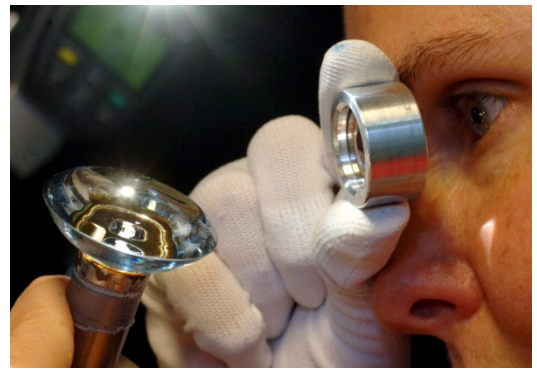


# A Closer Look

## The Dodd-Frank Wall Street Reform and Consumer Protection Act



To view our other *A Closer Look* pieces on Dodd-Frank, please visit [www.pwc regulatory.com](http://www.pwc regulatory.com)

Part of an ongoing series

## Impact On Foreign Banking Organizations and Foreign Nonbank Financial Companies

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) applies US national treatment policies to foreign banking organizations (FBOs) that do business in the United States through US branches, agencies, or bank subsidiaries.<sup>1</sup> These FBOs are generally subject to the same rules as comparable US bank holding companies (US BHCs), including, where applicable, those BHCs subject to enhanced prudential standards because they are considered to be systemically important.

In applying the “systemically important” provisions of the Act to FBOs, the Financial Stability Oversight Council (FSOC) and Federal Reserve Board (FRB) are directed to give “due regard to the principle of national treatment and equality of competitive opportunity” and to take into account the extent to which an FBO or Foreign Nonbank Financial Company (“foreign NFC”) is subject on a consolidated basis to

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<sup>1</sup> Section 211.21(o) of the FRB’s Regulation K defines a foreign banking organization as a foreign bank that (i) operates a branch, agency, or commercial lending subsidiary in the United States; (ii) controls a bank in the United States; or (iii) controls an Edge corporation acquired after March 5, 1987. Any company of which the foreign bank is a subsidiary is also included under the definition.

“home country standards that are comparable” to those applied to “financial companies in the United States.”<sup>2</sup> Historically, when applying new US banking legislation to FBOs and seeking comparable treatment with US BHCs, the FRB has taken into consideration the different structure of FBOs in the US market – FBOs have more branches than bank subsidiaries in the United States. The Act also amends the International Banking Act of 1978 to provide that the FRB may terminate a US branch or agency office of an FBO that presents a “risk to the stability of the United States” if its home country has not adopted or is not making demonstrable progress toward adopting an appropriate system of financial regulation to mitigate risk.

The Act also reaches foreign NFCs that are predominantly engaged in financial activities in the United States<sup>3</sup> and that are found by the FSOC to be systemically important and required to be supervised by the FRB. The Act seeks to apply to foreign NFCs national treatment policies similar to those applied to FBOs, to ensure comparability of treatment with US nonbank financial companies (US NFCs). FBOs and foreign NFCs are mutually exclusive categories under the Act.<sup>4</sup> If a foreign bank has a US branch or agency or a US bank subsidiary, it is regulated as a BHC for systemic purposes. This regulation would include foreign NFCs that are within an FBO’s consolidated structure and which are engaged in business in the United States. For example, a US broker-dealer subsidiary of an FBO would not be separately regulated as a systemically important foreign NFC. If a foreign NFC is engaged in business in the United States that is determined to be systemically important, it will be regulated as a foreign NFC so long as it is not controlled by an FBO. For example, if a foreign bank were to “debank” and no longer be an FBO, the FSOC could still determine (if applicable) that its US broker-dealer subsidiary was systemically important and subject to supervision by the FRB as a foreign NFC.

This *A Closer Look* continues our review of the “systemically important” provisions of Dodd-Frank and examines the impact some of these provisions may have on FBOs and foreign NFCs.

