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HIGHLIGHTS

This issue contains detailed descriptions of:

- The proposed [regulatory framework for swaps](#), including:
 - [Swap Market Structure](#)
 - [Swap Market Participants](#)
 - [Clearing Organizations](#)
 - [Trading Organizations](#)
 - [Swap Data Repositories and Swap Reporting](#)
- [Proposed Debit Card Interchange Fee and Routing Regulations](#)

In addition, it summarizes [other notable legislative, regulatory, and judicial developments that occurred during the fourth quarter of 2010](#).

New Regulatory Framework for Swaps and Security-Based Swaps

Titles VII and VIII of the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Dodd-Frank Act¹) direct the Commodities Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), in consultation with the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency (OCC), and the

Department of the Treasury, to create a new regulatory framework meant to reduce risk, increase transparency, and promote integrity in the swap market.

Although the SEC supervises security-based swaps and the CFTC supervises commodity-based swaps, they seek to regulate functionally or economically equivalent products in a similar manner. The commissions share supervision of mixed swaps. The following proposals and interim final rules define swap-related terms and entities, describe the mandatory swaps clearing process and exemptions,

¹ For more information on the Dodd-Frank Wall Street Reform and Consumer Protection Act, see [Banking Legislation and Policy, Volume 29, Number 2](#).

outline new regulation for registered entities, and prescribe reporting, governance, and antifraud measures.

Swap Market Structure

The Dodd-Frank Act requires derivatives contracts, formerly traded in the over-the-counter (OTC) market, to be cleared whenever possible and appropriate. For the purposes of the legislation, a wide range of derivatives are termed “swaps.”² The OTC derivatives market consisted of privately negotiated transactions in which counterparties assumed each other’s credit risk. The Dodd-Frank Act’s clearing requirement involves managing overall counterparty risk by using central clearinghouses that assume the original credit risk between two or more counterparties.

Swaps Required to Be Cleared by a Central Agency

The Dodd-Frank Act specifically gives the CFTC and the SEC the authority to determine whether a swap or security-based swap, respectively, requires central clearing. [One of the CFTC’s proposed rules](#) would require central clearing agents to submit a statement of eligibility to clear a swap or group of swaps, provide certain quantitative and qualitative information to regulators and market participants, and describe the notification and any opposition of its members. The CFTC would determine whether the swap or group of swaps should be cleared based on the material within 90 days of the submission.

² A swap is defined as a contract that is a put, call, cap, floor, collar, or similar option that is based on the value of rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, and other economic interests, property, or events. The definition of a swap includes interest rate, cross-currency, currency, foreign exchange, total return, equity index, equity, debt index, debt, credit default, credit, weather, energy, metal, agricultural, emissions, commodity, and other swaps; it does not include futures or options on futures.

After the CFTC decides whether a swap should be cleared, it may stay the clearing requirement while it conducts a review of the terms and the clearing arrangement. The CFTC would make a determination within 90 days as to whether the swap is subject to the mandatory clearing requirement.

The SEC [proposed a related rule](#) regarding the mandatory clearing of security-based swaps by a central clearing agency that functions as a central counterparty. The SEC’s rule includes specifications for submissions of security-based swaps that clearing agencies plan to accept for clearing, as well as an option to stay the SEC’s decision pending further review.

The Dodd-Frank Act also requires regulators to review on an ongoing basis any swap that a central clearing agent has not accepted to be cleared to determine whether it should be cleared. Under [a proposed rule](#), the CFTC would investigate and issue reports on swaps subject to mandatory clearing that remained OTC. The CFTC would establish margin or capital requirements, or any other action it determines to be necessary and in the public interest, for the parties to the identified swaps.

Exemptions from Mandatory Swap Clearing

In December, the CFTC and the SEC released parallel exemptions from the mandatory swaps clearing as required by the Dodd-Frank Act ([SEC proposal](#), [CFTC proposal](#)). Under the end-user exemption, a swap would be exempt from the mandatory clearing requirement if the end-user has at least one counterparty that is not a financial entity, uses the swap to hedge or mitigate commercial risk (not for speculation, investing, or trading), and shows regulators how it generally meets its financial obligations associated with noncleared swaps. The proposals outline the information that a counterparty would need to

submit in order to invoke the end-user clearing exemption and clarify the definition of hedging or mitigating commercial risk. They also describe a separate exemption that the CFTC and the SEC are considering for small banks, savings associations, farm credit system institutions, and credit unions.

Protection for Counterparties to Uncleared Swaps

On November 19, the CFTC proposed a rule to protect the collateral of counterparties to uncleared swaps ([74, Federal Register, pp. 75432-39](#)). CFTC regulations define two classes of large swap market participants, a swap dealer (SD) and a major swap participant (MSP), which will be discussed in greater detail below. Counterparties could require that their collateral be held in segregated accounts in a transaction with an SD or an MSP. The rule would not limit the type of margin posted and would allow the segregated margin to be invested like other customer property for futures transactions.

Interim Final Rules on Pre- and Post-Enactment Swaps

On October 1, the CFTC published an interim final rule regarding the reporting of swap transactions entered into before the passage of the Dodd-Frank Act on July 21, 2010, whose terms had not expired ([75, Federal Register, pp. 63080-5](#)). An SD, MSP, or another counterparty is required to retain information about such pre-enactment unexpired swap transactions and report them to a swap data repository (a new regulated entity described below) or the CFTC when registrations are complete and associated regulation becomes effective. The SEC issued an equivalent [interim rule on pre-enactment swaps](#) on October 13.

On December 9, the CFTC published an interim final rule regarding the reporting of swaps entered into on or after the date of enactment of the Dodd-Frank Act and prior to the effective date of swap data reporting rules ([75, Federal Register, pp. 78892-6](#)). The rule outlines the obligations of the

designated party to report the post-enactment swap transactions to the designated agency (reporting requirements will be discussed in greater detail below) when the CFTC completes related rulemaking, but no later than 90 days after July 15.

Swap Market Participants

Definitions of Swap Dealer and Major Swap Participant

On December 7, the SEC and the CFTC [jointly proposed a rule](#) to further define the participants in the regulated swap market: swap dealer (SD), security-based swap dealer, major swap participant (MSP), major security-based swap participant, and eligible contract participant, initially defined in Title VII of the Dodd-Frank Act. The definitions will help determine which entities will be subject to comprehensive regulation.

The commissions consider an entity an SD or security-based SD if it presents itself as a dealer, makes a market in swaps, enters into swaps as an ordinary course of business for its own account, or engages in activity causing it to be known as a dealer or market maker in swaps or security-based swaps. Entities that do not enter into swaps in the course of regular business or that engage in a de minimis quantity of swaps would be exempt from the definition of an SD but not a security-based SD.

