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CCH BRIEFING *Special Report*

Prospects for Financial Legislation in the 112th Congress

Highlights

- ✔ Reform of Fannie and Freddie a High Priority
- ✔ Creation of U.S. Covered Bond Market Possible
- ✔ Dodd-Frank Technical Corrections Bill Expected
- ✔ Substantive Changes to Dodd-Frank Gaining Support
- ✔ PCAOB Seeks Legislation Making Disciplinary Hearings Public
- ✔ FINRA Pushes for Investment Adviser SRO
- ✔ SEC-CFTC Funding Issues Looming

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With a Republican House in the 112th Congress, the legislative agenda for financial regulation will shift somewhat, but there is still an opportunity for reform and regulatory legislation this year. Reform of government-sponsored enterprises, including Fannie Mae and Freddie Mac, is at the top of the financial oversight committees' agenda. In conjunction with the ongoing reform of securitization and the issuance of mortgage-backed securities, there is a strong possibility of legislation creating a U.S. covered bonds market under SEC oversight. In addition, Congress is preparing a Dodd-Frank technical corrections bill, which may well include substantive changes to that historic legislation. There is also a possibility of legislation authorizing a new self-regulatory organization (SRO) for regulated investment advisers.

GSE Reform

There is growing, bipartisan support for reform of government-sponsored enterprises (GSEs), including Fannie Mae and Freddie Mac, as part of the overall reform of the securitized secondary mortgage market. GSE reform has been a special concern of Rep. Spencer Bachus (R-AL), the new chair of the House Financial Services Committee. As part of GSE reform, legislation creating a U.S. covered bond market under SEC supervision would replace the mortgage securitization function that GSEs currently perform. In July 2010, the House Financial Services Committee reported out by voice vote the U.S. Covered Bond Act, HR 5823. The bill had bipartisan support, having been co-sponsored by Rep. Bachus and Rep. Paul Kanjorski (D-PA).

An effort to include GSE reform in the Dodd-Frank Act failed, as House and Senate managers of Dodd-Frank decided to address GSE reform in separate legislation. The McCain-Shelby-Gregg GSE amendment to Dodd-Frank, which was not adopted, would have provided transparency to the conservatorships of the GSEs by establishing investigative oversight. It would also have required the inclusion of Fannie Mae and Freddie Mac in the federal budget while those entities were in conservatorship or receivership status.

Senator Richard Shelby (R-AL), the ranking member on the Banking Committee, has long supported GSE reform legislation. Senator Shelby championed S. 190, the Federal Housing Enterprise Regulatory Reform Act of 2005. Although there was strong support for the legislation and it was favorably reported out of the Banking Committee, it was not enacted. The legislation would have created a two-tier approval process through which the enterprises would need approval before they could offer any new product.

Recently, Chairman Bachus outlined the principles for draft legislation to reform the secondary mortgage market, with a covered bond market as an integral part of the effort. The legislation would wind down GSE operations over a four-year period, sunsetting the current GSE conservatorship and winding down the federal subsidies granted through the GSE charters. The legislation would also introduce full transparency and accountability to the secondary market and reduce leverage by phasing in, over four years, capital requirements consistent with global standards for large, complex financial institutions.

The legislation would create a regulatory safe harbor for mortgages that meet underwriting standards that are consistent with the Federal Reserve Board's final HOEPA rule. This provision is designed to encourage the return of private capital to the mortgage finance market by increasing transparency and giving investors confidence that the loans they purchase meet appropriate underwriting standards. This provision may involve amendments to the Dodd-Frank Act, which establishes only a limited safe harbor from legal liability and provides for expanded assignee liability for mortgages that meet stringent underwriting standards, thereby making it difficult to assess the legal risk of investment in mortgages.

A centerpiece of the Bachus reform legislation is the establishment of a regulatory framework for a U.S. covered bond market. Covered bonds are an innovative source of private mortgage market financing that has worked well in many European countries. They are a private market solution to the need for market participants to have "skin in the game."