*Consistent with longstanding US policy, the Act follows the principle of national treatment toward FBOs (foreign banks with US banking operations or subsidiaries) and toward foreign NFCs. In the case of FBOs, the comparative yardstick is the treatment of US BHCs; for foreign NFCs, it is the treatment of NFCs under the provisions of the Act. Foreign banking organizations that are from countries that do not adopt or make progress toward regulation to mitigate risk could, in the future, face restrictions on, or termination of, their US branch or agency offices if such situation were determined to pose risks to the US financial system.*

## Determining systemically important FBOs

Under the Act, BHCs with \$50 billion or more in consolidated assets are automatically included in the category of systemically important institutions. Under the definition of “bank holding company” in Section 102(a)(1) of the Act, this would include FBOs that meet the size criteria on a consolidated basis, including FBOs that have only branch or agency offices. However, it is not clear from the language of the statute whether this consolidated asset calculation for FBOs should be based on US assets only.

<sup>2</sup> The use of the term “financial companies” is somewhat ambiguous, since the comparability standard includes both FBOs and Foreign NFCs. Read logically, it would seem to suggest comparing FBO regulation in the home country with how BHCs are regulated in the United States and comparing how Foreign NFCs are regulated in their home country with how NFCs are regulated in the United States.

<sup>3</sup> A NFC is considered to be predominantly engaged in financial activities if 85% or more of the entity’s consolidated assets or revenues are derived from financial activities defined in Section 4(k) of the BHC Act.

<sup>4</sup> See definitions in Sections 102(a)(1) and (4) of the Act.

Using only US assets would appear consistent with the Act's overall intent to mitigate systemic risks to the US financial system, rather than the global financial system. While the major US BHCs include substantial foreign assets in their totals, they would still be systemic under the assets test even without those foreign assets—and in any event, they are supervised on a consolidated basis by the FRB. Using only US assets would also be consistent with the Collins Amendment capital provisions (discussed below), which, for the first time, mandate that US intermediate holding companies of FBOs begin complying with US bank capital requirements at the end of five years.

It will be up to the FRB to weigh the language of the Act against national treatment policies and decide whether for FBOs, US assets only should be included in calculating the \$50 billion “systemically important” threshold. Any FBO concerned about treatment as a systemic institution, and of a size that could benefit from use of US assets alone, should consider how the interpretation of consolidated assets might impact its status.

*It appears that FBOs will be treated as systemically important if they meet or exceed the BHC threshold of \$50 billion or more in consolidated assets. FBOs that don't own US banks but have branch or agency operations in the United States will also apparently be included in this group. It is unclear whether the BHC assets test for FBOs will be applied by the FRB only to US assets; such application would, on its face, appear consistent with the Act's purpose.*

## Determining systemically important foreign NFCs

The selection of foreign and US NFCs as systemically important rests with the FSOC, which must summon a two-thirds majority among its 10 voting members (which super-majority must include the secretary of the treasury as chairman) to designate such a company as systemically important. The Federal Insurance Office (FIA) has the right to recommend to the FSOC that insurers be treated as systemically important. (It is not clear whether the FSOC on its own can recommend that an insurer, either domestic or foreign, be designated as systemic.)

In contrast to the situation of FBOs, whose status appears to depend on a consolidated asset test applied to BHCs, the Act provides separate tests for inclusion of domestic versus foreign NFCs. For foreign NFCs, the FSOC must determine that material financial distress at the foreign NFC—or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the foreign NFC—could pose a threat to the financial stability of the United States. In making any designation for a foreign NFC, the Act also requires the FSOC to consult with the appropriate home country regulator of the foreign NFC.