The commissions propose that an entity should be considered an MSP or major security-based swap participant if it meets any of three attributes. First, an MSP would maintain a “substantial position” in four proposed major categories of commodity swaps (rate, credit, equity, and other commodity swaps) or two proposed major categories of security-based swaps (swaps based on one or more debt instruments, such as credit default swaps, and other security-based swaps, such as equity swaps), excluding hedges for commercial risk. The commissions would determine a “substantial

position” by evaluating current uncollateralized exposure and potential future exposure.³

Second, an MSP’s outstanding swaps would have “substantial counterparty exposure” and would affect the financial stability of the United States. Substantial counterparty exposure would be calculated similarly to substantial positions but would include all swaps instead of one category of swaps.⁴

Third, an MSP would be any financial entity that is “highly leveraged,” that is not subject to capital requirements established by a federal regulator, and that maintains a substantial position in any of the major categories of swaps as determined by the CFTC or the SEC. The commissions proposed two possible thresholds for a financial entity to be considered highly leveraged: a ratio of total liabilities to equity of at least 8 to 1 or at least 15 to 1.

The SEC⁵ estimates that 10 entities, including AIG and hedge funds with excessive swap positions, may be major security-based swap participants and that 50 entities may be security-based SDs. The CFTC anticipates the registration of 50 MSPs and 250 SDs. MSPs and SDs may be classified as such in some categories of swaps without being classified as such for others.

³ The daily average current uncollateralized exposure threshold for an MSP would be \$3 billion in the rate swap category or \$1 billion in any other major swap or security-based swap category. The threshold for an MSP combining potential future exposure, adjusted for risk, with current uncollateralized exposure would be \$6 billion in the rate swap category or \$2 billion in any other major swap or security-based swap category.

⁴ The CFTC proposes a \$5 billion threshold for current uncollateralized exposure or an \$8 billion threshold for combined current uncollateralized and potential future exposure, while the SEC proposes \$2 billion and \$4 billion thresholds, respectively, for exposures in the security-based swap market.

⁵ The SEC oversees roughly 5 to 10 percent of the \$600 trillion swap market.

The commissions also proposed an expansion of the definition of eligible contract participant (ECP) to include SDs and MSPs. An ECP previously included entities such as financial institutions, insurance companies, or commodity pools permitted to participate in transactions not generally available to other contract participants, such as retail customers. The Dodd-Frank Act restored CFTC regulation covering ECP transactions, which were previously exempt from supervision. The Dodd-Frank Act allows both ECPs and non-ECPs to trade on registered swap exchanges, but only ECPs can trade bilaterally or off of the exchanges.

Proposed Regulation for Swap Dealers and Major Swap Participants

On November 10, the CFTC proposed regulations for the registration of any SD and MSP using the same process as used by entities such as [futures commission merchants](#)⁶ (FCMs) — agents who take orders from customers ([75, Federal Register, pp. 71379-90](#)). Provisional registration would begin April 15, 2011, and full registration would occur after related rulemakings are complete and firms demonstrate continued compliance. SDs and MSPs would also be required to join a registered futures association.

On December 1, the CFTC proposed regulations to establish reporting, recordkeeping, and daily trading records requirements for SDs and MSPs ([75, Federal Register, pp. 76666-77](#)). SDs and MSPs would be required to maintain detailed daily trading information on the products and counterparties, including all submitted reports and related records that could provide a complete audit trail, and the rationale for determining large notional swaps and block trades.

⁶ 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.

Along with required basic business and financial records, all trade information would be open to inspection by the CFTC or the SEC.

The CFTC also proposed rules to mitigate conflicts of interest between SDs, MSPs ([75, Federal Register, pp. 71391-97](#)), FCMs, and introducing brokers (IBs) — agents who take orders from customers but do not trade directly on the floor of an exchange ([75, Federal Register, pp. 70152-59](#)). The rules would require SDs, MSPs, FCMs, and IBs to ensure the insulation of risk-taking units (employees who research or analyze any commodity or swap or employees who work on clearing-related activities) from pressure or oversight of people involved in potentially influential pricing, trading, and clearing activities. SDs, MSPs, FCMs, IBs, and employees involved in pricing, trading, and clearing activities would be prohibited from retaliating against analysts whose research adversely affects them. SDs, MSPs, FCMs, IBs, and employees who research or analyze derivatives would also face enhanced disclosure requirements to expose conflicts of interest.

As specifically required by the Dodd-Frank Act, each SD, MSP, and FCM must designate a chief compliance officer who would report to the entity's governing body ([75, Federal Register, pp. 70881-8](#)). The chief compliance officer would prepare and certify an annual report describing the registered entity's compliance with the regulations and resolution of conflicts of interest.

Proposed Business Conduct Rules for Swap Dealers and Major Swap Participants

On November 10, the CFTC proposed amendments to establish and govern the duties of SDs and MSPs ([75, Federal Register, pp. 71397-408](#)). SDs and MSPs would be required to monitor and police position limits established by the CFTC, or a centralized trading organization, to be discussed in detail below. The proposed rule would require SDs and

MSPs to establish risk management programs that consider market, credit, liquidity, foreign currency, legal, operational, and settlement risks. It would also require SDs and MSPs to mitigate conflicts of interest, which would include enhanced supervision of their traders and separation of traders from risk management units. In addition, the proposed rule would require SDs and MSPs to establish business continuity plans, promptly disclose all requested information to regulators, and refrain from anticompetitive actions.

On December 9, the CFTC proposed business conduct standards for SDs and MSPs dealing with counterparties ([75, Federal Register, pp. 80638-63](#)). The rule generally requires SDs and MSPs to tighten supervision of dealings with a counterparty, which includes identifying the true name and owner, verifying its eligibility to trade, and protecting confidential information. The rule would prohibit fraudulent, deceptive, and manipulative practices, as well as trading ahead and front running of counterparty swap transactions. SDs and MSPs would be required to disclose material risks and potential conflicts of interest, as well as provide the daily mid-market value of uncleared swaps, to all counterparties. They would also be required to notify a counterparty of its right to clear a swap that is exempt from mandatory clearing. SDs and MSPs would face more restrictions and requirements when they advise a special entity and/or take a special entity as a counterparty to a transaction. Special entities are federal agencies, state or political subdivisions, municipalities, employee benefit plans, governmental plans, or endowments.

