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CCH BRIEFING *Special Report*

Senate Passes Sweeping Financial Reform Bill

Highlights

- ✔ Financial Stability Oversight Council established as systemic risk regulator
- ✔ Resolution authority created to dismantle large, failing financial institutions
- ✔ Office of Thrift Supervision abolished, functions transferred
- ✔ Deposit insurance reform addressed
- ✔ OTC derivatives markets brought under harmonized SEC-CFTC oversight
- ✔ Credit rating agencies reformed to eliminate conflicts of interest and increase transparency
- ✔ Hedge fund advisers subjected to registration
- ✔ Holding company and bank regulation supervision tied to financial stability
- ✔ Office of National Insurance created
- ✔ Shareholder advisory vote on executive compensation mandated
- ✔ SEC enforcement powers expanded
- ✔ Consumer Financial Protection Bureau established

Inside

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On May 20, 2010, the U.S. Senate passed legislation to restructure the financial services regulatory system by a vote of 59 to 39. As discussed in this briefing paper, the Restoring American Financial Stability Act of 2010 (S 3217, the Senate version of H.R. 4173) would institute far-reaching reforms, including the creation of an independent Consumer Financial Protection Bureau housed within the Federal Reserve Board and new federal government power to wind down large, failing financial institutions. The bill would establish a nine-member Financial Services Oversight Council to oversee systemic risk, strengthen regulation of financial holding companies and abolish the Office of Thrift Supervision, transferring its functions to the Fed, Office of the Comptroller of the Currency and Federal Deposit Insurance Corp.

Other provisions of the bill would establish strict oversight of the derivatives market, including mandatory clearing and trading and real-time reporting of derivatives trades. It further calls for banks to spin off their derivatives activities. The legislation would also allow the Government Accountability Office to conduct a one-time audit of the Fed's emergency lending activities during the financial crisis and would establish the Office of National Insurance to supervise insurance products, other than health insurance, at the federal level. Among other measures, the bill would institute numerous investor protections, including stricter oversight of credit rating agencies, shareholder "say on pay," and expanded SEC enforcement powers.

Systemic Risk Regulator

Title I, Subtitle A, would create an independent agency charged with monitoring and responding to systemic risks posed by large, complex companies, products and activities. The new Financial Stability Oversight Council, chaired by the Treasury Secretary and composed of key regulators such as the Fed, OCC, FDIC, SEC and CFTC, would have the following enumerated purposes: (1) identifying risks to U.S. financial stability that could arise from the financial distress or failure of large, interconnected bank holding companies or nonbank financial companies; (2) promoting market discipline by eliminating expectations on the part of shareholders, creditors and counterparties of those companies that the government will shield them from losses in the event of failure; and (3) responding to emerging threats to the stability of U.S. financial markets.

Section 113 provides that the Council, by a two-thirds vote, can determine that a nonbank financial company will be supervised by the Fed and be subject to heightened prudential standards if the Council determines that material financial distress at the financial company would pose a threat to U.S. financial stability. Each determination will be based on a

consideration of enumerated factors by the Council, including, among others, the degree of leverage (e.g., a typical mutual fund could be an example of a nonbank financial company with a low degree of leverage); the amount and nature of financial assets; the amount and types of liabilities, including degree of reliance on short-term funding; the extent and type of off-balance-sheet exposures; the extent to which assets are managed rather than owned; and the extent to which ownership of assets under management is diffuse.

Size alone should not be dispositive in the Council's determination. In its consideration of the enumerated factors, the Council should also consider other indicia of the overall risk posed to U.S. financial stability, including the extent of the nonbank financial company's connections with other significant financial companies and the complexity of the nonbank financial company. The Senate Committee report notes that a Council determination should not be based on the exchange functions of securities or futures exchanges regulated by the SEC and the CFTC, to the extent that as part of these functions the exchanges act as administrators of marketplaces and not as counterparties.

Further, it is not intended that the activities of securities and futures exchanges overseen by the SEC and the CFTC that consist of, or occur prior to, trade executions be considered a clearing, settlement or payment business, provided that the activities do not include functioning as a counterparty (Senate Banking Committee Report, p. 42). This interpretation dovetails with House legislative history, which indicates that, although derivatives and securities exchanges would technically meet the definition of a "financial company" under Title I, the House intended the legislation to address the players in the marketplace rather than the administration of the marketplace (Peterson-Frank colloquy, Cong. Record, Dec. 9, 2009, H14425).

The Council would provide written notice to each nonbank financial company of its proposed determination and the company will have the opportunity for a hearing before the Council to contest the proposed determination. The Council would consult with the SEC or other primary federal regulator of each nonbank financial company before making any final determination. The Act also provides for judicial review of the Council's final determination. In the case of a foreign nonbank financial company, it is intended that the Council will consult, as appropriate, with the applicable foreign regulator for the company.