In making any such determination, the FSOC shall consider:

- The extent to which the company is leveraged
- The extent and nature of the company's US-related off-balance-sheet exposures
- The extent and nature of the company's transactions and relationships with other significant nonbank financial companies and significant bank holding companies
- The importance of the company as a source of credit for US households, businesses, and state and local governments, and as a source of liquidity for the US financial system
- The importance of the company as a source of credit for low-income, minority, or underserved communities in the United States, and the impact that the failure of such company would have on the availability of credit in such communities
- The extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse
- The nature, scope, size, scale, concentration, interconnectedness, and mix of the company's activities

- The extent to which the company is subject to prudential standards on a consolidated basis in its home country, and that such standards are administered and enforced by a comparable foreign supervisory authority
- The amount and nature of the company's US financial assets
- The amount and nature of company liabilities used to fund activities and operations in the United States, including the degree of reliance on short-term funding
- Any other risk-related factors that the FSOC deems appropriate

*Foreign NFCs will be designated as systemically important by the FSOC if two-thirds of the council's 10 members, including the secretary of the treasury as chair, determine that material distress at the foreign NFC could pose a threat to the US financial system. In making such a determination, the council must take into account a number of factors in the Act which are focused on the scope, scale, and importance of the foreign NFC's activities and operations in the United States.*

## Regulation of systemically important FBOs and foreign NFCs

Those FBOs that meet the \$50 billion threshold and those foreign NFCs that are designated as systemically important by the FSOC will have to comply with more stringent prudential standards that the FRB, on its own or at the recommendation of the FSOC, may impose. These standards must cover risk-based capital requirements and leverage limits unless the FRB, in consultation with the FSOC, determines that they are not appropriate for a company. Other standards must address liquidity requirements, risk management, resolution plan and credit exposure reporting, and concentration. Other discretionary standards include contingent capital, enhanced public disclosure, and short-term debt limits, among others. For foreign NFCs, the Act is specific in stating that the application of any standards will include only the US activities and subsidiaries of a foreign NFC.

In recommending standards, the FSOC is to take into account differences among NFCs and BHCs supervised by the FRB, including the factors utilized to designate a domestic or foreign NFC, and whether the NFC owns an insured depository institution (other than a bank). In setting standards, the FSOC is directed not to apply factors which could be impacted by small changes, and with respect to individual domestic or foreign NFCs, it is also directed to take into account the predominant line of business, including assets under management. In addition, the FRB or FSOC may differentiate among companies on an individual basis or by category, taking into account their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors deemed appropriate.

Given this flexibility, how will the FRB apply enhanced prudential standards to FBOs and foreign NFCs giving "due regard to the principle of national treatment and equality of competitive opportunity" and taking into account the extent to which an FBO or foreign NFC is subject on a consolidated basis to "home country standards that are comparable"? For FBOs, should these enhanced standards be applied only to US operations or to US intermediate holding companies on a consolidated basis?

When the FRB implemented the financial holding company (FHC) provisions of the Gramm-Leach-Bliley Act in 2000, it had to decide how to apply a well-capitalized requirement to FBOs that only had branches or agencies in the United States. For US FHCs, the well-capitalized requirement applied only to insured depository institutions controlled by the FHC, not to the FHC itself. The FRB concluded that Gramm-Leach-Bliley required it to treat FBOs with branch or agency operations in the United States using standards comparable to those applied to a US bank owned by a FHC, giving due regard to the principle of national treatment and equality of competitive opportunity. The FRB applied the US well-capitalized standards for US banks to parent foreign banks, except for the leverage ratio, which the FRB found was not generally required by home country supervisors.

From the standpoint of international comity, mutual recognition, and convergence on key supervisory policies being sought in such key forums as the G-20, the Basel Banking Committee, and the Financial Stability Board, a possible approach for FBOs would be to assess (i) the scope and degree of comparability of standards of home country regulators to those in the United States; (ii) the application of such home country standards to the US operations of FBOs through home country consolidated supervision; and (iii) if warranted, application of select US standards to US operations of FBOs when required to address specific systemic risk concerns to US financial markets not otherwise addressed. In the case of foreign NFCs, comparability would appear consistent with national treatment if assessed in terms of the treatment of domestic NFCs (e.g., examining comparability of standards as between domestic and foreign NFCs that are engaged in business in the United States in the same financial services sector).