A covered bond is a form of debt issued by a financial institution in which a specific set of high-quality assets, typically loans, are set aside into a pool for the bondholders' benefit. The issuers of covered bonds are responsible to their bondholders for the risk posed by the underlying loan pool. For example, if the underlying loans default, bondholders can make claims against the issuer. If the issuer becomes insolvent, bondholders retain a full claim on the loan pool. Additionally, issuers of covered bonds must account on their balance sheets for the risk posed by their bonds.

Chairman Bachus has historically supported this type of legislation. In a letter to then-Senate Banking Committee Chair Christopher Dodd (D-CT), co-signed with Rep. Scott Garrett (R-NJ), the principal author of the covered bond legislation Rep. Bachus said that Congress must consider creative means to enable the private sector to fund additional consumer credit and options for financial institutions to finance their operations. Establishing a U.S. covered bond market, according to the representatives, would further each of these shared policy goals. The letter also noted that a robust U.S. covered bond market would provide a significant source of much-needed liquidity for home mortgages, commercial real estate, student loans and public sector financing.

Covered bonds have been used in Europe to help provide additional funding options for the issuing institutions and are a major source of liquidity for many European nations' mortgage markets. The legislation would seek to provide the same benefits to the U.S. market. In Europe, covered bonds are subject to extensive regulation designed to protect the interests of investors from the risks of insolvency of the issuer. The United States does not currently have these statutory and regulatory regimes. It is likely that the legislation would provide for the regulatory oversight of covered bond programs, including provisions for default and insolvency of covered bond issuers, and would subject covered bonds to appropriate federal securities regulation.

The covered bond provisions narrowly missed being included in the Dodd-Frank Act. The Garrett provisions were supported in conference by Sen. Dodd, who had scheduled hearings on the covered bond legislation. At the hearings, Sen. Dodd said that covered bonds can provide an alternative to the two dominant funding mechanisms in the U.S. marketplace, which are securitization and the traditional portfolio-lender model where a bank holds mortgages on its balance sheet and funds them with deposits. He added that the proponents of covered bonds point to their greater transparency, because the assets covering the bonds remain on a bank's balance sheet. Proponents also note that issuers of covered bonds have a long-term interest in the underlying loans because their presence on the balance sheet increases investor confidence.

Senator Dodd said that legislation and agency rulemaking on covered bonds are needed to clarify how covered bonds would be regulated. The legislation would define the rights and responsibilities of investors, issuers and regulators. Among other things, the legislation would spell out the treatment of covered bonds should the issuer go into conservatorship or receivership.

The FDIC supports balanced covered bond legislation based on three key principles. First, the legislation should clarify the rights and responsibilities of investors, issuers and regulators. Second, it should ensure that investment risks will not be transferred to the public sector. Third, any changes should remain consistent with longstanding U.S. law and policy for secured creditors. According to the agency, the legislation should establish a regulatory framework for the appropriate federal regulators to jointly establish standards for covered bond issuances by regulated institutions. [Testimony of Michael Krimminger, Deputy to the FDIC Chairman, before Senate Banking Committee (Sept. 15, 2010)]

Representative Judy Biggert (R-IL) has introduced the Fannie Mae and Freddie Mac Accountability and Transparency for Taxpayers Act of 2011 (HR 31). The bill would enhance federal oversight of Fannie Mae and Freddie Mac by requiring the inspector general of the Federal Housing Finance Agency to submit quarterly reports to Congress during the conservatorship of the two GSEs. During the recent financial meltdown, explained Rep. Biggert, taxpayers were forced to take on the costs and risks associated with the GSEs, an estimated cost of $150 billion. The legislation would require the GSE inspector general to submit regular reports to Congress outlining taxpayer liabilities, investment decisions and management details of Fannie Mae and Freddie Mac. The bill would also require public availability of these reports, along with a system to report waste, fraud or abuse.

