Senator Dodd Releases a New Financial Regulatory Reform Bill: A Preliminary Overview

March 17, 2010

On March 15th, Senator Dodd (D-CT), Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, released a new version of the "Restoring American Financial Stability Act" ("Proposed Senate Bill") together with a legislative summary.

As its preamble states, the Proposed Senate Bill intends to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."

On the same day, Representative Barney Frank (D-MA), Chairman of the House Financial Services Committee and driving force behind the "Wall Street Reform and Consumer Protection Act of 2009" ("House Bill"), published a brief statement saying that the bill presented by Senator Dodd constitutes a solid basis for a House-Senate conference, and while there are some differences between the two bills, they are "more alike than they are different."

The Proposed Senate Bill would (a) create an independent consumer watchdog within the Board of Governors of the Federal Reserve System ("Federal Reserve Board"); (b) appoint the Federal Reserve Board as regulator for all financial firms with more than $50 billion in assets; (c) create an interagency council to identify and address systemic risks; (d) create a new resolution authority for systemically important firms; and (e) impose new requirements, including capital and leverage standards, on large firms that pose a risk to the financial system. Other key provisions include the regulation of derivatives, hedge funds, and rating agencies, shareholder "say on pay," improving investor protection, and increasing oversight of municipality securities and transparency with regard to companies that sell products such as mortgage-backed securities.

FINANCIAL STABILITY OVERSIGHT COUNCIL

The Proposed Senate Bill would create a new interagency council called the Financial Stability Oversight Council ("Council"). The main tasks of the Council would be to identify risks to the financial stability of the United States, to promote market discipline, and to respond to emerging threats to the stability of the United States financial markets. The Council would be chaired by the Secretary of the Treasury and consist of the Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection, the Chairman of the Securities and Exchange Commission ("SEC"), the Chairperson of the FDIC, the Chairperson of the Commodity Futures Trading Commission ("CFTC"), the Director of the Federal Housing Finance Agency, and an independent member with insurance expertise (to be appointed by the President and confirmed by the Senate). The Council would be supported by a new Office of Financial Research within the Treasury.

The Council would make recommendations to the Federal Reserve Board for increasingly strict rules pertaining to capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity, with significant requirements for companies that pose a risk to the financial system. The Council would also have the authority to require nonbank financial companies that pose a risk to the financial stability of the U.S. and systemically important clearing, payments, and settlements systems to be regulated by the Federal Reserve Board. As a last resort, the Council could approve (with a 2/3 vote) a

Attorney Advertisement

decision by the Federal Reserve Board to break up a large company if it poses a "grave threat to the financial stability of the United States."

PRUDENTIAL AND RESOLUTION AUTHORITY

By means of stricter rules for capital, leverage, liquidity and risk management, the Proposed Senate Bill is aimed at discouraging excessive growth and complexity. The Proposed Senate Bill also contains a provision akin to the so-called "Volcker Rule," which would require regulators to implement regulations that prohibit banks, their affiliates and bank holding companies, from proprietary trading, investing in and sponsoring of hedge funds and private equity funds, and would limit relationships between hedge funds and private equity funds. In addition, nonbank financial institutions supervised by the Federal Reserve Board would also be restricted in their proprietary trading and hedge fund and private equity investments. The Proposed Senate Bill does not define the details of such rules but delegates the authority to do so to the Federal Reserve Board, which will act upon the recommendations of the Council.

Large complex companies would be required to periodically submit plans for a quick, orderly wind down of their companies (so-called "living wills") in the event of financial distress. This is intended to help regulators better understand the structure of the companies they oversee and serve as a roadmap for winding down such companies should they fail. There would be an orderly liquidation mechanism by which the FDIC can unwind systemically significant financial companies that are failing. Treasury, FDIC and the Federal Reserve Board must agree to place a company into the liquidation process and a panel of three bankruptcy judges must convene and agree (within 24 hours) that the company is insolvent. In order to avoid the use of taxpayer money for future bailouts, the largest financial firms must contribute to a $50 billion upfront fund that would be used in connection with any liquidation.