In addition to the standards, systemically important BHCs and FBOs must provide prior written notice to the FRB before acquiring certain US financial companies with assets in excess of \$10 billion. Systemically important domestic or foreign NFCs must also comply with Bank Holding Company Act requirements on bank acquisitions, meaning acquisitions totaling 5% or more of a US bank's voting shares will require prior Fed approval. All systemically important public company NFCs must also create a risk committee within one year of their designation. The FRB must also conduct annual stress tests on systemically important BHCs/FBOs and domestic and foreign NFCs that provide for three different sets of conditions: baseline, adverse, and severely adverse. The Act also requires systemically important FBOs and foreign NFCs with assets in excess of \$50 billion to conduct semi-annual stress tests.

If a systemically important BHC or FBO or domestic or foreign NFC poses a "grave" threat to US financial stability, it must maintain a 15-to-1 debt-to-equity ratio and, with approval of two-thirds of the Financial Stability Oversight Council, may be required by the FRB to limit its activities, restrict product offerings, divest assets, or take other major steps to reduce systemic risk. This latter is the so-called "break-up" provision.

*FBOs covered as systemically important will be subject to enhanced prudential standards, as will foreign NFCs designated as systemically important (for US activities only). The FSOC or FRB must take into account differences between banking and nonbank financial companies in applying such standards. The FSOC and FRB are also provided with substantial discretion in applying the standards to different types of institutions, and even in application to individual institutions. For FBOs, comparability of home country standards would logically be applied to standards for comparable US BHCs, and for foreign NFCs comparability would logically be applied to similar domestic NFCs. Particularly in the case of FBOs, an important element in that process will be taking into account multilateral efforts at convergence in key prudential areas in assessing comparability. The degree of progress in the G-20, the Basel Banking Committee, and the Financial Stability Board on key reform elements could make this process less or more difficult.*

## Other provisions impacting FBOs and foreign NFCs

**Capital requirements.** The Act includes statutory requirements (the "Collins Amendment") that extend the current capital adequacy framework for insured depository institutions (including the risk-based capital framework, as detailed under Section 38 of the Federal Deposit Insurance Act) and leverage standards to intermediate US holding companies owned by FBOs, and to NFCs that are systemically important and supervised by the FRB. The Act gives a five-year period before these new requirements are imposed on FBOs' intermediate holding companies and on systemically important NFCs.

**The Volcker Rule: prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds.** The Volcker Rule amends the Bank Holding Company Act to prohibit

a “banking entity” from engaging in proprietary trading or sponsoring or investing in hedge funds or private equity funds except as authorized under the Act. A banking entity would include an FBO and its branches, agencies, bank subsidiaries, or other nonbank subsidiaries engaged in activities in the United States. A foreign NFC would not have to comply with the permissibility restrictions of the Volcker Rule, but would be subject to additional capital requirements and quantitative limits with regard to proprietary trading and hedge and private equity fund investments and sponsorship, which the Volcker Rule generally prohibits.

There are two exceptions to the general prohibition on proprietary trading and hedge/private equity fund investment and sponsorship that are intended to prevent the extraterritorial impact of the prohibitions and will likely be available only to FBOs. Namely:

- Proprietary trading conducted solely outside of the United States by a banking entity pursuant to Sections 4(c)(9)<sup>5</sup> or 4(c)(13)<sup>6</sup> of the Bank Holding Company Act, insofar as that entity is not directly or indirectly controlled by a banking entity constituted under the laws of the United States or one or more states.
- The acquisition of an equity or other ownership interest in, or the sponsorship of, a hedge fund or private equity fund by a banking entity pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, provided that no such interests are offered for sale or sold to residents of the United States, and the banking entity is not directly or indirectly controlled by a banking entity constituted under the laws of the United States or one or more states.<sup>7</sup>

The Act’s Volcker Rule provisions become effective 12 months after the federal banking agencies (the SEC and the CFTC) promulgate rules to enforce the Act’s provisions, or two years after enactment. Banking entities must divest impermissible ownership interests in hedge or private equity funds within two years of the issuance of final rules or the effective date of this section of the Act. The FRB may extend this divestiture period by rule or order for up to three one-year terms. The FRB may also extend the divestiture period for illiquid ownership interests for up to five years after the issuance of final rules or the effective date of this section of the Act.