On December 16, the CFTC proposed rules regarding confirmation, portfolio reconciliation, and portfolio compression requirements for SDs and MSPs ([75, Federal Register, pp. 81519-32](#)) in an attempt to reduce risk and improve operational efficiency. The requirements vary, based on

whether the swaps transaction or portfolio is between an SD and an MSP or other counterparties. Generally, SDs and MSPs would be required to confirm all of the swap transaction terms on the day of the execution and to reconcile swap portfolios on a daily, weekly, or quarterly basis (depending on the size of the portfolio). Portfolio reconciliation allows counterparties to resolve any existing discrepancies and to understand the risk exposure they have to each other. SDs and MSPs would also be required to net trades and eliminate fully offsetting trades to reduce the number and notional value of total multilateral trades. These portfolio compression exercises improve operational efficiency and allow for more precise measurement of actual counterparty exposures.

Clearing Organizations

General Regulation of Derivatives Clearing Organizations

With a series of proposed rulemakings, the CFTC is crafting new regulatory standards for derivatives clearing organizations (DCOs), including the implementation of core principles amended by the Dodd-Frank Act with which DCOs must comply to maintain registration.

In its proposed [definitions of clearing member, clearing organization, and related terms](#), the CFTC characterized a DCO as an entity that enables parties who are involved in an agreement, contract, or transaction to substitute the entity's credit for their own; that settles obligations between parties; or that provides clearing services or arrangements that transfer credit risk. The definition of a clearing organization would be amended to match that of a DCO and would incorporate futures contracts and swaps. A clearing member would be defined as any entity that has clearing privileges such that it can process, clear and settle trades through a DCO on behalf of itself or others.

On December 1, the CFTC proposed rules for registration and transfer procedures and eight core principles. One rule would streamline the DCO application process and clarify procedures for a DCO to request a transfer of registration in anticipation of a corporate change ([74, Federal Register, pp. 77576-88](#)). To comply with the core principles, DCOs would be required to develop an appropriate legal framework for their activities and appoint a chief compliance officer to develop and report on compliance practices.

On October 26, the CFTC proposed a process for the review and designation of swaps for mandatory clearing by DCOs ([75, Federal Register, pp.67277-82](#)). The proposal would allow a DCO to accept any swap in the group or class for which it is already approved; it would need to request approval from the CFTC to accept a type of swap that it does not already clear.

In a subsequent rule, the CFTC proposed guidelines to implement the core principle of participant and product eligibility. DCOs would be required to offer fair and open access, ensure participants have financial resources and operational capacity to meet their obligations, and regularly monitor and report violations or sanctions against clearing members and participants.

Risk Management

On December 16, the CFTC proposed rules for six core principles, including risk management, default rules and procedures, and system safeguards ([75, Federal Register, pp. 3698-742](#)). A DCO would be required to measure its credit exposure to each clearing member at least daily and use margin requirements and other risk control mechanisms to limit exposure to losses. As a result, DCOs would need to make sure that a default does not adversely affect clearing operations or expose nondefaulting members to losses they cannot anticipate or control.

The proposed rule would require a DCO to establish and state its procedures for the management of a member's default in a way that contains losses, mitigates liquidity pressure, and allows the DCO to continue meeting its obligations. A DCO would also be required to analyze its operational risk by establishing emergency procedures, backup facilities, and a disaster recovery plan.

The proposal places higher standards on systemically important DCOs with respect to system safeguards supporting business continuity and disaster recovery. The CFTC would hold special enforcement authority over systemically important DCOs, as dictated by the Dodd-Frank Act.

Information Management

Several proposed amendments to DCO core principles deal with information management ([75, Federal Register, pp. 78185-97](#)). These rules would require DCOs to report to the CFTC margin, cash flows, and end-of-day positions on a daily basis, financial resources on a quarterly basis, and compliance reports on an annual basis. Significant financial changes at the DCO or problems with a clearing member would be reported on an event-specific basis. DCOs would be required to publicly disclose information such as clearing fees, margin methodology, financial resources, rules, and procedures so that market participants could assess the costs and risks associated with using their services.

In addition, the proposed rules would codify the Dodd-Frank Act's information sharing and antitrust considerations.

Financial Resources Requirements for DCOs

On October 1, the CFTC issued proposed rules on financial resources requirements for DCOs and systemically important DCOs ([75, Federal Register,](#)

[pp. 63113-20](#)). A DCO would need to maintain the level of liquid resources necessary to fulfill any obligations to counterparties in the event its largest member or affiliated members defaulted. The amounts would be determined by a monthly stress test of the DCO and reported to the CFTC. The value of the financial resources used to fulfill the requirement, including the margin of the defaulting clearing member, the DCO's own capital, the DCO's guaranty fund deposits, default insurance, and assessments on nondefaulting members by the DCO, would be calculated monthly, as well. In addition, the rule would require the DCO to maintain sufficient financial resources (generally, the DCO's own capital) to cover its operating costs for one year.

Systemically important DCOs would face higher standards, such as maintaining enough resources necessary to withstand the default of the two largest members or affiliated members. Systemically important DCOs would also have limited financing options in the event of a default by a clearing member and would face limitations on the use of assessments on members to cover its obligations. In general, a systemically important DCO would hold a larger portion of financial resources in margin and the guaranty fund than a DCO that is not systemically important.

Systemically Important Financial Market Utilities

On December 15, the SEC [proposed a rule](#) for clearing agencies and other financial market utilities that the Financial Stability Oversight Committee (FSOC) deems systemically important. The Dodd-Frank Act defines a financial market utility as any entity that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person. The term financial market utility would include, but would not be limited to, DCOs or other

organizations that clear swaps. A systemically important financial market utility would be required to notify its supervising agency in advance of any changes in its rules, procedures, or operations that could affect the utility's risk management or ability to perform its core clearance and settlement functions.

Trading Organizations

The Dodd-Frank Act requires that swaps subject to mandatory clearing must occur either on a designated contract market (DCM) or a new swap market category called a swap execution facility (SEF), unless the swap is not made available to trade in any exchange.

General Regulation of Designated Contract Markets

A DCM is a board of trade or exchange under CFTC oversight that provides a facility to trade futures, options on futures, or options on commodities. Contract markets that provide a facility to trade options on securities and securities indexes are supervised by the SEC. DCMs, like the CME Group's exchanges and board of trade, generally have open order books and computerize the match process of bids to offers.

On December 1, the CFTC proposed core principles and other requirements for DCMs, which ultimately require DCM applicants and existing DCMs to comply with 23 core principles to become or continue as a DCM ([75, Federal Register, pp. 80572-636](#)). The rules would replace the eight criteria for designation as a contract market with five new core principles (disciplinary procedures, system safeguards, financial resources, diversity of boards of directors, the SEC) and amendments to many others. In general, the proposed rule would codify best practices on the processing, trading, and execution of swaps on DCMs.