Dodd-Frank Act

At the same time that Congress is preparing a Dodd-Frank technical corrections bill, some members have expressed concern that the regulatory deadlines in Dodd-Frank, particularly those relating to derivatives, are too ambitious. Other substantive changes may also be advanced, either as part of the technical corrections legislation or separately.

Derivatives regulation

Chairman Bachus has questioned the direction and pace of the SEC-CFTC efforts to implement the derivatives regulatory regime mandated by the Dodd-Frank Act. In a recent letter to SEC Chair Mary Schapiro and CFTC Chair Gary Gensler, Chairman Bachus warned that derivatives regulations adopted hastily and without due care could damage the economy. He said that Congress will consider legislation to delay the statutory deadlines in Dodd-Frank if that will allow the SEC and CFTC to move deliberately and carefully to ensure that the derivatives regulatory regime is correctly implemented. More broadly, he warned that creating a prohibitively expensive and rigid market for using and trading derivatives in the United States could shift the market overseas. The Chairman's concern essentially raised the specter of regulatory arbitrage. The letter was co-signed by Rep. Frank Lucas (R-OK), chair of the House Agriculture Committee.

Regulatory arbitrage is also a concern for Chairman Bachus in connection with the Volcker provisions of Dodd-Frank. He has noted that any Volcker Rule regulations adopted by U.S. financial regulators must be set against the international regulatory framework so as not to foster regulatory arbitrage and not unfairly affect U.S. financial firms. In the view of Chairman Bachus, the Volcker provisions collide with the European universal banking model, a system that the European Union is unlikely to abandon in the spirit of regulatory harmonization. European Central Bank members have noted that the Volcker Rule is incompatible with the universal banking model, which allows all banks to offer all banking services, and could have the unintended consequence of banning activities that might mitigate risk.

In the letter to the SEC and CFTC on derivatives regulation, Chairman Bachus, alluding to the earlier Dodd-Lincoln letter and a House colloquy between Rep. Barney Frank (D-MA) and Rep. Collin Peterson (D-MN), stressed that is critical that the SEC and CFTC implement the commercial end-user exemption consistently with legislative intent and allow companies to hedge legitimate business risks. For example, end users must not have to post margin, he said, and must be able to rely on their exemption from clearing and trading rules without having to overcome "unnecessary bureaucratic obstacles." He also cautioned the SEC and CFTC against applying margin to existing derivatives contracts, because doing so would upset the rational expectations of thousands of end users.

In addition, Chairman Bachus urged the commissions to consider carefully the scope of the definitions of "swap dealer," "security-based swap dealer," "major swap participant" and "security-based swap participant." Overly broad definitions, he warned, could force smaller participants to leave the market and eliminate some types of hedging contracts, thereby exposing businesses to market volatility.

Noting that they are unlike other derivatives regulated by Dodd-Frank, Chairman Bachus said it is vital that foreign exchange swaps and forward contracts be exempted from Dodd-Frank's clearing and exchange trading rules. He predicted that an already stable foreign exchange swap market would become more transparent with the imposition of Dodd-Frank reporting rules.

Chairman Bachus also warned that implementing real-time reporting and trade execution requirements without adequate safeguards could increase the price of derivatives contracts to hedge risk by facilitating speculative front running. Although recognizing that the SEC and CFTC must have real-time access to derivatives data, Chairman Bachus argued that mandating real-time reporting of thinly-traded products in illiquid markets in an effort to force derivatives to trade similarly to exchange-traded products is a fundamentally flawed approach.

At the time the Dodd-Frank Act was passed by the House, Rep. Bachus and Rep. Randy Neugebauer (R-TX), chair of the Subcommittee on Oversight and Investigations, favored an alternative derivatives regulatory regime whose centerpiece would have been a comprehensive OTC derivatives trade repository that would provide transparency to the market, helping regulators analyze appropriate data to detect and prevent fraud. It would also help regulators understand and analyze counterparty exposures in order to prevent excessive risks from building up within the system.

