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The Securities and Exchange Commission Approves Final Rules for Implementing the Whistleblower Bounty Program Under the Dodd-Frank Act

By Jyotin Hamid, Mary Beth Hogan and Kristin A. Lieske

Introduction

The Securities and Exchange Commission has now approved its final rules for implementing the whistleblower incentive program created by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Dodd-Frank Act was signed into law on July 21, 2010, in the wake of the 2008-2009 financial crisis. One of the most significant – and controversial – features of the law, as it relates to securities regulation, was the creation of a potentially far-reaching whistleblower bounty program. Under Dodd-Frank, an eligible whistleblower is entitled to a bounty of between 10% and 30% of the monetary sanctions collected by the SEC if the whistleblower voluntarily provides original information that leads to a successful enforcement action in which the SEC obtains more than $1 million in sanctions. Dodd-Frank also includes expansive anti-retaliation protections for whistleblowers.

The SEC published its proposed regulations for implementing the whistleblower provisions of Dodd-Frank on November 3, 2010. The proposed regulations generated enormous attention from corporate America and the legal community. During the public comment period, over 1,500 statements were submitted to the SEC regarding the proposed regulations. Many of the comments pertained to the anticipated effect of the regulations on corporate compliance programs. Other comments addressed the regulations governing the anti-retaliation protections and the exclusion of certain categories of whistleblowers from eligibility for monetary awards.

On May 25, 2011, a divided SEC voted 3-2 to adopt the final whistleblower regulations, with the two Republican commissioners objecting. Although the final rules differ from those proposed in several important ways, fundamental features of the proposed regulations have been retained. This article summarizes provisions of the new rules that pertain to the whistleblower bounty program, anti-retaliation protections and corporate compliance programs.

Whistleblower Bounty Provisions

To qualify for a whistleblower bounty, an individual must (i) voluntarily provide the SEC (ii) with original information (iii) that leads to the successful enforcement by the SEC of a federal court or administrative action (iv) in which the SEC obtains monetary sanctions totaling more than $1,000,000. The final rules elaborate on each of these four requirements, list factors for the SEC to weigh in determining the amount of any bounty and carve-out from eligibility certain categories of whistleblowers and information.

"Voluntarily" Provided Information. A whistleblower will be found to have provided information "voluntarily" under the rules if the information is provided before the whistleblower receives any request, inquiry or demand relating to the same subject matter by the SEC or other federal or state regulatory authorities. Information may be deemed "voluntarily" provided even if the whistleblower provides the information only after being contacted as part of a company's internal investigation.

Continued on page 17

WHAT'S INSIDE

UPCOMING EVENT

Dodd-Frank Act "Living Wills" Seminar

Co-hosted by Debevoise & Plimpton LLP and The Risk Management Association

The Federal Reserve and the FDIC are expected to soon complete regulations that will require Resolution Plans (a/k/a "Living Wills"). Once implemented, Living Wills will likely require large U.S. banks, foreign banks with a U.S. presence and systematically significant non-bank financial institutions to complete a detailed operational, structural and strategic analysis. Debevoise and The Risk Management Association (RMA) will co-host a conference in New York on this important topic shortly after the rules are finalized. We plan to distribute a formal invitation after the timing of regulatory approval of the final rules is established.

For details please email debevoiseevents@debevoise.com.

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Debevoise & Plimpton LLP
919 Third Avenue
New York, New York 10022
+1 212 909 6000

www.debevoise.com

Washington, D.C.
+1 202 383 8000

London
+44 20 7786 9000

Paris
+33 1 40 73 12 12

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+49 69 2097 5000

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Bank Preemption after Dodd-Frank: The OCC Speaks

By David A. Luigs and Pratin Vallabhaneni

The Dodd-Frank Wall Street Reform and Consumer Protection Act includes several new statutory provisions regarding the preemption of state laws for national banks and federal thrifts. These provisions have been the subject of a fierce debate between those who believe they dramatically alter the basic preemption standard and overturn the existing rules on preemption versus those who view the new provisions as principally a codification in statute of an existing body of precedent that was based primarily on caselaw and regulation. Both sides have looked to the Office of the Comptroller of the Currency ("OCC") for its authoritative interpretation of the new Dodd-Frank provisions.

Roughly two months before the new Dodd-Frank provisions are to become effective, the OCC spoke. The acting Comptroller of the Currency issued a detailed letter providing his views on these issues in response to a request from members of Congress, followed by a formal notice of proposed rulemaking to implement those interpretations. In brief, the Comptroller's letter and the proposed new OCC regulations come down firmly in support of the view that Dodd-Frank codified the existing substantive standard for preemption and that the OCC's existing specific regulations on the types of state laws that are preempted survive and continue in force.

Background

Subtitle D of Title X of Dodd-Frank contains five provisions focused on bank and thrift preemption, Sections 1043 - 1047. Four of these provisions relate to relatively specific matters such as visitorial powers, operating subsidiaries, and harmonization of the preemption standards for national banks and federal thrifts. These provisions are relatively straightforward and have been subject to less controversy. Section 1044 of Dodd-Frank, however, provides for a detailed description of the general banking preemption standard, as well as new requirements for how the OCC must act when it makes a determination that a state law is preempted. Dodd-Frank also provides an effective date for these new provisions as the transfer date, when the OCC will assume the responsibilities of Office of Thrift Supervision (the "OTS") for regulating and supervising thrifts, July 21, 2011. The new preemption provisions, and especially Section 1044, raise several questions, not least among them whether they change the general preemption standard and whether they effectively repeal the existing preemption regulations of the OCC and the OTS.

Prior to Dodd-Frank's passage, both the OCC and the OTS promulgated detailed preemption regulations. The OCC's most notable preemption regulations were released in 2004 (the "2004 Regulations").[1] The 2004 Regulations provided, among other things, that national banks are generally not subject to state laws that "obstruct, impair or condition" a bank's exercise of its federally authorized powers, including laundry lists of the types of state laws that are preempted. *See* 12 C.F.R. 7.4007, 7.4008, 34.4. The OTS took an even broader position than the OCC with its preemption regulations, which, *e.g.*, asserted a broad field preemption for "the entire field of lending regulation" for federal thrifts.

On May 12, 2011, the acting Comptroller issued an Interpretive Letter (the "Letter"),[2] detailing the OCC's views, in response to a set of questions from Senators Mark Warner and Tom Carper, the latter of whom was a principal sponsor of language that became imbedded in the final version of Dodd-Frank's preemption provisions. On May 25, 2011, the OCC followed up with its notice of proposed rulemaking[3] (the "NPR") proposing to implement Dodd-Frank and the points articulated in the Letter (as well as a variety of other matters relating to the transfer of OTS authorities to the OCC under Dodd-Frank). The Letter and the NPR explain the OCC's views and set forth the changes the OCC would make to its preemption regulations to effectuate Dodd-Frank's preemption provisions. Comments on the NPR are due by June 27, 2011.

The OCC's Interpretation of Dodd-Frank

The Letter and the NPR clarify the OCC's position on preemption

Bank Preemption after Dodd-Frank

Continued from previous page

under Dodd-Frank in the areas of operating subsidiaries, visitorial powers, the general preemption standard and related new procedural requirements, and the harmonization of national bank and federal thrift preemption standards.

Operating Subsidiary Preemption Rule to Be Repealed

Both the OCC and the OTS, under their existing regulations, extended the benefits of federal preemption to their respective national bank and thrift operating subsidiaries. In 2007, the Supreme Court validated this position for national banks in *Watters v. Wachovia Bank*.[4] Dodd-Frank, however, eliminates federal preemption for such operating subsidiaries, as well as for other affiliates and agents. Thus, the OCC's NPR proposes to eliminate the OCC's operating subsidiary preemption regulation. The NPR also indicates that the OCC will repeal affected OTS preemption regulations.