General Regulation of Swap Execution Facilities

An SEF is a new type of registered entity, created by the Dodd-Frank Act, that provides a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers. The definition includes facilities that execute swaps between persons and excludes national exchanges. The CFTC anticipates 30 to 40 SEF registrations by companies such as Bloomberg LP, Tradeweb LLC, and Intercontinental Exchange. Many eligible firms may register as SEFs under both the CFTC and the SEC.

On December 16, the CFTC proposed 15 core principles and other requirements for SEFs that are generally consistent with the existing or proposed regulations for those applicable to DCMs ([75, Federal Register, pp. 1214-59](#)). SEFs would be allowed to implement swap execution through a "request for quote" system, whereby market participants must transmit a request for a quote to buy or sell a specific instrument to at least five other participants. SEFs could also operate order books, where all market participants can enter and observe bids and offers. SEFs would be required to provide impartial access to the market and allow participants to post both firm and indicative quotes to multiple parties.

On February 2, the SEC [proposed separate but similar parameters](#) for security-based SEF operations. The SEC would allow security-based SEFs to operate request for quote and open book systems. An SEF would be exempt from regulation as an exchange or a broker under the Exchange Act. The proposal requires SEFs to provide impartial access to registered security-based SDs, major security-based swap participants, brokers, and eligible contract participants. SEFs would be allowed to give unregistered eligible contract participants access if they are able to manage the attendant risks. SEFs would be required to comply

with all core principles outlined in the Dodd-Frank Act and codified by the SEC's proposal, which include rules governing the type and terms of swaps traded, processing and monitoring trades, emergency authority over trades, dissemination of post-trade information, recordkeeping, governance, and conflicts of interest.

Foreign Boards of Trade

The CFTC also proposed a rule that would require the registration of foreign boards of trade (FBOTs) that provide their members and participants located in the United States with access to their trading systems ([75, Federal Register, pp.70973-98](#)). Registration requirements and the review process would be similar to the current evaluation for no-action relief.

Conflicts of Interest

The CFTC proposed rules to mitigate conflicts of interest in DCOs, DCMs, and SEFs ([75, Federal Register, pp. 63732-53](#)). Under the rule, DCM or SEF members would be prohibited from owning more than 20 percent of any class of voting equity in the registered entity or from having over 20 percent of the voting power. DCOs would choose from two alternatives, which limit individual ownership of voting equity and voting power to 20 percent (40 percent collectively) or 5 percent. Structural governance requirements for DCOs, DCMs, and SEFs would include changing the composition of boards of directors, creating disciplinary panels, and forming committees for nominations of directors, risk management, regulatory oversight, and membership.

On October 13, the SEC issued similar rules in "[Proposed Regulation MC](#)" to mitigate conflicts of interest involving security-based swap clearing agencies, security-based SEFs, and national exchanges that post security-based swaps. The covered entities would also choose from two alternatives to voting and membership limits, in

addition to implementing other governance measures.

Another CFTC rule focusing on governance would dictate to DCOs, DCMs, and SEFs specific diversity standards for the board of directors and which board of director decisions to report to regulators ([75, Federal Register, pp. 722-37](#)). DCOs, DCMs, and SEFs would be required to establish procedures to mitigate conflicts of interest and protect nonpublic information. The governance rules would apply to any DCO or DCM that clears or lists swap contracts or commodity futures or options.

Swap Data Repositories and Swap Reporting

On November 19, the CFTC and the SEC published separate but similar proposals to establish and assign duties to centralized recordkeeping facilities known as swap data repositories (SDRs) and to develop rules for the reporting of swaps, as required by Title VII of the Dodd-Frank Act. Both commissions aim to improve the post-trade transparency of the swap markets they oversee to inform market participants and enhance regulation.

General Responsibilities

SDRs would maintain records of all swap transactions and provide access to records relevant to authorities. The [SEC's proposal](#) requires SDRs to register with the SEC, keep their information current, and designate a chief compliance officer. SDRs would accept all security-based swaps reported to them, providing the data and reports based on the data to the SEC. SDRs would be required to accept transaction data and maintain the data for at least five years after the expiration of the applicable swap, as well as calculate and maintain positions for at least five years. SDRs would also be expected to develop policies and procedures to resolve disputes over data accuracy, ensure system capacity and security, and protect the privacy of information and intellectual property. The proposed rule would also require

SDRs to provide market participants with disclosures of the risks and costs associated with using the SDR's services.

The [CFTC proposal for SDRs](#) is essentially the same as the SEC's security-based SDR proposal, requiring entities to register with the CFTC, provide access to data and reports, maintain certain records for at least five years, develop policies and procedures, protect the privacy of information, and furnish disclosures for market participants.

Reporting and Recordkeeping

The [SEC's proposed rules on security-based swap reporting](#) require that details of all swap transactions be reported to an SDR, which would in turn publicly disseminate certain aspects of the trade. The rules cover which party should report the trade, in what format it should be reported, what information should be included, and how real-time reporting should be implemented. Each participant in a swap would be recorded with a unique identifier. Swap participants would have to report information about the asset class, underlying security, price, notional amount, time of execution, effective date, and scheduled termination date. They would also have to report the counterparty, the participant IDs, amounts of up-front payments, terms of the payment streams, title of any master agreement, and data needed to determine the market value of the transaction; however, SDRs would be restricted from publishing this information. The proposal also instructs SDRs to establish policies and procedures to register with the SEC as securities information processors and develop policies and procedures involving the reporting and dissemination of swap information.

The [CFTC's proposed rules on swap reporting](#) also include recordkeeping and reporting requirements for all activity relating to a swap transaction. In some instances, the proposed regulations would require the creation of a unique identifier for any

swap transaction executed in swap execution facilities or designated contract markets. The CFTC's proposed rules on [real-time reporting of swap transaction data](#) require swaps transactions to be reported immediately to a real-time disseminator. Block trades and large notional swaps would be delayed 15 minutes.

Certification and Approval of New Products, Rules, and Amendments

On October 26, the CFTC [proposed provisions](#) in regard to the certification and approval of new products, rules, and rule amendments, which would apply to DCMs, SEFs, DCOs, and SDRs. Registered entities would be allowed to list for trading or clearing any product after providing the terms and conditions and certifying that it complies with the Commodity Exchange Act (CEA) and CFTC regulations. Products may not be easily susceptible to manipulation and must abide by appropriate position limits. Products that are based on excluded commodities and that involve terrorism, war, gaming, or other unlawful activity would be prohibited.

New rules or rule amendments would be reviewed by the CFTC in 10 days unless their complexity requires an extension. A systemically important DCO would be required to notify the CFTC 60 days in advance of a rule, procedure, or operational change that would materially affect its risk profile.