The Bachus-Neugebauer alternative would also have required regulators to review market data and report back to Congress if they identified an entity not already regulated by a prudential regulator that should be more heavily regulated based on its size or activities in the OTC derivatives markets.

Interchange fees

The interchange fee provisions of Dodd-Frank may also become the subject of new legislation. Authored by Sen. Richard Durbin (D-IL), Dodd-Frank Section 1075 requires that the Federal Reserve issue three final rules on interchange fees reflecting a reasonable and proportional debit fee structure, fees for fraud prevention on debit transactions, and debit-transaction network fees. Issuers with less than $10 billion in assets are statutorily exempt from the new debit fee rules.

Thirteen U.S. senators, including leading members of the Banking Committee, have expressed concern with the consequences of replacing a market-based system for debit card acceptance with a government-controlled system pursuant to Dodd-Frank Act Section 1075. In a bipartisan letter to Fed Chair Ben Bernanke, the senators argued that having the government fix prices in any venue would be inappropriate. As the Fed implements Section 1075, the senators want to ensure that all costs to the issuers and economic value to the merchants are considered in the regulations. The senators urged the Fed to take the time to consider all the implications of implementing Section 1075 and exercise the discretion granted by Dodd-Frank to minimize negative consequences. The letter was signed by Sen. Richard Shelby (R-AL), the Banking Committee's ranking member, and two influential members of the committee, Sen. Mark Warner (D-VA) and Sen. Bob Corker (R-TN). In his own letter to the Fed, Chairman Bachus expressed concern that the small-issuer exemption may put small issuers like community banks and credit unions at a competitive disadvantage.

PCAOB Disciplinary Proceedings

Another piece of probable legislation with apparent bipartisan support involves the reform of PCAOB procedures. The PCAOB has requested legislation amending the Sarbanes-Oxley Act so that Board disciplinary hearings against individual auditors and accounting firms will be public. Currently the entire proceeding—from the initiation of the PCAOB disciplinary proceeding through the SEC decision to let the sanctions commence—takes place behind closed doors. The closed nature of Board disciplinary proceedings stands in sharp contrast to similar SEC proceedings against auditors. The draft legislation would make PCAOB disciplinary proceedings public when the Board decides that the evidence gathered in an investigation warrants charging a firm or individual with a violation, while at the same time maintaining existing confidentiality of Board inspections. The legislation would also retain the PCAOB's flexibility to order nonpublic proceedings if appropriate.

In the Board's view, the requirement of nonpublic proceedings prevents litigated proceedings from coming to light until long after the information would be most relevant to investors, auditors and other interested parties. The need to prepare for and staff litigation also consumes substantial resources that otherwise could be devoted to other important investigative work by the Board's enforcement program. Because the Act's nonpublic proceedings shroud the results of a vast portion of the Board's investigative work, the PCAOB's enforcement program cannot fully satisfy its investor-protection objectives. Thus, this legislation is becoming an imperative for the Board.

Agency Funding

The 112th Congress must also address the funding need of federal financial regulators charged with implementing the mandates of the Dodd-Frank Act. The 111th Congress was unable to pass the Consolidated Appropriations Act for fiscal year 2011 and instead passed a Continuing Resolution to keep the federal government running until March 4, 2011. Under the resolution, funding for most programs would continue at levels enacted for FY 2010.

A measure passed by the House in the 111th Congress, but not agreed to by the Senate, to fund the government in FY 2011 would have boosted SEC and CFTC funding so that the agencies could carry out their Dodd-Frank mandates. The House Appropriations Committee was trying to provide the SEC and CFTC with the resources necessary to combat the financial fraud and excessive risk-taking that provoked the 2008 financial crisis.