Visitorial Powers Regulation to Be Amended

Subject to limited exceptions, the OCC's visitorial powers regulation currently provides that only the OCC and its authorized representatives may exercise visitorial powers with respect to national banks. Previously, the OCC had interpreted the visitorial powers prohibition broadly to include that a state official may not exercise visitorial powers over a national bank through a judicial mechanism. In *Cuomo v. The Clearing House Association*,[5] although the Supreme Court generally upheld the exclusive administrative oversight of the OCC over national banks, it also held that the prohibition on visitorial powers did not extend to a lawsuit in court by a state attorney general enforcing nonpreempted state laws against national banks.

> The OCC's much awaited interpretation of the preemption provisions of Dodd-Frank provide important clarity around how the agency charged with implementing these provisions will interpret and apply them. Now the stage turns to the courts, where numerous challenges to preemption and the OCC's interpretations can be expected.

The OCC, in the Letter and NPR, acknowledges that Dodd-Frank codifies the *Cuomo* holding. Specifically, the NPR proposes to revise the OCC's visitorial powers regulation to provide that an action by a state attorney general (or other chief law enforcement officer) in a court of appropriate jurisdiction to enforce a non-preempted state law against a national bank and seek relief is not an exercise of visitorial powers. The Letter and NPR also explain that nonjudicial investigations generally do constitute an exercise of visitorial powers.

Dodd-Frank's "Clarified" Preemption Standard for State Consumer Financial Laws

The heart of the Act's preemption provisions are in Section 1044, which, as its title indicates, is intended to "clarif[y]" the circumstances generally under which state laws are preempted. Section 1044 relates only to "state consumer financial laws," which Dodd-Frank defines in principal part as a law that "directly and specifically regulates the manner, content, or terms and conditions of any financial transaction or any related account with respect to a consumer." The Comptroller's Letter and NPR do not discuss with specificity what types of state laws might fall outside this definition; but footnote 15 of the Letter explains that some categories of state laws, which the Letter does not identify, that are covered as preempted in the current OCC regulations "would not be defined as 'state consumer financial laws.'" The OCC's NPR proposes to retain the 2004 Regulations' current existing categories of preempted state laws, including these laws that the Letter explains do not meet the definition of "state consumer financial laws." By continuing to take the position that these laws are preempted, even though they do not meet that definition, the Letter appears to make clear that state laws falling outside the definition of "state consumer financial laws" do not thereby fall outside the scope of preemption, as some preemption opponents have advocated, but remain preempted under pre-Dodd-Frank principles.

Bank Preemption after Dodd-Frank

Continued from previous page

A state consumer financial law will be preempted under Section 1044 if:
• the law would have a discriminatory effect on a federal bank;
• the law prevents or significantly interferes with the exercise by a federal bank of its powers under the legal standard for preemption in *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner,* 517 U.S. 25 (1994), as determined by the Comptroller of the Currency on a case-by-case basis or by a court; or
• the law is preempted by another federal law.

The first and third such standards appear relatively straightforward, but significant questions have been asked about the second standard.

The Barnett Standard – Same as it Ever Was

First, the Letter and NPR clarify the OCC's interpretation that the basic preemption standard in Dodd-Frank is essentially a codification of the pre-Dodd-Frank "conflict" preemption standard and is the same standard on which the OCC based its current preemption regulations. Specifically, the OCC also explains that rather than focusing solely on whether a federal law "prevents or significantly interferes" with a bank's exercise of a power, Dodd-Frank's *Barnett* conflict preemption standard incorporates those words from *Barnett* as the "touchstone or starting point in the analysis," but that Dodd-Frank's standard also incorporates the full breadth of the *Barnett* decision. As such, the Letter and NPR explain that "precedents that are consistent with the principles of the *Barnett* conflict preemption analysis are preserved." Notably, the Letter and NPR list examples of such precedents that survive Dodd-Frank to include judicial decisions, interpretations, and the OCC's rules, where preemption was premised on *Barnett*-based principles of conflict preemption.

The Letter and NPR also cite the Eleventh Circuit's recent *Baptista v. JPMorgan Chase*[6] case as an example of a decision based on Dodd-Frank's use of the "whole" *Barnett* preemption standard and to illustrate that there are other valid "formulations of conflict preemption used in the Barnett decision," in addition to solely the words "prevent or significantly interfere." In *Baptista*, which was decided on May 11, 2011, the Eleventh Circuit interpreted Dodd-Frank's preemption provisions as asking if there is "significant conflict" between state and federal laws, which, as the court explained, is "the test for conflict preemption."[7] In doing so, the Eleventh Circuit quoted language from *Barnett* ("forbid or impair significantly") other than the phrase from *Barnett* used in Dodd-Frank ("prevents or significantly interferes"), thus supporting the OCC's interpretation that Dodd-Frank incorporates the whole *Barnett* standard, rather than just four particular words.

The Letter, as confirmed by the NPR, explains that, to avoid confusion, however, the OCC proposes to remove references in OCC regulations to preemption of laws that "obstruct, impair or condition" the exercise of a national bank's powers. Nonetheless it seems clear that going forward the OCC intends to apply the same general preemption standards, albeit under new procedures, discussed below, and with a slightly amended set of regulations. Furthermore, as explained in the NPR, the OCC views any precedent that cited the "obstruct, impair or condition" language in the OCC's 2004 Regulation as valid precedent.

Existing OCC Regulations and Interpretations on Preempted State Laws Survive

Perhaps most importantly, the Letter and the NPR are clear that the OCC views that its regulations identifying specific types of preempted state laws will survive and continue in force after Dodd-Frank. Those regulations, at 12 C.F.R. 7.4007, 7.4008, and 34.4, list types of state law limitations that would purport to regulate a national bank's deposit-taking, real estate lending and other lending powers, and are summarized at a high level in the chart below.

The OCC draws support for its reading of Dodd-Frank from the legislative process and history. The OCC explains that earlier versions of Dodd-Frank would have created new preemption standards and thus would have had a retroactive impact, invalidating prior preemption cases and existing OCC regulations; but this approach was rejected in the final Dodd-Frank, which included the direct reference to *Barnett* in order to ensure consistency and legal certainty. The Comptroller's Letter responds to Senator Carper, a principal author of the final

Bank Preemption after Dodd-Frank

Continued from previous page

Dodd-Frank's preemption provisions, and references Senator Carper's description of his purpose for including the *Barnett* reference to accomplish this objective of consistency with pre-Dodd-Frank principles and legal certainty. Thus, the NPR does not propose to change the OCC regulations' lists of preempted state laws.

New Procedures Apply to New OCC Determinations

Section 1044 of Dodd-Frank also provides that OCC preemption determinations may be made under Dodd-Frank's preemption standard "on a case-by-case basis," defined as a determination regarding the impact of a "particular" state consumer financial law or, after consultation with the Consumer Financial Protection Bureau, the law of another state "with substantively equivalent terms." Such a determination must also be supported by "substantial evidence made on the record of the proceeding."