Fraud Prevention

In October, the CFTC and the SEC proposed similar rules to prevent fraudulent and manipulative practices in the swap and security-based swap markets ([75, Federal Register, pp. 67301-3](#) and [SEC proposal](#)). The Dodd-Frank Act explicitly prohibits any trading, practice, or conduct that violates bids or offers, demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period, or leads to bidding or offering with the intent to cancel before execution.

The proposed rules would prohibit the use of manipulative devices and schemes, including false statements and material omissions. The CFTC's rule would prohibit fraud manipulation and deception in connection to the offers, purchases, and sales of swaps. The SEC's rule would cover the same areas for security-based swaps, in addition to cash flows, payments, deliveries, and other ongoing obligations specific to the market.

Whistleblower Incentives and Protection Program

In November, the CFTC and the SEC proposed rules to reward individuals who voluntarily provide the agency with high-quality information about violations of the CEA that leads to successful enforcement action and monetary sanctions of over \$1 million ([75, Federal Register, pp. 75728-60](#) and [SEC proposal](#)).

Board of Governors of the Federal Reserve Propose Debit Card Interchange Fee and Routing Regulations

On December 16, the Board of Governors of the Federal Reserve (the Board) published a proposal to limit debit card⁷ interchange fees and routing restrictions ([75, Federal Register, pp. 81721-63](#)), as required by section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (commonly known as the Durbin Amendment). The proposal includes two alternatives each for interchange fees and transaction routing.

⁷ The proposal defines the term "debit card" as "any card or other payment code or device issued or approved for use through a payment network" that taps funds in an account located in the United States for personal, household, or business use. The definition includes general-use gift cards, which are prepaid and can be redeemed at a variety of merchants or ATMs, but not gift cards that are restricted for use at a limited number of merchants. The proposal covers transactions authorized in any manner, including personal identification number (PIN) and signature.

Interchange Fees

An interchange fee is any fee set by a network (such as Visa or Interlink) and paid to a card issuer (such as a consumer's bank) by institutions that acquire and settle payments (such as a merchant's bank) for a debit transaction. The Dodd-Frank Act mandates that interchange fees must be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction" by July 21, 2011, but allows the Board to set the standards. The Board has determined that only incremental costs can be recovered through interchange fees. These incremental costs include the cost of authorization, clearance, and settlement of a transaction. Fixed costs, which do not vary by the number of transactions,⁸ are not included as allowable costs. In a survey of debit market participants organized by the Board, the median variable cost per transaction in 2009 was 7 cents and the 80th percentile was 12 cents. These results were used to craft the two interchange fee proposals, which apply to debit card issuers and affiliates with combined assets of at least \$10 billion. Debit cards administered for government benefit programs and reloadable, general-use prepaid cards would be exempt from the rules.

Interchange Fee Proposals

The first alternative would force payment networks to impose a maximum interchange fee for each issuer equal to its average allowable costs per transaction (calculated as total allowable costs over the number of debit transactions for which the issuer is charged an interchange fee per year), up to a cap of 12 cents per transaction. Issuers that decline to calculate their average allowable costs could take advantage of the safe harbor, which allows them to receive interchange fees under 7 cents per transaction without supporting documentation. The second alternative skips the

⁸ Examples of fixed costs include overhead, network fees not intended as processing fees, fraud losses, fraud prevention, and rewards programs.

average cost calculation altogether and simply imposes a 12 cent cap on any issuer's interchange fee per transaction.

In the Board's survey, networks reported that the average transaction interchange fee in 2009 was 44 cents and 1.14 percent of the transaction amount. Adopting either proposed alternative would result in a maximum interchange fee of 12 cents, which is 70 percent lower than the average interchange fee in 2009. The rule would take effect July 21, 2011.

Adjustments for Evasion and Fraud Prevention

The Dodd-Frank Act authorizes the Board to write regulations to prevent evasion of interchange fee restrictions. Since interchange fees are set by networks, issuers could circumvent the interchange fee limits by receiving rebates and incentive payments from the networks themselves. Therefore, the Board's proposal explicitly prohibits networks from providing net compensation to issuers. Issuers would retain the right to charge fees to their cardholders or earn revenue from other sources. An adjustment to incorporate the cost of fraud prevention will be determined in a future rulemaking.

Network Exclusivity and Transaction Routing

The Dodd-Frank Act also directs the Board to establish regulations to give merchants more freedom to choose the networks over which they route a debit transaction. Currently, payment networks offer issuers incentives to influence where transaction volume will flow during authorization and clearance. Some issuers channel

all of their transaction volume through one network or through affiliated personal identification number (PIN) and signature networks. Such "network exclusivity" can lower costs for issuers and enable consumers to receive benefits such as zero liability protection and text message alerts regarding suspicious activity on an account. However, network exclusivity forces merchants to route debit transactions over the networks that issuers choose, rather than networks that offer merchants the lowest cost. The proposed alternatives to eliminate network exclusivity would apply to all issuers and to all debit and prepaid cards, including those exempt from interchange fee regulation.

Alternatives for Transaction Routing

The first proposal (Alternative A) requires issuers to enable debit card transactions to be routed over two unaffiliated networks, regardless of whether the transaction is authorized via PIN or signature. If a card can handle both PIN and signature authorization, the issuer may choose one PIN-based and one signature-based network as long as they are unaffiliated. If a card uses only one method of authorization, the issuer would have to enable two separate networks for that method. Alternative B would require issuers to enable cards with more than one unaffiliated network for each method of authorization. After the authorization method is selected, a merchant would be able to choose between at least two unaffiliated networks under Alternative B but would have only one network option under Alternative A.

Federal Legislation

Enacted Legislation

Clarifying Amendments to the Credit Union Stabilization Fund

On January 4, President Obama signed into law [amendments](#) to the [Federal Credit Union Act](#) that clarify certain accounting practices and affect the management of the National Credit Union Share Insurance Fund (NCUSIF) and the Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund). Initially proposed by Senate Banking Committee Chairman Christopher Dodd on December 16, the bill passed through both houses of Congress by unanimous consent. One provision allows the National Credit Union Administration (NCUA) to replenish the Stabilization Fund before borrowing from the Treasury, which will reduce interest expense that is covered by assessments on insured credit unions. Another provision clarifies that the NCUSIF equity ratio, measured by the amount of capital in the fund compared with the aggregate amount of insured shares in credit unions, is calculated with unconsolidated financial statements that do not include the Stabilization Fund or credit unions under conservatorship. The third measure includes the amount of NCUSIF assistance to the credit union capital, which would ease the merger of a troubled credit union with a stronger one.