The Federal Reserve Board's Section 13(3) of the Federal Reserve Act lender of last resort authority would be limited to "system-wide support" for healthy institutions or systemically important companies only.

STRENGTHENING THE FEDERAL RESERVE

As mentioned below, the Federal Reserve Board would oversee larger, more complex holding companies with assets of more than $50 billion and other systemically significant financial firms. In order to guarantee transparency and eliminate conflicts of interest, the Proposed Senate Bill would:

- give the Government Accountability Office ("GAO") the authority to audit any emergency lending facility set up by the Federal Reserve Board under Section 13(3) of the Federal Reserve Act;
- give the Federal Reserve Board the responsibility of identifying, measuring, monitoring, and mitigating risks to U.S. financial stability;
- create a Vice Chairman for Supervision (a member of the Federal Reserve Board designated by the President) to develop policy recommendations for the Federal Reserve Board regarding the supervision and regulation of the institutions supervised by the Federal Reserve Board;
- prohibit any legal entity that is supervised by the Federal Reserve Board from voting for the directors of the Federal Reserve Banks, and also prohibit past or present officers, directors, and employees of such legal entity from serving as directors of the Federal Reserve Banks; and
- require that the president of the New York Federal Reserve Bank be appointed by the President.

CONSUMER FINANCIAL PROTECTION WATCHDOG

A new independent Bureau of Consumer Financial Protection ("Bureau") would be created to protect American consumers from unfair, deceptive, and abusive financial products and practices. The Bureau,

Attorney Advertisement

funded by the Federal Reserve System and led by an independent director appointed by the President and confirmed by the Senate, would have the ability to autonomously write consumer protection rules governing all entities that offer consumer financial services or products – banks as well as nonbanks. However, the Bureau would have examination and enforcement power only with respect to banks with more than $10 billion in assets, all mortgage-related businesses, and certain large nonbank financial companies. Banks with assets of $10 billion or less would continue to be examined by their primary banking regulator. In order to increase consumer education, a new Office of Financial Literacy would be created.

The new Bureau would consolidate certain consumer protection responsibilities currently handled by the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA"), and the Federal Trade Commission ("FTC"). The bill requires the Bureau to coordinate with other regulators when examining banks and before issuing new regulations to prevent undue regulatory burden and ensure that such regulation does not conflict with safety and soundness standards. However, other regulators could appeal such regulations to the newly created Financial Stability Oversight Council (*see below*), if they believe that the new regulation would put the safety and soundness of the banking system or the stability of the financial system at risk.

BANK REGULATION

The Proposed Senate Bill intends to streamline bank supervision and establish clear lines of responsibilities as follows:

- The **FDIC** would regulate (i) state banks and thrifts of all sizes; and (ii) bank holding companies of state banks with assets below $50 billion.
- The **OCC** would regulate (i) national banks and federal thrifts of all sizes; and (ii) the holding companies of national banks and federal thrifts with assets below $50 billion. The **OTS** would be eliminated.
- The **Federal Reserve Board** would regulate bank and thrift holding companies with assets of $50 billion or more.

The Proposed Senate Bill would preserve the dual banking system, leaving in place the state banking system that governs most of the nation's community banks.

TRANSPARENCY AND ACCOUNTABILITY FOR DERIVATIVES

The language in the Proposed Senate Bill referring to derivatives is more or less identical to the language in the discussion draft "Restoring American Financial Stability Act" published—and later withdrawn by Senator Dodd in November 2009 ("November Proposal"). Senator Dodd stated in his summary of the Proposed Senate Bill that Senators Jack Reed (D-RI) and Judd Gregg (R-NH) are working on a substitute amendment to be introduced at full committee in the near future. The November Proposal was designed to give the SEC and the CFTC the authority to regulate over-the-counter derivatives and to require central clearing and exchange trading for certain derivatives. Both regulators and the clearing houses would be given a role in determining which contracts should be cleared.