The Letter explains that these new procedures apply to "future

Deposit Taking	Real Estate Lending	Non-Real Estate Lending
• abandoned and dormant accounts • checking accounts • disclosure requirements • funds availability • savings account orders of withdrawal • state licensing or registration requirements • special purpose savings services	• licensing, registration, filing, or reports by creditors • the ability of a creditor to require or obtain insurance for collateral or other credit enhancements or risk mitigants, in furtherance of safe and sound banking practices • loan-to-value ratios • the terms of credit • escrow accounts, impound accounts, and similar accounts • security property • access to, and use of, credit reports • disclosure and advertising • disbursements and repayments • rates of interest on loans	• licensing, registration, filing, or reports by creditors • the ability of a creditor to require or obtain private mortgage insurance, insurance for collateral or other credit enhancements or risk mitigants, in furtherance of safe and sound banking practices • loan-to-value ratios • the terms of credit • the aggregate amount of funds that may be loaned upon the security of real estate • escrow accounts, impound accounts, and similar accounts • security property • access to, and use of, credit reports • disclosure and advertising • processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages • disbursements and repayments • rates of interest on loans • due-on-sale clauses • covenants and restrictions in a lease to qualify the leasehold as acceptable security for a real estate loan

Bank Preemption after Dodd-Frank

Continued from previous page

preemption determinations" but that there is no statement in Dodd-Frank that "Congress intended to retroactively apply these procedural requirements to overturn existing precedent and regulations," as the Letter suggests would be required to overcome the presumption against retroactive legislation from the Supreme Court's *Landgraf* case.[8] The Letter also notes Senator Carper's statement that these new procedural provisions were not intended to repeal the OCC's 2004 Regulations. Thus, the Letter and the NPR clarify that the OCC interprets Dodd-Frank's new procedural provisions as applicable only to new determinations the OCC makes in the future with respect to other types of state laws that have not previously been determined to be preempted.

Dodd-Frank also sets forth a standard of judicial review for OCC preemption determinations that depends upon "the thoroughness evident in the consideration of the agency, the validity of the reasoning of the agency, the consistency with other valid determinations made by the agency, and other factors which the court finds persuasive and relevant to its decision." The Letter explains that this standard clarifies the criteria for judicial review of the OCC's new preemption determinations under the new case-by-case standards. The Letter and NPR also acknowledge Dodd-Frank's additional provisions requiring the OCC to publish and update quarterly a list of preemption determinations then in effect that identifies the activities and practices covered and the state law requirements and constraints determined to be preempted. The Letter and NPR further acknowledge that the OCC is required every five years to conduct a review, through notice and public comment, of each of its preemption determinations, and to submit a report of each review to the Congress.

The Impact on Federal Thrifts

The Comptroller's Letter focused principally on national banks. The NPR provides further clarity on how the OCC intends to implement the provisions of Dodd-Frank making the preemption standards for federal thrifts the same as those for national banks. The NPR explains that the OCC intends to repeal existing, affected OTS preemption regulations and proposes new regulations to provide that "state laws," as well as the visitorial powers provisions of the National Bank Act, both apply to federal thrifts "to the same extent and in the same manner" that they apply to national banks and their subsidiaries. Thus, the OCC interprets Dodd-Frank to provide that the same types of state laws, summarized in the chart on page 6, that the OCC's regulations currently provide are preempted as to national banks will also continue to be preempted for federal thrifts.

* * * * *

The OCC's much awaited interpretation of the preemption provisions of Dodd-Frank provide important clarity around how the agency charged with implementing these provisions will interpret and apply them. Now the stage turns to the courts, where numerous challenges to preemption and the OCC's interpretations can be expected, including questions such as: (i) whether the general preemption standard must be thought of only in terms of the words "prevent or significantly interfere" or is better understood as based on the entire teaching of the *Barnett* opinion, including the precedents upon which that opinion relies, and whether any such difference changes the outcome with respect to any specific state law requirement; (ii) whether individual state laws previously identified by the OCC regulations remain preempted under Dodd-Frank's *Barnett* standard; and (iii) whether Dodd-Frank has a retroactive impact on the preemption determinations in existing regulations in the absence of new individualized determinations. The battle lines may change, but the preemption wars continue. ■

David A. Luigs is counsel and Pratin Vallabhaneni[9] *is an associate in Debevoise & Plimpton LLP's Washington, D.C. office.*

daluigs@debevoise.com
pvallahaneni@debevoise.com

1. 69 Fed. Reg. 1904 (Jan. 13, 2004).
2. O.C.C. Interp. Ltr. 1132 (May 12, 2011).
3. Office of the Comptroller of the Currency, "Office of Thrift Supervision Integration; Dodd-Frank Act Implementation," available at http://www.occ.treas.gov/news-issuances/news-releases/2011/nr-occ-2011-62.html (to be published in the Federal Register on May 26, 2011).
4. 50 U.S. 1 (2007).
5. 129 S. Ct. 2710 (2009).
6. No. 6:10-cv-00139, slip op. (11th Cir. 2011)
7. Id. at 5.
8. 511 U.S. 244, 272-273 (1994).
9. Admitted in California only.

IRS Issues Second Notice on FATCA

By Daniel Backenroth, Burt Rosen and Robert J. Staffaroni

On April 8, 2011, the Internal Revenue Service ("IRS") issued a second notice (Notice 2011-34) providing guidance on the Foreign Account Tax Compliance Act ("FATCA").

Background

FATCA was enacted on March 18, 2010 as part of the Hiring Incentives to Restore Employment Act of 2010.

Beginning in 2013, payments to foreign financial institutions ("FFIs") and foreign entities that are not FFIs ("NFFEs") of (i) dividends, interest and certain other items of income from U.S. sources and (ii) proceeds from the disposition of U.S. stocks and securities (together, "withholdable payments") generally will be subject to a new 30% withholding tax, unless the recipient complies with the applicable U.S. reporting requirements or an exception applies. Payments on, and proceeds of, an obligation (not including shares of stock) outstanding on March 18, 2012 generally are exempt (except in the event of certain subsequent modifications of the obligation).

An FFI generally includes any non-U.S. entity that:

- is a bank;
- holds, as a substantial portion of its business, financial assets for the account of others (*e.g.*, broker-dealers, trust companies and certain custodians); or
- is engaged primarily in the business of investing or trading in securities, partnership interests or commodities (*e.g.*, private equity and hedge funds).

To avoid the new withholding tax, an NFFE generally will have to (i) certify that it does not have any "substantial" U.S. owners or (ii) provide information regarding each such U.S. owner. Publicly traded corporations and certain of their affiliates and certain other foreign entities generally will be exempt from the reporting requirements for NFFEs.

For FFIs, the reporting requirements are considerably more substantial. Unless an FFI qualifies for an exemption, in order to avoid the new withholding tax it generally will be required to enter into an agreement with the IRS ("FFI Agreement") pursuant to which the FFI agrees to:

- comply with due diligence, reporting and other procedures established by the IRS with respect to "U.S. accounts" (generally, financial accounts maintained by a financial institution (as well as non-traded debt or equity interests in such financial institution) held by U.S. persons or foreign entities with a specified level of U.S ownership); and
- withhold on "passthru payments" (generally including withholdable payments and, as discussed below, any other payments attributable to withholdable payments) to its account holders that fail to comply with reasonable information requests or to FFIs which do not themselves enter into an FFI Agreement or otherwise comply with the requirements of FATCA.

Notice 2010-60

In August, 2010, the IRS issued Notice 2010-60, which provided initial guidance on certain issues arising under FATCA. Among other things:

- Notice 2010-60 describes certain entities that generally will be exempt from FATCA, including certain holding companies and treasury centers for non-financial groups, certain start-ups, insurance companies that issue solely property and casualty insurance or reinsurance or term life contracts, and retirement plans that do not allow U.S. participants.
- Notice 2010-60 provides preliminary guidance on the procedures to be followed by FFIs that enter into FFI Agreements ("participating FFIs") to identify their U.S. account holders. Importantly, Notice 2010-60 distinguishes between the procedures to be followed for financial accounts in existence at the time an FFI Agreement becomes effective (pre-existing accounts) and financial accounts other than pre-existing accounts.
- Notice 2010-60 describes the preliminary views of the IRS regarding the annual information reporting requirements applicable to a participating FFI with respect to its U.S. accounts.