Amendments to Insure Interest on Lawyers Trust Accounts

On December 29, President Obama signed into law [an amendment to the Federal Deposit Insurance Act](#) that requires the Federal Deposit Insurance Corporation (FDIC) to fully insure interest on lawyers trust accounts (IOLTAs). Interest from lawyers trust accounts is pooled to provide civil and legal aid to low-income clients. Deposit insurance for IOLTAs was due to expire after December 31, 2010, but the legislation extends coverage through 2012 by treating IOLTAs like noninterest-bearing transaction accounts under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Federal Regulation

Board of Governors of the Federal Reserve

Interim Final Rule for Real Estate Appraisers

On October 18, the Board of Governors of the Federal Reserve announced [an interim final rule](#) amending Regulation Z (Truth in Lending Act) to safeguard the real estate appraisal process when a loan is secured by a consumer's principal dwelling. The rule, which is required by the Dodd-Frank Act, replaces the [Home Valuation Code of Conduct's](#) standard for appraisal independence for loans purchased by Fannie Mae and Freddie Mac and includes some of the same measures in the Board's [2008 Home Ownership and Equity Protection Act \(HOEPA\) rules](#). The Board's interim final rule protects appraisers from coercion and prohibits them from holding a financial stake in the properties or credit transactions. It prohibits creditors from following through with a transaction tainted by coercion or conflicts of interest and requires them to report the misconduct. Entities that extend credit or provide services related to a credit transaction secured by a principal dwelling, such as creditors, appraisal management companies, appraisers, mortgage brokers, real estate agents, title insurers and other firms that provide settlement services, must comply with the interim rule by April 1, 2011.

Proposed Rule to Expand Consumer Protection Regulations on Credit and Leases

On December 13, the Federal Reserve proposed two rules ([75, Federal Register, pp. 78636-45](#) and [75, Federal Register, pp. 78632-36](#)) that would implement section 1100E of the Dodd-Frank Act, which expands the

coverage for consumer protection on credit transactions and on leases up to \$50,000. Currently, the Truth in Lending Act and the Consumer Leasing Act require creditors and lessors to provide consumers with key disclosures of contract terms and prohibit certain practices if the total obligation is below a threshold of \$25,000. The new threshold would become effective July 21, 2011, and would be adjusted annually for inflation.

Proposed Rule to Clarify Credit Card Accountability Responsibility and Disclosure Act

On October 19, the Federal Reserve announced [a proposal](#) to clarify three separate portions of the Credit Card Accountability Responsibility and Disclosure (Credit CARD) Act. The proposed rule clarified that a temporary waiver for interest charges could not be revoked unless an account becomes more than 60 days delinquent, the same protection offered with promotional programs that feature reduced interest rates. The rule also clarified that application and similar fees paid before a credit card account is opened count toward total fees charged during the first year of account ownership, which are limited to 25 percent of the total initial credit limit. In addition, the rule would require credit card issuers to consider an individual's income, instead of total household income, when determining the ability of a consumer to make payments for a new account or a credit limit increase on an existing account.

Federal Deposit Insurance Corporation

Final Rule on Insurance Coverage for Noninterest-Bearing Transaction Accounts

On November 9, the FDIC board approved a [final rule](#) that provides temporary, unlimited deposit insurance for noninterest-bearing transaction accounts through 2012. The coverage is separate from, and in addition to, the standard \$250,000 deposit insurance for other accounts at insured depository institutions. The rule implements section 343 of the Dodd-Frank Act, which defines noninterest-bearing transaction accounts as basic accounts that do not accrue interest, from which a depositor can deposit or withdraw funds at any time without giving advance notice. The definition of eligibility is similar to the FDIC's Transaction Account Guarantee Program (TAGP), which expired at the end of 2010, but excludes low-interest negotiable order of withdrawal (NOW) accounts and interest on lawyers trust accounts (IOLTAs).

Deposit Insurance Fund Restoration Plan and Designated Reserve Ratio Final Rule

On October 19, the FDIC adopted a revised Restoration Plan ([75, Federal Register, pp. 66272-92](#)) to achieve a Deposit Insurance Fund (DIF) Designated Reserve Ratio (DRR) of 1.35 percent by 2020, as required by the Dodd-Frank Act, and issued a notice of proposed rulemaking to ensure future stability of the fund. The former minimum DRR was 1.15 percent, and the FDIC distributed dividends back to insured depository institutions when it grew to more than 1.5 percent. The actual reserve ratio dipped below zero in 2010, but lower expected losses for the period 2010 through 2014 allowed the FDIC to eliminate from the plan a broad 3 basis point increase in assessment rates for January 1, 2011. The FDIC will charge banks uniform assessments until the reserve ratio reaches 1.15 percent and then shift a greater portion of the funding burden to large banks (with assets over \$10 billion) to attain the statutory minimum of 1.35 percent.

In its first action to manage the DIF, the FDIC board voted to raise the long-term minimum DRR to 2 percent ([75, Federal Register, pp. 79288-93](#)), which it believes would allow the DIF to maintain a positive balance through simulated financial crises. Other features of the plan remain in the proposal stage. The FDIC plans to reduce the assessment rate when the reserve ratio exceeds 1.15 percent. The proposal would eliminate the

dividends previously given when the reserve ratio exceeds 1.5 percent but would reduce assessment rates by 25 and 50 percent when the reserve ratio reaches 2 and 2.5 percent, respectively. The FDIC's gradually decreasing fee structure would achieve a long-term average assessment rate of 8.5 basis points, allowing for a more consistent and predictable stream of assessments. Because the proposal is designed to reduce the pro-cyclical effects of collecting from banks during an economic contraction, the FDIC believes that moderating the assessments will allow the fund to weather future banking crises without overtaxing banks.

Two Proposed Changes to Deposit Insurance Assessments

On November 9, the FDIC Board proposed two rules to amend the deposit insurance assessment regulations in concordance with its Deposit Insurance Fund Restoration Plan (as discussed above). [One proposal](#) would change the assessment base from its historical measure of adjusted domestic deposits to a measure of assets (average consolidated total assets minus average tangible equity⁹), as required by the Dodd-Frank Act. The FDIC also proposed to modify or eliminate the adjustments to the assessment rate for unsecured debt, secured liabilities, and brokered deposits incorporated in 2009. The FDIC would lower the deposit insurance assessment rate schedules to compensate for the increased assessment base and to collect the same amount of revenue despite changes in the underlying assessment components. The total assessment rates for institutions with less than \$10 billion in total assets would vary by risk category and would run from 2.5 to 45 basis points. When the reserve ratio reaches 1.15 percent, the range of total assessment rates would drop to 1.5 to 40 basis points. Pursuant to the proposed Restoration Plan, the assessment rates would also decrease when the reserve ratio reaches 2 and 2.5 percent.