*FBOs with intermediate US holding companies and foreign NFCs determined to be systemically important will have to comply with bank capital adequacy requirements—both risk-based capital requirements and leverage limits—at the end of five years. FBOs will also have to comply with the Volcker Rule prohibitions on proprietary trading and sponsorship or investment in hedge or private equity funds, except such restrictions shall not apply to their investments and activities conducted outside of the United States. Foreign NFCs do not have to comply with the investment or activity limitations of the Volcker Rule, but will be required to maintain additional capital against such investments or activities otherwise prohibited to BHCs.*

## Other provisions applicable to FBOs

**Derivatives push-out.** Under Section 726 of the Act (the “Lincoln Amendment”), an FBO that decides to become a swaps entity (either through a US branch or agency, parent bank, or US bank or other US subsidiary) would be subject to prohibitions on certain Federal Reserve or FDIC financial assistance. A “swaps entity” means either a swaps dealer or major swap participant (except that the definition does

<sup>5</sup> Section 4(c)(9) of the Bank Holding Company Act is generally intended to exempt the operations and activities of FBOs conducted outside the United States from that act’s nonbanking restrictions.

<sup>6</sup> Section 4(c)(13) of the Bank Holding Company Act exempts from that act’s nonbanking prohibitions shares of companies that do no business in the United States except as an incident to business outside the United States. As qualified, the exemption would be limited to a BHC that was owned or controlled by an FBO.

<sup>7</sup> See *A Closer Look: Banks, Thrifts, and Their Holding Companies* for a fuller discussion of the provisions of the Volcker Rule.

not include a major stock participant that is an insured depository institution). While this prohibition applies equally to FBOs and domestic banking organizations, there is a “safe harbor” in Section 716 for derivatives activities that may be conducted by banking organizations without triggering the prohibition. Congress neglected to apply this safe harbor in a way that would include uninsured branches and agencies of FBOs. This lack of equal treatment was apparently inadvertent, as confirmed by Senator Blanche Lincoln in a colloquy on the Senate floor just prior to passage. Presumably, a conforming amendment to correct this oversight will be included in a technical corrections bill, if and when one is introduced.

**Swaps: international harmonization and extraterritorial impact.** The Act’s derivatives title includes Section 752, which requires the CFTC to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation of contracts for future delivery and options on those contracts.

There are also provisions in the Act that seek to limit any extraterritorial jurisdiction of the derivatives title. Section 729 states that the provisions of the Commodities Exchange Act relating to swaps shall not apply to activities outside the United States unless those activities have a “direct and significant connection with activities in, or effect on, commerce of the United States” or contravene rules designed to prevent evasion of any provision. Section 772 states that no provision of the derivatives title applicable to security-based swaps administered by the SEC applies insofar as a person conducts transactions in swaps outside the United States, so long as such transactions are not in contravention of rules intended to prevent evasion of the derivatives title.