Notice 2011-34

Notice 2011-34 provides additional guidance. Among other things:

- Notice 2011-34 describes certain classes of FFIs that will be deemed compliant with FATCA without having to enter into an FFI Agreement ("deemed compliant FFIs"; *e.g.*, certain local banks which do not solicit account holders outside their countries of organization).
- Notice 2011-34 revises certain of the procedures set forth in Notice 2010-60 to be followed by participating FFIs to identify U.S. account holders of pre-existing individual accounts, including singling out for a heightened level of scrutiny "private banking accounts" and accounts with a balance or $500,000 or more.

IRS Issues Second Notice on FATCA

Continued from previous page

• Notice 2011-34 modifies and relaxes certain of the information reporting requirements described in Notice 2010-60 with respect to U.S. accounts.

Of particular interest in Notice 2011-34 are the IRS's views on the withholding responsibilities of participating FFIs. As mentioned above, FATCA requires a participating FFI to deduct 30% of any "passthru payment" it makes (i) to any account holder that refuses to provide the information the FFI is required to collect pursuant to its FFI Agreement (a "recalcitrant account holder") or (ii) to any other FFI that is neither a participating FFI nor a deemed compliant FFI (a "non-participating FFI"). A "passthru payment" is any withholdable payment or any other payment, to the extent attributable to a withholdable payment.

The IRS rejected the suggestion of some commentators that only payments directly traceable to withholdable payments (*i.e.*, U.S.-related payments) should be passthru payments, and instead proposed a proportionate approach (generally based on the portion of an FFI's assets that are U.S. assets). One result of this proportionate approach is that a non-participating FFI that does not have U.S.-related investments may still be subject to U.S. withholding tax if it maintains financial accounts with a participating FFI. This will make it even more difficult for an FFI to simply choose not to participate in FATCA and will encourage nonparticipating FFIs to deal with other nonparticipating FFIs, rather than with participating FFIs. In addition, a participating FFI may have a withholding obligation on its financial accounts that have no relationship to the U.S. (other than that its account holder did not comply with certain information requests required to be made under FATCA). This broad approach to passthru payments significantly expands the scope and complexity of the already broad and complex FATCA rules.

Notice 2011-34 sets out different proposed rules for payments an FFI makes in its capacity as an agent (*e.g.*, as a broker) and for payments an FFI makes for its own account (*e.g.*, to holders of its equity and debt interests).

Payments by a Participating FFI for its Own Account

When a participating FFI makes a payment for its own account, under Notice 2011-34 it would be required to determine what percentage of such payment is a passthru payment by determining the ratio of the gross value of such participating FFI's U.S. assets to the gross value of its total assets (its "passthru payment percentage"). For this purpose, certain rules, summarized in the table below, apply.

Payments by a Participating FFI as an Agent

When a participating FFI makes a payment as an agent, under Notice 2011-34 it would be required to withhold on any portion of such payment that is a withholdable payment unless the withholding obligation with respect to such payment has been satisfied by another withholding agent. In addition, the FFI would be required to treat any portion of such payment that is made with respect to a debt or equity interest in another FFI as a passthru payment subject to 30% withholding to the extent of the passthru payment percentage of such other FFI.

Two examples may help to illustrate the operation of the rules on passthru payments set out in Notice 2011-34:

Example 1: Foreign Bank 1, which is a participating FFI, makes a $100 principal payment after 2012 to Foreign Fund, which is a non-participating FFI, on a loan entered into after March 18, 2012. Foreign Bank 1 has $1,000 of total assets:

Type of interest held by FFI	Treatment as U.S. or non-U.S. asset
Debt or equity interest in U.S. corporation	U.S. asset
Debt or equity interest in NFFE	Non-U.S. asset
Debt or equity interest in another participating or deemed compliant FFI	Treated as a U.S. asset to the extent of the other FFI's passthru payment percentage. If not published, such percentage is presumed to be 100%
Debt or equity interest in non-participating FFI	Non-U.S. asset

IRS Issues Second Notice on FATCA

Continued from previous page

$700 of loans extended to non-U.S. borrowers that are not FFIs; $200 of loans extended to U.S. borrowers after March 18, 2012; and a $100 equity interest in Foreign Bank 2, which has a passthru payment percentage of 50%. Foreign Bank 1's passthru payment percentage is therefore [$200 (loans extended to U.S. borrowers) plus 50% * $100 (portion of investment in Foreign Bank 2 that is treated as a U.S. asset)] divided by $1,000 = 25%. Foreign Bank 1 must therefore withhold [$100 * 25%] * 30%, or $7.50, from its $100 principal payment to Foreign Fund.

Example 2: Client holds an account with Foreign Bank, which is a participating FFI. Client has not provided information requested by Foreign Bank pursuant to Foreign Bank's FFI Agreement, and Foreign Bank is required to treat Client as a recalcitrant account holder. At some time after 2012 Foreign Bank makes the following payments to Client: $50 with respect to Client's interest in Foreign Fund 1, a non-participating FFI; $100 with respect to Client's interest in Foreign Fund 2, a participating FFI; and $500 with respect to a deposit account (not grandfathered) held at a non-U.S. branch of Foreign Bank. Foreign Fund 2 has not published its passthru payment percentage. Foreign Bank need not withhold any amount from the $50 payment with respect to Client's interest in Foreign Fund 1, since Foreign Fund 1 is a non-participating FFI and its passthru payment percentage is presumed to be 0%. Because Foreign Fund 2 has not published its passthru payment percentage, Foreign Bank must presume such percentage to be 100%, and must therefore withhold 30% from the $100 payment to Client with respect to Client's interest in Foreign Fund 2. Foreign Bank must determine its own passthru payment percentage and withhold the appropriate amount from the $500 payment with respect to Client's deposit account at Foreign Bank's non-U.S. branch. For example, if Foreign Bank's passthru payment percentage is 10%, it must withhold [$500 * 10%] * 30%, or $15, from its $500 payment with respect to Client's deposit account. ■

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The foregoing was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. Federal tax law.

Daniel Backenroth is an associate and Burt Rosen and Robert J. Staffaroni are partners in Debevoise & Plimpton LLP's New York office.

dbackenroth@debevoise.com
brosen@debevoise.com
rjstaffaroni@debevoise.com

A Look Back Upon Nearly Two Years of FDIC-Assisted Private Equity Deals: The Top 10 Lessons Learned

By Paul L. Lee, Satish M. Kini, Gregory J. Lyons, David A. Luigs and Pratin Vallabhaneni

On September 2, 2009, in reaction to investments firms' ("PE Firms") growing appetite in failed banks, the Federal Deposit Insurance Corporation (the "FDIC") released its Final Statement of Policy on Qualifications for Failed Bank Acquisitions. Referred to by FDIC staff as the private equity statement of policy, or "PE SOP," it sets forth an unprecedented framework for PE Firm vetting, compliance and supervision.

After facing various stumbling blocks in applying PE SOP, the FDIC clarified the PE SOP in the form of two sets of Q&As, the first released in January 2010 and the second released April, 2010. However, these clarifications have been augmented by unpublished internal policy guidelines, leading to increased opacity for PE Firms seeking to obtain approval from the FDIC to bid on FDIC-assisted failed bank transactions (each a "Bank Deal").

Reviewing the Bank Deals of the past few years can help illuminate how PE Firms and their advisors can approach the FDIC and its sister federal and state regulators with Bank Deals more efficiently, effectively, and in a way that will establish a positive supervisory relationship between the banking regulators and the PE Firms. The following sections highlight 10 of the most crucial lessons learned over the past few years for the

FDIC-Assisted PE Deals - Lessons Learned

Continued from previous page

benefit of PE Firms seeking Bank Deal approval.