In [a related notice](#), the FDIC proposes changes to the assessment of large (at least \$10 billion in total assets) or highly complex insured depository institutions, which supersede a similar notice published in April 2010 prior to the passage of the Dodd-Frank Act. The FDIC proposes using a scorecard method to calculate assessment rates for these firms instead of its traditional risk categories and debt ratings. The scorecard would combine CAMELS ratings and other measures predictive of long-term performance to more accurately control for a firm's risk to the DIF.

Both assessment proposals would become effective April 1, 2011, and affect invoices for assessments due September 30, 2011.

Final Guidance on the Overdraft Payment Program

On November 24, the FDIC [published final guidance](#) on automated overdraft programs that incorporates comments from the FDIC's [proposed guidance in August](#) and its 2008 [Study of Bank Overdraft Programs](#). The guidance focuses on mitigating harm to consumers who use the programs in excess (over six times per year), instead of the ad-hoc basis for which they were intended. State-chartered banks that are not members of the Federal Reserve System are expected to begin to monitor the use of overdraft programs, promote responsible use, avoid maximizing costs to consumers, and offer less costly alternatives for short-term credit by July 1, 2011.

⁹ The FDIC proposes to adopt the industry standard definition of tangible equity that would also provide a real capital buffer to the DIF in the event of failure: tier 1 capital.

Commodity Futures Trading Commission

Proposed Rule Regarding Investment of Customer Funds

On October 26, the CFTC proposed rules to simplify the regulation and impose requirements that better ensure the preservation of principal and maintenance of liquidity of investments of customer segregated funds ([75, Federal Register, pp. 67642-57](#)). The Commodities Exchange Act previously restricted investment of customer funds to U.S. government obligations or obligations fully guaranteed by the federal government, state government, or other political subdivision. The proposed rule would narrow the scope of investment choices in order to eliminate the potential use of instruments that may pose unnecessary risk. The CFTC would promote investment diversification by setting concentration limits based on asset class and repurchase agreement counterparties. The proposed rule would also remove the credit rating requirements in the regulation, as required by the Dodd-Frank Act.

Securities and Exchange Commission

Final Rules for Transparency of Asset-Backed Securities

On January 20, the SEC [approved regulation](#) regarding the use of representations and warranties of asset-backed securities (ABS), as required by Title IX of the Dodd-Frank Act. The integrity of representations and warranties is important because they are used to determine the characteristics and quality of the bundled loans in an ABS. Under the rule, ABS securitizers would be required to disclose fulfilled and unfulfilled repurchase requests for all transactions and maintain such repurchase history for at least five years. If a component of an ABS is found to be inconsistent with its representation, investors may request that the issuer repurchase or replace it. A history of repurchase requests would allow investors to identify issuers with unreliable underwriting. The rule would require issuers to include a three-year repurchase history for the relevant asset class in the body of a prospectus for an ABS offering.

The rule would also require nationally recognized statistical rating organizations to provide information regarding the representations, warranties, and enforcement mechanisms available with any credit rating issued in connection to an ABS offering.

On the same day, the SEC [approved a separate rule](#) to enhance disclosure to investors in the ABS market. Issuers of ABS would be required to review the assets underlying the securities and publish the nature, findings, and conclusions of the review. The final rule requires the review to provide “reasonable assurance,” at minimum, that disclosures to investors are accurate. ABS issuers could hire third parties to conduct the reviews, as long as the party accepts the designation of “expert” under SEC regulation and may be held liable for mistakes in the documentation. The disclosure should make clear whether the review was handled by the issuer or a third party.

Proposed Rules to Improve Oversight of Investment Advisers

On November 19, the SEC issued [a proposed rule](#) to amend the Investment Advisers Act, as required by Title IV of the Dodd-Frank Act. The proposed rules would require advisers to hedge funds and other private funds to register with the SEC¹⁰ and abide by the regulations that apply to investment advisers already registered with the SEC. Advisers to private funds would be required to provide the SEC with basic organizational and

¹⁰ Prior to the passage of the Dodd-Frank Act, advisers handling fewer than 15 private funds were exempt from SEC registration.

operational information about the funds they manage, as well as the identification of auditors, prime brokers, custodians, administrators, and marketers who work with the advisers. All registered advisers would be asked to provide information about the types of clients they advise, their employees, and their advisory activities, in addition to business practices leading to potential conflicts of interest.

Advisers solely to venture capital funds and advisers solely to private funds with less than \$150 million in assets — collectively referred to as exempt reporting advisers — as well as certain foreign advisers without a place of business in the U.S. would be exempt from the new registration requirement. Exempt reporting advisers would still be required to report basic identifying information, information about the adviser’s private funds and other business activities, and the adviser’s disciplinary history. In a [separate proposed rule](#), the SEC defines the term “venture capital fund” as a private fund that invests in equity securities of private operating companies to provide operating or expansion capital, U.S. Treasury securities with remaining maturity of 60 days or less, or cash. A venture capital fund is not leveraged and its portfolio companies may not borrow in connection with the fund’s investment. A venture capital fund offers to provide managerial assistance or controls its portfolio companies and does not offer redemption rights to its investors.

The Dodd-Frank Act increased the managed assets level for registration with the SEC to \$100 million and gave state regulators oversight for advisers with between \$25 and \$100 million in managed assets. The proposed rules codify this change and facilitate the transition of advisers between federal and state registration.

Multiple Sponsors

Federal Regulators Propose Revisions to Capital Standards at Large Banks

On December 15, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the FDIC issued [a proposed rule](#) to align market risk capital rules with the Basel Committee on Banking Supervision’s 2009 [revisions to Basel II](#).¹¹ In general, the rule enhances the required measures of market risk and risk modeling standards. The proposed rule would apply to banks with assets of at least \$1 billion or aggregate trading assets and trading liabilities equal to 10 percent or more of total assets. Federal regulators would have the ability to apply the rules to a bank that does not initially qualify or to exempt from the rules a bank that does initially qualify based on the level of the bank’s market risk and to “ensure safe and sound banking practices.”

The rule would require banks to have clearly defined policies for identifying and managing covered positions. The proposed rule changes the definition of a covered position to include trading assets and trading liabilities that are held by the bank for the purposes of short-term resale, taking advantage of short-term price movements, or profiting from arbitrage, as well as hedges that offset the risk of such trading positions.

Under the proposed rule, banks would be required to use internal models to assess and manage risk, including a Value-at-Risk (VaR) model for daily analysis and an incremental risk model to measure the default risk of a position. A bank would need to garner approval for its internal market risk models, as well as any significant modifications, from federal regulators before incorporating them. A bank would need to calculate a weekly stressed VaR-based measure based on its model, as well as stress test the market risk of its covered positions at

¹¹ The market risk capital proposal does not include Basel II’s requirements for debt and securitization positions, which mandate reliance on credit ratings, because it conflicts with a provision in the Dodd-Frank Act.

least quarterly, taking into consideration account concentration risks (including but not limited to concentrations in single issuers, industries, sectors, countries, and markets), liquidity risk, and other risks that may not be captured by internal models.