Under that measure, the SEC would have been funded at $1.25 billion under the House Continuing Resolution. The President had requested a total of $1.258 billion for the SEC in FY 2011, a 12-percent increase over the FY 2010 funding level. In testimony before the Senate Appropriations Committee, SEC Chair Mary Schapiro stated that, if enacted, the requested amount would permit the Commission to hire an additional 374 professionals, a 10-percent increase over FY 2010. That would bring the total number of staff to about 4,200.

In the Enforcement Division, the budget request would have enabled the SEC to add about 130 new full-time employees so it could reinforce its investigations process, support more cases, and strengthen the intelligence-analysis function. Similarly, in the Examinations unit, the budget request would have allowed the SEC to add about 70 staff members to increase the number of examiners to keep pace with the growing number of registered firms the Commission must oversee. The request would also have permitted the SEC to continue expanding its investments in surveillance, risk analysis and other technology, as well as support better training for SEC staff. The SEC Chair noted that the proposed increase in spending would be fully offset by the fees the Commission collects on transactions and registrations. In FY 2011, the SEC estimates that it will collect $1.7 billion, an increase of $220 million over FY 2010.

The President also had requested $261 million for the CFTC in his FY 2011 budget, including $216 million and 745 full-time employees for pre–Dodd-Frank authorities and $45 million to provide half of the estimated staff needed to implement Dodd-Frank. The House matched the President's request with a $261 million appropriation for the CFTC.

At recent hearings, CFTC Chair Gary Gensler told the Senate Banking Committee that the CFTC requires additional resources to enhance its surveillance program, prevent market disruptions and implement the Dodd-Frank Act. He said that the CFTC will require approximately 400 new staff members over the level needed to fulfill its pre-Dodd-Frank mission.

Because of this budgetary and funding uncertainty, the SEC has postponed its plans to create and staff the Whistleblower Office and five other new offices mandated by the Dodd-Frank Act. The functions that were to be performed by the Whistleblower Office, mandated by Section 924, have been temporarily assigned to existing Division of Enforcement staff. Similarly, the creation and staffing of the Office of Investor Advocate, mandated by Dodd-Frank Act Section 915, has been deferred. The Office of Women and Minority Inclusion, mandated by Section 342, has also been deferred. In addition, the new Office of Credit Ratings, created by Section 932, will not be staffed at this time. Finally, the new Investor Advisory Committee mandated by Section 911 will not be created until the budgetary uncertainty is resolved.

SRO for Investment Advisers

Section 914 of the Dodd-Frank Act requires the SEC to review and analyze the need for enhanced examination and enforcement resources for investment advisers, revise its regulations as necessary, and report to Congress on regulatory or legislative steps necessary to address concerns identified in its study.

In a letter to the SEC, FINRA said that, given the Commission's funding limits, it is unlikely that the SEC will be able to accomplish more frequent adviser examinations on its own. To deal with what it called an "intractable resource problem," FINRA urged the SEC to seek legislative authority to establish an SRO for investment advisers to augment the government's efforts in overseeing advisers.

Industry associations have voiced strong opposition to the idea of an SRO for advisers. For example, in a letter to the SEC, the Investment Company Institute said that the SRO model is inappropriate for the oversight of the principles-based system of adviser regulation, which is critically important to protect the fiduciary culture of the adviser industry. The advisory experience is not readily transferable to the prescriptive, rules-based model that works best in the SRO context, noted the ICI. Further, the conflicts of interest inherent in industry self-regulation, or even the illusion of such conflicts, could harm the public perception of investment advisers.

About the Author

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of the Dodd-Frank Act. His analysis of that legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis, is widely read. His earlier analysis of the Sarbanes-Oxley Act, the Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules, is considered a definitive explanation of the Act. His other works include the popular guidebook Responsibilities of Corporate Officers and Directors under Federal Securities Law, the Guide to Internal Controls, and the monthly newsletter Hedge Funds and Private Equity: Regulatory and Risk Management Update. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the CCH Federal Securities Law Reporter. Hamilton received an LL.M. from New York University School of Law.

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