LESSON 1: THE FDIC PREFERS DEALS IN WHICH PE FIRMS ARE NOT THE BANK DEAL'S DRIVER

Examining the Bank Deals presented to the FDIC over the last few years illustrates that each Bank Deal has a unique genesis and story. Some Bank Deals stem from a bank management team's desire to firm up its bank's capital base and grow through FDIC-assisted acquisitions. Other Bank Deals stem from a bank, on the brink of failure and under enforcement orders requiring a capital raise, hiring an investment bank to tap into the investment bank's network of private equity clients. Yet other Bank Deals are assembled by organizers and their attorneys seeking to establish a *de novo* banking operation using a failed bank's asset base and deposit franchise as an initial platform. Each of these Bank Deals present the FDIC with different review obstacles, but a central lesson to be drawn from them is that the FDIC prefers deals in which PE Firms are not the Bank Deal's driver.

Various commenters on the FDIC's review and approval process for PE Firms have provided guidance on how a PE Firm should approach the FDIC and describe itself, its experience in the banking industry, and so forth. Such meetings certainly can be worthwhile on a more general basis, so that the regulators can become more knowledgeable about and comfortable with the PE Firms investing in deals. However, when a particular Bank Deal is being presented to the agency, the FDIC, as a conservative bank regulator, strongly favors Bank Deals that are rooted in traditional banking principles and that are organized, directed, and presented by seasoned commercial banking professionals. Thus, the FDIC is likely to more quickly approve a Bank Deal when the presentations and submissions for the Bank Deal convey to the FDIC that a strong commercial bank management team is in command.

LESSON 2: THE FDIC PREFERS BANK DEAL BUSINESS PLANS THAT EMPHASIZE A TRADITIONAL BANKING PLATFORM

A central part of the FDIC's review of a Bank Deal is analysis of the Bank Deal's business plan. While PE Firms, organizers, and their advisors have a wealth of experience in writing business plans to raise funds, attract participants, and for other commercial means, the PE SOP framework presents idiosyncratic issues. As a result, many experienced financial professionals have been surprised by the resistance that the FDIC has shown toward the business plans submitted for Bank Deals. The following points help illuminate the FDIC's Bank Deal business plan review process.

• *Traditional Banking Platform.* Backed by its empirical research on bank failures and unsafe and unsound practices and driven by policy pressures, the FDIC strongly favors traditional banking platforms, based on conservative growth, strong local deposit and customer ties, low concentration levels, and high amounts of core capital. Often such features are not conducive, on their face, to high rates of return. Tools that could generate significant returns, such as extra-territorial deposit redeployment, heavy reliance on brokered deposits, and high cost non-core deposit funding, are red flags for the FDIC, particularly for de novo institutions applying for shelf charters. While such tools need not necessarily be completely avoided, we suggest they be balanced by a strong, traditional business plan.

• *D.C. and the Regions*. The FDIC and its sister federal banking regulators operate utilizing a tapestry of delegated authorities, whereby novel policy issues are generally handled by the agency's Washington, D.C. headquarters and day-to-day supervisory issues are delegated to the agency's regional offices. This delegated authority structure creates a high potential for confusion as to where PE Firms should take their Bank Deal inquiries. Furthermore, the delegated authority structure oftentimes creates conflicting perspectives, whereby the FDIC's regional office provides guidance on what is an acceptable business platform that the FDIC's headquarters later modifies. Because the regional offices and headquarters of the banking regulators concern themselves with different perspectives and have different levels of local insight, their guidance is not always the same. As a result, we would suggest facilitating coordination between the relevant regional office and Washington, D.C. by approaching both the FDIC's relevant regional

FDIC-Assisted PE Deals - Lessons Learned

Continued from previous page

office and headquarters at an early stage in the process.

• *Specificity v. Opportunism.* When a Bank Deal is approved, its sponsors have the ability to bid on FDIC-assisted failed banks. Given the nature of the bidding process, acquirors do not know the exact nature of the assets and deposits they may acquire, when they may acquire them, where they will be located, and a host of other items. However, despite this uncertainty, the FDIC responds best to submission of well-defined, pre-formulated growth plans that, while of course considering contingencies, should nevertheless define measurable targets and goals. Such plans are not only easier for the FDIC to understand, approve, and supervise, but they comport with the FDIC's perspective on safe and sound practices. Acquirors that have provided the FDIC concrete business plans based on well-defined assumptions that detail financial projections, acquisitions (number, size, geographies), management teams, and so forth, rather than purely opportunistic assumptions, have found the most success with the FDIC.

LESSON 3: THE FDIC IS CONCERNED WITH THE MANAGEMENT AND EXECUTION OF ACQUISITIONS, GROWTH, AND THE AGGREGATOR MODEL During the initial wave of bank failures following the publication of the PE SOP, PE Firms were routinely presented with the opportunity to acquire assets bases and deposit franchises of just one or two banks that would total well over $1 billion. However, as time has progressed, the size of failed banks with desirable assets bases and deposit franchises has generally decreased. These events have precipitated the rise of the aggregator model, in which PE Firms seek to build a franchise of at least four or five banks. However, this model was not necessarily contemplated during the genesis of the PE SOP and the FDIC has reviewed business plans and acquisition proposals based on the aggregator model critically. Below are factors that the most successful PE Firms have worked through when presenting the FDIC with a Bank Deal and, in particular, an aggregator-based Bank Deal.

• *Detailed Growth Plan.* Growth plans submitted to the FDIC for review should specify in detail an ultimate growth goal. When the FDIC approves a Bank Deal, the FDIC generally will establish an initial asset bid limit on the PE Firm's bank. Even when PE Firm-backed management teams successfully acquire and manage their acquisitions, the FDIC generally disfavors the so-called "pay as you go" strategy and will generally not want to raise the initial bid limit or permit follow on capital raises to fund a PE Firm's bank's acquisitions. It thus benefits PE Firms to work with their banks or organizers to submit detailed growth plans inclusive of all rounds of contemplated capital and potential acquisitions, and to obtain approval for this maximum bid limit early on in the deal planning and review processes.

• Contingent Staffing. A common problem that PE Firms have faced in staffing the board and management of their banks has been finding appropriate personnel in the specific locations where the PE Firms seek to establish franchises. Given the reality that acquisitions may occur in different geographies, a natural tension arises between casting the widest net possible for bids and creating an executive team that satisfies the FDIC's safety and soundness review criteria. In the past the FDIC has disfavored creative proposals to contingent staffing, ranging from remote executive teams to post-acquisition staffing. Recently, successful PE Firms and, in particular, those with aggregator models, have become increasingly adept at formulating a roster of screened candidates in each local market for which the PE Firm's submit bids for. By doing so, these PE Firms have avoided last minute scrambling to staff key positions and the risk of not being approved to bid on target bank failures.

• *Post-merger Integration: Cooling-off Period*. The FDIC, reacting to the rise of the aggregator model, has begun to implement cooling-off periods between Bank Deals. The FDIC has sought evidence that after an acquisition a PE Firm's bank has been able to manage and integrate each acquired bank into its overall banking franchise. This cooling-off requirement can be frustrating to PE Firms that have successfully bid on failed banks and view as limited the window of opportunity to make quality acquisitions within their geographic target areas. Accordingly, when bringing an aggregation plan to the FDIC for review and approval

FDIC-Assisted PE Deals - Lessons Learned

Continued from previous page

PE Firms may have greater success with a detailed timeline for how and when acquisitions will be made and reasonable projections of what post-merger integration hurdles and benchmarks their bank can reach and by when. We suggest that a PE Firm's bank also prepare itself to work with the FDIC to enable FDIC examiners to monitor post-merger integration and report on post-merger integration successes or failures.