**FHCs must be well capitalized and well managed.** Sections 606 and 607 of the Act require BHCs that are FHCs to be and remain well capitalized and well managed to continue to engage in expanded activities and make interstate bank acquisitions. Presently, only depository institutions must meet such enhanced criteria. FBOs that are FHCs and that have branches and agencies in the US already meet these criteria, as the FRB requires the parent foreign bank FHC to be well capitalized and well managed. As long as the foreign bank FHC meets the criteria, the FRB under SR 01-01 determined that any intermediate US holding company would not be required to meet the criteria. With the Collins Amendment requiring that US intermediate holding companies of FBOs meet US bank capital requirements at the end of five years, it is at least somewhat confusing as to whether FBOs’ US intermediate holding companies will have to meet well-capitalized criteria in 12 to 18 months (when Sections 606-607 may become effective), in five years, or never. Since the Act requires a study of the capital treatment of FBOs’ US intermediate holding companies within 18 months, any decision on these issues should logically be deferred until the results of that study are completed.

**Application of affiliate transaction requirements: limits to derivative transactions and securities borrowing and lending transactions.** Section 608 amends Section 23A of the Federal Reserve Act to treat derivative transactions and securities lending and borrowing transactions between banks and their affiliates as “covered transactions” to the extent, in each case, that these types of transactions cause a bank to have “credit exposure” to an affiliate. Covered transactions with any one affiliate are limited to 10% of a bank’s capital and surplus, and with all affiliates are limited to 20% of a bank’s capital and surplus. Covered transactions that involve extensions of credit are subject also to collateral requirements. In this regard, Section 608 amends Section 23A to treat a repurchase agreement as an extension of credit subject to collateral requirements. For FBOs, Section 23A applies not only to a US bank subsidiary but also to any US branch or agency in its dealings with securities affiliates or affiliates engaged in expanded FHC activities. These amendments are effective one year after a transfer date to be determined, which date is likely to be 12 to 18 months after enactment.

**Lending limits expanded to include credit exposure on derivatives, repurchase agreements, reverse repurchase agreements, and securities borrowing and lending transactions.** Section 609 of the Act amends the National Bank Act section on lending limits to extend such limits to include credit

exposure on derivatives, repurchase or reverse repurchase agreements, and securities borrowing and lending transactions with a customer, The Federal Deposit Insurance Act is also amended to require insured state banks to include credit exposures on derivatives in state lending limits. Federal branches and agencies of FBOs in the aggregate must comply with the same lending limits as national banks, provided that the capital limit is based upon the capital of the parent foreign bank. FBOs are also required to apply the same lending limits at federal branches to all of their federal and state-licensed branches and agencies in the aggregate.

**Interstate branching.** Section 613 amends federal banking law to remove the last impediments to de novo interstate branching by US banks. FBOs generally have the same interstate branching rights as US banks and thus will be able to branch and change home states with greater ease.

**Expanded FRB examination authority over functionally regulated subsidiaries.** Section 604 eliminates a number of restrictions that were imposed under Gramm-Leach-Bliley on the ability of the FRB as “umbrella supervisor” of FHCs to examine, require reports from, impose prudential rules on, or take enforcement actions with respect to functionally regulated subsidiaries of FHCs.

*FBOs that may wish to become swap dealers do not have the benefit of the Act’s “safe harbor” for permissible swap activities that will not trigger blocking of any FRB or FDIC financial support. This appears to have been an oversight and the safe harbor will likely be extended to FBO branches and agencies if a technical corrections bill is passed. FBOs otherwise receive national treatment—both pro and con—on interstate de novo branching, and regarding expansion of 23A affiliate transaction requirements and bank lending limits to include any credit exposures for derivatives transactions, the borrowing and lending of securities, and repurchase and reverse repurchase transactions. These will apply to FBO branches and agencies based on existing FRB rules in its Regulation W and Regulation K. Expanded FRB examination authority over functionally regulated subsidiaries may impact a number of FBOs that have significant nonbank financial subsidiaries in the United States.*

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While Dodd-Frank will have significant impact on foreign banking organizations and foreign nonbank financial companies, many implementation issues are currently unclear and are subject to the SEC and other agencies' rule-making processes and various statutorily directed studies. PricewaterhouseCoopers will continue to monitor those developments and provide you with updates, which will all be available at [www.pwc regulatory.com](http://www.pwc regulatory.com).

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