FEDERAL RESERVE ACT 23A

The Proposed Senate Bill would make certain changes to the definition of a covered transaction under Section 23A of the Federal Reserve Act to include securities lending and derivatives transactions with affiliates. However, neither securities lending nor derivatives transactions would be included in the

quantitative limits under Section 23A if they are collateralized by U.S. government and agency securities. The federal bank regulators would have the authority to exempt certain transactions from being covered transactions if such exemption is in the public interest and does not present an unacceptable risk to the Deposit Insurance Fund.

HEDGE FUNDS

Hedge funds that manage over $100 million would be required to register with the SEC as investment advisers and provide information relating to their trades and portfolios, and such information would be shared with the Council. The Proposed Senate Bill would also raise the threshold for investment advisers to be subject to federal regulation from $25 million to $100 million, which would automatically increase the number of state supervised investment advisers.

INSURANCE

A new Office of National Insurance would be created within the Treasury to monitor the insurance industry and coordinate international insurance issues, and the Proposed Senate Bill requires a study on ways to modernize insurance regulation.

CREDIT RATING AGENCIES

A new Office of Credit Rating Agencies would be created within the SEC to strengthen the regulation of credit rating agencies generally and to establish new rules for internal controls, independence, transparency, and penalties for poor performance. Nationally Recognized Statistical Ratings Organizations ("NRSROs") would be examined by the SEC at least annually and would have to disclose their methodologies, use of third parties for due diligence efforts, and rating track records. The SEC would have the right to deregister NRSROs for bad ratings over time. In rating an organization, NRSROs would also be required to consider information from a credible source other than the organization being rated in order to maintain a certain level of independence. Rating analysts would be required to pass qualifying exams and enroll in continuing education.

EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE

Shareholders would be given a "say on pay" with a right to a non-binding vote on executive pay and the SEC would be given the authority to grant shareholders proxy access to nominate directors. Under the Proposed Senate Bill, in order to get listed on an exchange, companies would be required to have compensation committees composed only of independent directors. Public companies would have to establish policies to "claw back" executive compensation if such compensation was based on inaccurate financial statements.

SEC AND INVESTOR PROTECTION

A program within the SEC would be created to encourage individuals to report securities violations. Whistleblowers would be entitled to rewards of up to 30% of the funds recovered based on such information. The Proposed Senate Bill would create an Investment Advisory Council (a committee composed of investors) to advise the SEC on its regulatory priorities and practices, as well as an Office of Investor Advocate to identify areas where investors have significant problems in dealing with the SEC.

Attorney Advertisement

SECURITIZATION

The Proposed Senate Bill would require companies that sell products such as mortgage-backed securities to retain at least 5% of the credit risk, unless the underlying products meet certain standards. Issuers of such

products would also be required to disclose further information about the underlying assets and analyze the quality of the underlying assets.

MUNICIPAL SECURITIES

Municipal financial advisers, swap advisers, and investment brokers would be required to register with the SEC and would be subject to rules issued by the Municipal Securities Rulemaking Board ("MSRB") and enforced by the SEC. The MSRB would consist predominantly of investors and public representatives.

Please note that this is a preliminary overview of the Proposed Senate Bill. We will follow up with additional in-depth alerts and analysis on individual aspects of the Proposed Senate Bill.

The following are links to the legislative summary entitled "Summary: Restoring American Financial Stability" and the Proposed Senate Bill published by the Senate Committee on Banking, Housing and Urban Affairs, as well as Representative Barney Frank's statement:

http://banking.senate.gov/public/_files/FinancialReformSummary231510FINAL.pdf

http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf

http://www.house.gov/apps/list/press/financialsvcs_dem/pr_031510.shtml

Please feel free to contact us if you have any questions:

Henry Fields (213) 892-5275
Mark Gillett (213) 892-5289
Oliver Ireland (202) 778-1614
Barbara R. Mendelson (212) 468-8118
Anna Pinedo (212) 468-8179
Marc-Alain Galeazzi (212) 336-4153
Judy Mok (212) 336-4073