LESSON 4: THE FDIC CLOSELY WATCHES A PE FIRM'S SCOPE OF DUE DILIGENCE AND COOPERATION WITH OTHER INVESTORS

One of the central concerns that PE Firms have when performing due diligence and preparing to invest in a bank is the level of information-sharing and coordination they can have with other investors without running afoul of regulatory restrictions. Under certain circumstances, when investing parties act together in their due diligence efforts, the FDIC or its sister banking regulators may deem the PE Firms collectively to have control over the bank and subject the PE Firms to certain untenable regulatory burdens.[3] Prior to the release of the FDIC's PE SOP, advisors to private equity firms developed advice based on past bank regulatory guidance on definitions of control; however, the control concepts underlying these definitions are not the same as those found in the FDIC's PE SOP.[4] This low threshold for possible perceived collusion has been the source of great frustration for numerous PE Firms seeking to structure due diligence and investments without triggering heightened FDIC requirements.

Unfortunately, structuring a Bank Deal is more of an art than a science and requires sensitivity to the appearance of control that the FDIC may impute to otherwise standard industry due diligence best practices. The following bullets set forth some of the most salient points that we recommend PE Firms follow when pursuing a Bank Deal.

- *Co-investment Agreement.* Avoid entering into agreements that condition investment activities on the actions of other bank investors or management. Similarly, avoid agreements that establish parallel exit plans from the bank investment.

- *Independent Investment Decision.* Document the independent decision to invest in a bank based on independent analysis.

- *No Common Advisor.* Do not share the same financial advisor, general partner, or similar entity.

- *Limit Investor Discussions.* Generally, limit discussion of the investment with other investors. In many cases, a blind investment structure is not possible. In cases where PE Firms know of, and talk with, other investors, we recommend that those discussions, to the extent practical, avoid addressing strategies, policies, or other items as they relate to a PE Firm's investment plans with respect to a bank. Certain minimal financial analysis and discussion, as it relates to the analytical features of the bank and its performance, generally has been found acceptable by the FDIC.

- *Prior Relationships.* Recognize that prior relationships with other firms involved with a Bank Deal will come under regulatory scrutiny as an indicium that the PE Firms are jointly exercising a controlling influence over a bank. As a result, prior to proposing a Bank Deal to the FDIC, we recommend performing conflict checks that include whether the PE Firms have co-invested with the other investing entities, have invested in funds managed by the other investing entities, have received investments by the other investing entities in the PE Firms' managed funds, have operating agreements with the other investing entities, or have key personnel that share positions on board of directors with other investing entities' key personnel. Understanding such information at the outset can identify potential problems and enable affected firms to take steps to address them early in the process.

LESSON 5: THE FDIC HEAVILY SCRUTINIZES PROPOSED BANK DIRECTORS AND EXECUTIVE MANAGERS IN BANK DEALS

Vetting a bank's proposed directors and executive managers is, for both the PE Firms interested in a bank as well as the FDIC, an important and sometimes contentious issue. Deals brought to the FDIC have frequently been delayed, rejected, or complicated by the choice and structure of a bank's board and management. Because the FDIC is deeply concerned about the individuals who will serve on a bank's board and as the bank's executive managers, we recommend that PE Firms carefully select these individuals with the following in mind:

FDIC-Assisted PE Deals - Lessons Learned

Continued from previous page

• *Qualifications*. The qualifications of proposed directors and executive management is a highly sensitive and personal issue for those individuals subject to the FDIC's scrutiny. In numerous Bank Deals, the FDIC has raised objections to the qualifications of proposed board and executive management. As a general principle, the FDIC wishes plans to include individuals with strong commercial banking backgrounds, and in the cases of growth-based business plans, the FDIC also seeks individuals who have a demonstrated track record of safe and sound bank growth experience. For example, the FDIC is said to informally apply a so-called "lending test" as a base threshold for senior bank management; that is, whether the executive has ever underwritten a loan.

• *Local Market Insight.* The FDIC carefully examines whether a bank in a Bank Deal will be able to, first and foremost, satisfy the needs of its local community, and has greatly favored a local community-based business model. As such, the FDIC pays close attention to whether the board and management of a bank have local insight into the products and culture of the PE Firm's target markets. Proposals for remote board and management, or early expansion into novel lines of banking in which a management team does not have experience can raise difficulties, especially with *de novo* platforms.

• *Supervisory History.* A point of particular sensitivity for the FDIC is the prior adverse supervisory history, if any, of the proposed board members and executives. This history will include any actions brought against these individuals, as well as the ratings and track record of institutions with which those individuals have been associated. Individuals who have been involved with past failed banks, have faced enforcement actions, or who currently have investigations or enforcement actions pending against them will face a significant hurdle in the FDIC review process. Screening potential board and executives early in the FDIC process is important for a timely and smooth review.

LESSON 6: THE FDIC IS SENSITIVE TO THE INVESTOR COMPOSITION OF EACH BANK DEAL

The FDIC's review of a Bank Deal's investor composition is riddled with technical legal and policy issues pertaining to control, the FDIC's public reputation, and a host of other issues. As such, the FDIC is sensitive to which investors it accepts into the banking system and what fundamental values those investors purport to bring with them. In particular, the FDIC is wary that some PE Firms may have relatively short-term investment horizons and non-community based interests. While dealing with these biases is a difficult task, the following are guidelines we recommend when assembling an investor group.

• *Diverse Investor Composition.* When examining an investor group the FDIC sometimes expressly, and sometimes implicitly, looks at the diversity of the parties involved. Bank Deals that include not only PE Firms but also smaller, community-based institutional and other investors are generally reviewed more favorably by the agency.

• *Number of Parties.* The development of the PE SOP has witnessed an evolution of the FDIC's thinking on the ideal number of parties in a Bank Deal. On the one hand, the FDIC originally seemed to have favored smaller investors, each with only a limited influence over a bank. Subsequent to the initial phase, the FDIC encouraged larger investments, such that investors would be covered under the regulatory requirements of its PE SOP, and not qualify for a *de minimis* exception. The current FDIC thinking appears to be that although PE Firms should be large enough to be covered by the PE SOP, a moderate number of diversified covered parties is ideal.

• *PE Firm Background.* Before approaching the FDIC with a Bank Deal, it's best for a PE Firm to fully understand its regulatory history and general reputation in the financial services marketplace. Aside from a PE Firm's involvement in failed or troubled banks in the past, the FDIC will look at a PE Firm's other governmental investigations, criminal actions, significant lawsuits, or other similar items. The FDIC is particularly concerned with financial crimes, such as money laundering. A PE Firm desiring to hold significant stakes in a banking enterprise should be prepared to respond to a detailed inquiry about its history. Proactively addressing any questions about government

FDIC-Assisted PE Deals - Lessons Learned

Continued from previous page

investigations or lawsuits can build trust with the FDIC and expedite the review process.

LESSON 7: THE FDIC HAS A MINIMAL RISK TOLERANCE FOR BROKEN DEALS

The FDIC has a unique posture among governmental entities. On the one hand, its actions are driven by unquantifiable factors, such as its mission to increase the public's confidence and trust in the banking system. On the other hand, its actions are driven by measurable factors, such as resolving failed banks in a manner that is least costly to the Deposit Insurance Fund. As a result, when the FDIC resolves a failed bank, it is under a host of statutory, policy and practical constraints that require it to enter into Bank Deals only with counterparties that are firmly committed to them; that is, Bank Deals that pose minimal broken deal risk. The FDIC's risk aversion to broken deals has resulted in the creation of a "firm-commitment" framework that applies both when approaching the FDIC to negotiate Bank Deal terms and when forming funds such that those funds will be able to bid within the FDIC's PE SOP structure.

• *Firm Capital Commitments*. PE Firms that wish to obtain clearance from the FDIC to access due diligence materials on failing banks and eventually bid on them will need to demonstrate to the FDIC that they are firmly committed to pursuing a Bank Deal. While that firm commitment need not be completely binding, the FDIC will require certain funding obligations as indicia of a PE Firm's firm commitment. Specifically, PE Firms must place into escrow up to 10% of their capital raise amount during the pendency of their due diligence. Seven days before the FDIC's bid date, the PE Firms must commit that, barring certain significant exogenous events or FDIC approval, the PE Firms cannot break the deal, aside from simply not submitting a bid. The FDIC, of course, may disqualify a PE Firm from the bid process. We recommend PE Firms contemplating bidding on failed banks should carefully consider these requirements and incorporate them into their fund formation documents and negotiations with investors participating in their funds.