Regulators could require a bank to calculate capital requirements in a way that better reflects the market risk of certain covered positions or portfolios, as well as require a bank to hold more capital than otherwise required by the rule.

A separate but [related proposed rule](#) would implement part of section 171 of the Dodd-Frank Act (commonly known as the Collins Amendment), which requires federal regulators to establish a floor for minimum risk-based capital requirements equal to that of the current general risk-based capital requirements. Advanced approaches in Basel II allowed some large financial institutions to operate under reduced risk-based capital requirements.

The proposed rule would require banking organizations subject to “advanced approaches” rules to also calculate their required minimum risk-based capital under general rules on a quarterly basis. Banks must meet the 4 percent tier 1 capital requirement and the 8 percent total risk-based capital requirement under both approaches.

Other aspects of section 171 of the Dodd-Frank Act will be addressed in future rulemaking.

Federal Regulators Include Neighborhood Stabilization Program in Community Reinvestment Act Consideration

On December 15, the Federal Reserve, the OCC, the FDIC, and the Office of Thrift Supervision (OTS) published [a final rule](#) to expand the Community Reinvestment Act (CRA) to include the Department of Housing and Urban Development (HUD) Neighborhood Stabilization Program (NSP). The final rule, unchanged from the proposal in June 2010, encourages depository institutions to offer loans, investments, and services in areas with high rates of foreclosure and vacancy.

Federal Regulators Finalize Guidance on Appraisal and Evaluation

On December 2, the Federal Reserve, the OCC, the FDIC, the OTS, and the NCUA jointly issued final guidance on minimum standards for real estate appraisals and evaluations, replacing guidelines from 1994 ([75, Federal Register, pp. 77449-73](#)). Financial institutions use appraisals and evaluations to assess the value of collateral for mortgages and other loans, which factors into an institution’s lending decision. The new *Interagency Appraisal and Evaluation Guidelines* focuses on how prudent internal policies, procedures, and practices can help financial institutions ensure reliable appraisals and evaluations.

Federal Regulators Propose Changes to Consolidated Reports of Condition and Income

On October 25, the Federal Financial Institutions Examination Council (FFIEC) approved a proposal by the FDIC, the Federal Reserve, and the OCC to revise the Consolidated Reports of Condition and Income (Call Report) in order to enhance the safety and soundness of the banking system ([75, Federal Register, pp. 60497-506](#)). More detailed data on lending, securitization, and deposit sources will allow regulators to have a better understanding of banks’ exposure to credit and liquidity risk. The proposed revisions would become effective March 31, 2011.

Basel Committee on Banking Supervision

Final Basel III Package Published

On December 16, the Basel Committee on Banking Supervision (Basel Committee) published the final Basel III¹² rules text for global regulatory standards on bank [liquidity risk](#) and [capital adequacy](#), which was approved by the Group of Governors and Heads of Supervision and G20 leaders. The text includes more detailed explanations of the key elements largely developed in the first half of 2010, including new liquidity ratios and amendments to existing counterparty credit risk requirements. The Basel Committee clarified the definition of high-quality assets used in the numerator of the liquidity coverage ratio (LCR) as assets that have low credit and market risk, ease and certainty of valuation, low correlation with risky assets, and are listed on a developed and recognized exchange market; high-quality liquid assets remain intact through periods of idiosyncratic and market stress. A bank's LCR (stock of high-quality liquid assets divided by total net cash outflows over 30 calendar days) must meet or exceed 100 percent. The LCR will become official in 2015 after a transitional observation period that started on January 1, 2011. The Basel Committee also issued a revised metric to better address counterparty credit risk, credit valuation adjustments, and wrong-way risk that will become effective on January 1, 2013.

The Basel Committee also released a revised [quantitative impact study](#) that outlines the effects of the new capital and liquidity requirements.

On January 13, the Basel Committee issued [an annex to the final Basel III text](#) approved in December regarding the loss absorbency of a bank's own capital before a publicly funded bailout occurs. The rule requires banks to have a provision to write off or convert tier 1 and tier 2 capital into common equity if the bank would otherwise become nonviable or accept an injection of public funds. The new criteria apply to capital instruments issued on or after January 1, 2013.

Judicial Decisions

Settlements

Bank of America Settles Bid-Rigging Charge

On December 7, the Bank of America Corporation agreed to global resolution of actions coordinated by the United States Department of Justice (DOJ), which included \$137 million in restitution and formal agreements with the [SEC](#), the [OCC](#), the Internal Revenue Service, and 20 state attorneys general.¹³ Bank of America also made a written agreement with the [Federal Reserve Bank of Richmond](#) in a related matter.

Bank of America was caught in part of a widespread and ongoing investigation in the municipal reinvestment industry. Generally, a competitive bidding process allows municipalities to temporarily reinvest proceeds from bond sales at fair market value prior to their intended use. In this case, certain bidding agents manipulated the bidding process by giving Banc of America Securities LLC¹⁴ (BAS), an investment bank subsidiary of the public corporation, information on competing bids and deliberately obtained bids that would

¹² For more information on the Basel III Accord, see [Banking Legislation and Policy, Volume 29, Number 3](#).

¹³ The 20 states involved in the settlement were Alabama, California, Connecticut, Florida, Illinois, Kansas, Maryland, Massachusetts, Michigan, Missouri, Montana, Nevada, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, South Carolina, and Texas.

¹⁴ BAS is now known as Merrill Lynch, Pierce, Fenner & Smith Incorporated following a merger.

lose to bids by BAS. BAS rewarded the bidding agents by providing them with business, nonwinning bids by request, undisclosed gratuitous payments, and kickbacks. As a result, BAS bids won 88 affected reinvestment instruments between 1998 and 2002, such as guaranteed investment contracts, repurchase agreements, and forward purchase agreements. The misconduct affected bond issuers and purchasers who relied on the assumption that the bids were competitive.

Bank of America earned the DOJ's highest cooperation status by being the first entity to self-report its involvement in the bid-rigging practices before the start of the investigation, which remains active and ongoing. After charging Bank of America with securities fraud, the SEC issued a censure, demanded that the bank pay \$36 million in restitution to the affected entities, and issued an order to cease and desist from committing or causing violations of Section 15(c)(1)(A) of the Exchange Act. The SEC did not charge a civil penalty, citing Bank of America's cooperation. The OCC also required Bank of America to compensate affected counterparties, as well as to assess and reform its policies, procedures, and controls related to the sale of certain derivative financial products.