of broad negative sentiment and turbulence in the markets on May 6, 2010, during which automated execution programs and algorithmic trading strategies constricted liquidity and caused extreme price movements. The proposal would prevent trades in listed equity securities outside a price band calculated around the average price of a security over the previous five minutes. Stocks currently subject to the circuit breaker program would have a price band of 5 percent above and below the average price, while stocks not subject to the circuit breaker program would have a price band of 10 percent above and below the average price. Stocks priced below $1 would have wider price bands. During opening and closing periods, the price bands would be doubled. All trading centers would be required to establish policies and procedures to help keep trading within the established price bands.

Order to Adjust Performance Fee Restrictions for Inflation
On July 12, the SEC issued an order to adjust the criteria for determining if investment advisers can charge their clients performance fees. An investment adviser can now charge performance fees only if the client has at least $1 million under management or has a net worth excluding a primary residence of $2 million. These thresholds were previously $750,000 and $1.5 million, respectively. In the future, the thresholds will be adjusted every five years to account for inflation.

Proposals to Bolster Assessments of Creditworthiness
On May 18, the SEC proposed rules to boost the transparency and integrity of credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs). The proposal would require NRSROs to report on internal controls; guard against conflicts of interest; develop professional standards for credit analysts; publicly disclose the methodologies used in determining a credit rating; and improve upon the public

25 For example, a broker-dealer must hold at least a dollar in highly liquid assets for each dollar of liabilities, and it must segregate customers’ assets from its proprietary business activities.
disclosures of how their credit ratings perform. In the case of asset-backed securities, the proposal additionally necessitates disclosure pertaining to due diligence reports by third parties.

Earlier in April, the SEC proposed rule amendments to eliminate references to credit ratings found in several of its rules under the Securities Exchange Act of 1934. In most cases, the credit ratings would be replaced by alternative methods for determining creditworthiness. Both proposals implement provisions of the Dodd-Frank Act.

Proposed Rule to Disqualify from Exemptions Securities Offerings Involving Bad Actors
On May 25, the SEC proposed rules to disqualify securities offerings involving certain “bad actors” from exemptions for registration in Regulation D. Bad actors have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other specified law violations.

Multiple Sponsors
Final Rule Establishes Risk-Based Capital Floor
On June 14, the Federal Reserve Board, the FDIC, and the OCC adopted a joint final rule that implements a risk-based capital floor, as required by section 171 of the Dodd-Frank Act. The rule requires that any banking organization following the so-called “advanced approaches” rules for risk-based capital requirements calculate its tier 1 and total risk-based capital ratios using both the advanced approaches rules and the current general rules. The organization’s tier 1 and total risk-based capital ratios must be above 4 and 8 percent, respectively, under both approaches in order to meet its minimum capital requirements. The rule aims to prohibit large banking institutions subject to the advanced approaches rules from operating under reduced risk-based capital requirements. The final rule also supplies limited flexibility for the appropriate capital requirements pertaining to certain low-risk assets held by bank holding or nonbank financial companies.

Final Rules Repeal Ban on Interest-Bearing Checking Accounts
The Federal Reserve and the FDIC released similar final rules that allow state-chartered member26 and nonmember banks to pay interest on demand deposits. Pursuant to Section 627 of the Dodd-Frank Act, the Federal Reserve’s rule repeals Regulation Q, which previously banned such forms of interest.

Final Rules on Credit Score Disclosures to Consumers
On July 6, the Federal Reserve and Federal Trade Commission issued a joint final rule that requires creditors to disclose a consumer’s credit score in risk-based pricing notices27 if it is used to set unfavorable terms of credit. The Federal Reserve also adopted a final rule that requires creditors to disclose a consumer’s credit score if it is used in taking adverse action. Adverse action is broadly defined to include credit denial, adjustment of terms on existing credit arrangements, and credit grants that differ substantially in amount or terms from a consumer’s request. Both of these final rules implement new credit score disclosure requirements found in the Dodd-Frank Act.

26 A member bank is an institution that is a member of the Federal Reserve System. Nonmember banks are overseen by the FDIC.
27 A risk-based pricing notice is sent to a consumer to alert him to negative information in his credit report.

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