LESSON 8: THE FDIC FAVORS A HIGH LEVEL OF REGULATORY CANDOR AND DISCLOSURE

PE Firms with histories of financial institution investments are familiar with the depth and extent of bank regulatory supervisory reach into those PE Firms' intimate financial, operational, and proprietary details. Generally, the PE SOP allows the FDIC wide latitude to request information the FDIC deems necessary to evaluate a PE Firm's finances, operations, structure, funding, regulatory history, and other aspects. Submitted in the form of information requests, the FDIC has expected PE Firms to provide uncensored operating documents, organizational charts, and qualitative explanations of those firms' Bank Deal origins. The FDIC's Bank Deal history has proved to be instructive for many of these concerns, and is incorporated in the following guidance on Bank Deal candor and disclosure.

• *Document Production.* There are few if any documents the FDIC will deem are beyond the scope of appropriate FDIC Bank Deal review. PE Firms should be prepared, at a minimum, to provide their relevant fund operating agreements, formation documents, investor lists, and recent financials, and to make certain certifications regarding their relationships with insured depository institutions, among other items.

• *Fund Formation Documentation.* PE Funds investing in Bank Deals require special provisions. The agencies do not provide much leeway as to inclusion of certain core elements. Having formation documents that incorporate the PE SOP's framework, such as in the areas of disclosures and capital call deadlines, would be of great assistance in ensuring that funds avoid delay or even preclusion from investing in Bank Deals.

• *Tax Authority Disclosure.* PE Firms occasionally have expressed concerns that documentation sent to the FDIC or other regulators would be scrutinized with an eye toward tax law compliance or that such documentation would be forwarded to the relevant tax authorities. However, Bank Deal experience to date suggests that the aim of the PE SOP is not to criticize the tax compliance of funds. Rather, the FDIC is concerned with the safety and soundness of its banks, not the with technical tax details of the PE Firms that are providing much-needed capital to the banking industry.

FDIC-Assisted PE Deals - Lessons Learned

Continued from previous page

• ***Proactive Disclosure.*** Through its review of Bank Deals and implementation of the Dodd-Frank Act, the FDIC has learned a great deal more about PE Firms than it knew during the inception of PE SOP application. Nevertheless, each Bank Deal and each PE Firm presents the FDIC with a unique and complex structure with which the FDIC may not be familiar. As a general proposition, a PE Firm will ingratiate itself with the FDIC if the PE Firm candidly and proactively discloses its operations, organization, and funding structure to the FDIC. During the past few years, PE Firms that have volunteered to speak candidly about their firm, even outside of a deal process, with the FDIC have generally received a more expedited review of their Bank Deals.

LESSON 9: THE FDIC'S PE SOP POLICIES ARE CONTINUALLY EVOLVING

The body of both successful and unsuccessful Bank Deals has grown over the past few years, establishing a significant base of precedent deal history. Nevertheless, the FDIC continues to establish novel requirements or approaches to Bank Deals. In this regard, the PE SOP is a policy statement, not a regulation or statute by which the FDIC is firmly bound. As a result, we recommend that PE Firms approach the FDIC with an understanding that Bank Deal models that have worked in the past may not be wholly-acceptable in the current deal environment. Early and ongoing dialogue with the FDIC and other relevant agencies is critical to developing documents that will enable banks to bid on failed banks as quickly as possible.

LESSON 10: THE FDIC'S STRUCTURE AND CULTURE INFORM HOW THE FDIC WILL REVIEW A BANK DEAL

Although the prior lessons have detailed aspects of the FDIC's structure and culture, it is worth taking a moment to focus on this aspect of the FDIC again as it plays a significant role in the overall Bank Deal dynamic that PE Firms will experience in working with the FDIC. The FDIC is a conservative bank regulator and is mindful of the possibility that unsafe and unsound Bank Deal decisions today to resolve a failed bank may simply create another failure or unsafe or unsound problem in the future. Further, the FDIC's staff dedicated to Bank Deal review is small and generally resource-stretched. Working with the FDIC and showing an appreciation for the resource and policy pressures the FDIC faces in reviewing Bank Deals will generally result in the greatest success.

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The past few years has witnessed great evolution in the field of Bank Deals under the framework of the PE SOP. Some PE Firms have been highly successful in navigating the FDIC's PE SOP regulatory landscape while others have not. The deal precedence from both successful and unsuccessful deals over the past two years allows the private equity industry to extract from those Bank Deals valuable lessons.

Looking forward, banks will continue to fail, and those PE Firms well equipped to navigate the FDIC's PE SOP framework will disproportionately benefit from FDIC-assisted deals. Those successful firms will have retooled their formation documents and will have prepared their investors for the PE SOP framework. They will also have engaged business and legal advisors that are capable of managing Bank Deals under the dynamic and evolving PE SOP review framework. ■

Paul L. Lee and Gregory J. Lyons are partners in Debevoise & Plimpton LLP's New York office. Satish M. Kini is a partner, David A. Luigs is counsel and Pratin Vallabhaneni [5] is an associate in Debevoise & Plimpton LLP's Washington, D.C. office.

pllee@debevoise.com
gjlyons@debevoise.com
smkini@debevoise.com
daluigs@debevoise.com
pvallabhaneni@debevoise.com

1. For ease of reference throughout this article, FDIC review and approval may also refer to sister federal and state banking regulator review and approval.
2. Throughout this article, PE Firms are described as making submissions or representations to the FDIC and its sister banking agencies. However, when possible, and in line with Lesson 1, these submissions should be made by the organizers or banks involved in the Bank Deal. Further, discussions of PE Firm diligence and structuring might equally apply to bank organizers, advisors, and investment bank underwriters.
3. For instance, when parties are deemed to be "acting in concert," their equity interests in a bank may be aggregated to trigger a control finding under the Change in Bank Control Act (the "CIBC Act") or to find that the investors, collectively, constitute a bank holding company under the Bank Holding Company Act of 1956 (the "BHC Act"). In both cases PE Firms would become subject to regulatory scrutiny and operating restrictions that do not comport with most PE Firm structures.
4. Confusingly, the "acting in concert" concept found in both the BHC Act and CIBC Act is not the same as the "concerted action" concept found in the PE SOP.
5. Admitted in California only.

SEC Whistleblower Rules

Continued from page 1

"Original" Information. The rules define "original information" as information derived from a whistleblower's "independent knowledge" or "independent analysis." To be deemed "original," information must be not already known to the SEC from another source and not derived from allegations made by others in any hearing, report, audit, investigation or news source. "Independent analysis" can be based on publicly available information.

Leads to Successful Enforcement. Under the rules, a whistleblower's information will be deemed to have led to a successful enforcement action if the information caused the SEC to open, re-open or expand an investigation and the SEC brought a successful judicial or administrative action based, at least in part, on conduct that was the subject of the information provided. Additionally, even if the information provided relates to conduct already under investigation, it will be deemed to have led to successful enforcement if it significantly contributed to the success of the SEC's action.

$1,000,000 Recovery. Although a bounty is available only in a successful action in which the SEC recovers at least $1 million in sanctions, the rules allow for the sanctions recovered in two or more proceedings to be combined for purposes of meeting the $1 million threshold if the proceedings arise out of the same nucleus of operative facts.

Determining the Amount of the Bounty. Dodd-Frank mandates that a whistleblower bounty must be no less than 10% and no more than 30% of the monetary sanctions collected by the SEC. The amount of the award within that range is left to the SEC's discretion. The rules list factors that the SEC may consider in exercising that discretion, including the significance of the information provided by the whistleblower to the success of the action; the level of assistance provided by the whistleblower (including the timeliness of the whistleblower's report, the level of cooperation with the SEC's investigation, any efforts to encourage others to assist and any unique hardships experienced by the whistleblower); the SEC's policy interests in making awards; the extent to which the whistleblower reported internally and assisted (or interfered with) internal compliance efforts; and the role, involvement or culpability of the whistleblower in the conduct and violations at issue in the SEC's action.

Ineligible Whistleblowers and Information. The final rules carve out from eligibility for awards certain categories of whistleblowers and information. The following will not be considered "independent" knowledge or analysis for purposes of establishing eligibility for an award:

- Information obtained by an attorney or other person from a communication covered by the attorney-client privilege or as the result of legal representation of a client.
- Information learned by officers, directors, trustees or partners of an entity through being informed of allegations of misconduct or in connection with the entity's processes for identifying, reporting and addressing potential legal violations.
- Information learned by an entity's employees whose principal duties involve compliance or internal audit work and by employees of firms retained to perform compliance or internal audit work.
- Information learned by employees of a public accounting firm in the course of performing an engagement required under the federal securities laws.
- Information learned by employees of a firm retained to conduct an internal investigation of potential violations of law.
- Information acquired as a result of any violation of federal or state criminal law.

Many of these excluded categories are subject to limited exceptions. The exclusion for information learned from attorney-client communications or legal representations, for example, does not apply if disclosure would be permitted under applicable rules of legal ethics. The exclusions for information learned by officers, directors, trustees, partners, personnel with internal audit or compliance responsibilities, investigators and public accountants do not apply if the whistleblower has a reasonable basis to believe that disclosure of information to the SEC is necessary to prevent the entity from engaging in conduct that is likely to cause substantial injury to the entity or investors or to impede an investigation. Finally, the exclusions do not apply if 120 days have elapsed since the whistleblower provided the information to the audit committee, chief legal officer, chief compliance officer or the whistleblower's supervisor or since the whistleblower received the information under circumstances indicating that one of those individuals was already aware of the information.

SEC Whistleblower Rules

Continued from previous page

Anti-Retaliation Provisions

Dodd-Frank includes expansive anti-retaliation protections for whistleblowers. Employers are prohibited from discharging, demoting, suspending, threatening, harassing or taking any other discriminatory action against a whistleblower. Dodd-Frank creates a private right of action for employees who claim that they have been retaliated against for whistleblowing activity.

A whistleblower is entitled to anti-retaliation protection regardless of whether the whistleblower satisfies all of the regulatory requirements to qualify for a bounty. Rather, the anti-retaliation safeguards are triggered upon a whistleblower reporting to the SEC. The final rules provide that a whistleblower is covered under Dodd-Frank's anti-retaliation provisions if the whistleblower: (1) has a reasonable belief that the information the whistleblower is providing relates to a possible securities law violation that has occurred, is ongoing, or is about to occur and (2) engages in one of three forms of conduct listed in Section 922(h)(1) of Dodd-Frank, including: (i) providing information to the SEC in accordance with Section 922 of Dodd-Frank; (ii) initiating, testifying in, or assisting in any investigation or judicial or administrative action of the SEC based upon or related to such information; or (iii) making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002, the Securities Exchange Act of 1934 or any other law, rule, or regulation subject to the jurisdiction of the SEC.

Many comments received by the SEC on the proposed rules sought changes to prevent employees from making frivolous complaints as a tactic to avoid termination or other discipline based on legitimate considerations. Such comments suggested that to be deemed a whistleblower, an employee should provide information about a "probable," "likely" or "material" violation of the securities laws. Commentators also suggested that the rules should make explicit that employees who make whistleblower reports may be disciplined for reasons independent of their whistleblowing activities.

In adopting the final rules, the SEC declined to require that a whistleblower's information involve a "probable," "likely" or "material" violation of the securities laws. The SEC found that the requirement of a "possible" violation was sufficient to ensure a facially plausible relationship to some securities law violation and struck the right balance between encouraging employees to provide high-quality tips and discouraging frivolous complaints. The SEC also declined to adopt suggestions to state explicitly that employees may be disciplined for reasons unrelated to whistleblowing. The SEC found that such a change would be unnecessary given that the statute itself prohibits only retaliatory actions taken "because of" an employee's whistleblowing activity. The SEC observed that case law under analogous anti-retaliation provisions of the False Claims Act and the Sarbanes-Oxley Act provides a robust legal framework for making this factual determination on a case-by-case basis.

Impact on Internal Compliance

A great deal of the commentary submitted to the SEC on its proposed rules focused on the likely impact of the bounty provisions on companies' internal compliance processes. The potential financial rewards for making a complaint to the SEC are enormous, and the danger that an employee's information may not be deemed "original" if someone else reports first creates a tremendous incentive to report to the SEC at the earliest possible moment. For these reasons, many commentators argued that the bounty provisions would undermine internal compliance by encouraging employees to bypass internal processes and rush to make external complaints to the SEC. Such commentators urged the SEC to adopt rules that would require whistleblowers to report violations internally first, before blowing the whistle to the SEC. Many such commentators also proposed that officers, directors and other personnel with responsibility for investigating and addressing legal compliance be ineligible for participating in the bounty program.

In the final rules, the SEC declined to require employees to report violations internally before blowing the whistle to the SEC. The final rules do, however, attempt to incentivize (or at least avoid dis-incentivizing) internal reporting in other ways. For example, the rules provide that a whistleblower's internal reporting and cooperation with any internal investigation are positive factors that the SEC may rely upon to enhance the amount of any award within the permissible 10% to 30% range. Likewise, the SEC may decrease a whistleblower's award if the whistleblower interfered

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or failed to cooperate with internal processes. The rules also make clear that a whistleblower's information may be considered "original" even if the whistleblower first reports internally, so long as the whistleblower also reports to the SEC within 120 days.

The final rules do exclude information obtained by officers, directors and other personnel with responsibility for investigating and addressing legal compliance, but the exclusions are subject to exceptions. Most significantly, such persons may disclose and be eligible for a bounty if they can show a reasonable belief that disclosure of information to the SEC is necessary to prevent the entity from engaging in conduct that is likely to cause substantial injury to the entity or investors or to impede an investigation.

As reflected by the split 3-2 vote adopting the final rules, there is room for disagreement about whether the rules strike the appropriate balance between creating incentives for people to report wrongdoing to the SEC and supporting internal corporate compliance programs. Chairman Shapiro stated her belief that the rules do indeed "strike[] the correct balance – a balance between encouraging whistleblowers to pursue the route of internal compliance when appropriate – while providing them the option of heading directly to the SEC." In his dissenting statement, by contrast, Commissioner Paredes stated his belief that the SEC "could have and should have calibrated the final rule differently, shifting the tradeoffs in favor of ensuring the integrity of internal compliance programs as a complement to government enforcement."

Time will tell whether the bounty program enhances government enforcement without unduly undermining internal compliance. In the meantime, there is no question that the bounty and anti-retaliation provisions of Dodd-Frank create new and profound challenges for companies in implementing their internal compliance programs, responding to any internal indications that unlawful conduct may be occurring and in disciplining or terminating employees for reasons unrelated to their whistleblowing activity. Companies would be prudent to re-examine thoroughly their relevant policies and practices in light of these dramatic changes in the regulatory environment, particularly those involving internal complaint procedures and protections and those aimed at a robust performance evaluation system. ■

Jyotin Hamid and Mary Beth Hogan are partners and Kristin A. Lieske is an associate in Debevoise & Plimpton LLP's New York office.

mbhogan@debevoise.com
jhamid@debevoise.com
klieske@debevoise.com