Under Section 115, the Council may make recommendations to the Fed concerning the establishment and refinement of prudential standards and reporting and disclosure requirements for: (1) nonbank financial companies supervised by the Fed under a determination that they pose a systemic risk; and (2) large, interconnected bank holding companies. The standards and requirements must be more stringent than those applicable to other nonbank financial companies and bank holding companies that do not present similar risks to financial stability, and they must increase in stringency as appropriate in relation to certain characteristics of the company, including its size and complexity. The Council may only recommend standards for bank holding companies with total consolidated assets of $50 billion or more, and the Council may recommend an asset threshold greater than $50 billion for the applicability of any particular standard.

Section 115(b) provides that the prudential standards may include risk-based capital requirements, leverage limits, liquidity requirements, a contingent capital requirement, resolution plan and credit exposure report requirements, concentration limits, enhanced public disclosures and overall risk-management requirements. Contingent capital is a special form of debt that, when a company gets into trouble, will immediately convert into equity on previously negotiated terms, thus causing the firm to be recapitalized without requiring public funds.

Under Section 117, a bank holding company that could pose a risk to U.S. financial stability if it experienced material financial distress would remain supervised by the Federal Reserve Board and subject to the prudential standards authorized by the legislation even if it sold or closed its bank (Senate Banking Committee Report, p. 43).

Section 119 requires the Council to resolve disputes among member agencies about the respective jurisdiction over a particular financial company, activity or product if the agencies cannot resolve the dispute without the Council's intervention. The Council's written decision is binding on the member agencies that are parties to the dispute (Senate Banking Committee Report, p. 43).

Under Section 120, the Council may issue recommendations to the primary financial regulatory agencies to apply new or heightened prudential standards and safeguards for a financial activity or practice conducted by bank holding companies or nonbank financial companies under their jurisdiction. The Council would make this recommendation if it determines that the conduct of the activity or practice could create or increase the risk of significant liquidity, credit or other problems spreading among banks and nonbank financial companies or U.S. financial markets. The Council would consult with the primary financial regulatory agencies, provide notice and opportunity for comment on any

proposed recommendations, and consider the effect of any recommendation on costs to long-term economic growth. The Council may recommend specific actions to apply to the conduct of a financial activity or practice, including limits on scope or additional capital and risk-management requirements.

Section 121 authorizes regulators to address grave threats to U.S. financial stability if the prudential standards would not otherwise do so. For example, regulators can require financial institutions to comply with conditions on the conduct of certain activities, terminate certain activities, or sell or transfer assets to unaffiliated entities, with an affirmative vote of two thirds of the Council members and after notice and the opportunity for a hearing.

Office of Financial Research

Title I, Subtitle B, would establish an executive agency to collect and standardize data on financial firms and their activities to aid and support the work of the federal financial regulators. The Office of Financial Research, headed by a director appointed by the president for a six-year term, would provide the Council and financial regulators with the data and analytic tools needed to prevent and contain future financial crises by measuring and monitoring systemic risk. The logic behind the Office is that it makes no sense to create a systemic risk regulator when there are no standardized tools for measuring systemic risk.

Comment: *The Office is patterned on an executive agency envisioned by the National Institute of Finance Act of 2010, S 3005, sponsored by Senator Jack Reed, Chair of the Securities Subcommittee.*

The Office would not only develop the metrics and tools financial regulators need to monitor systemic risk, it would also help policymakers by conducting studies and providing advice on the impact of government policies on systemic risk. Thus, the Office would have to provide independent periodic reports to Congress on the state of the financial system. This will ensure that Congress is kept apprised of the overall picture of the financial markets. Section 154(b) provides for the Office to house a data center that would collect, validate and maintain key data to perform its mission.

Resolution Authority

Title II would establish an orderly liquidation authority for large, failing financial institutions. This authority would give the U.S. government a viable alternative to the undesirable choice it faced during the financial crisis: (1) allow a large, complex financial company to file for bankruptcy protection, disrupting markets and damaging the economy; or (2) bail out the company, exposing taxpayers to losses and undermining market discipline. The new orderly liquidation authority would allow the FDIC to safely unwind a failing nonbank financial firms or bank holding companies, an option that was not available during the financial crisis. The process includes several steps intended to discourage the use of this authority. There is a strong presumption that the Bankruptcy Code will continue to apply to most failing financial companies.

Once a failing financial company is placed under this authority, liquidation is the only option; the failing company cannot be kept open or rehabilitated. The firm's business operations and assets will be sold off or liquidated, the culpable management will be discharged, shareholders will have their investments wiped out, and unsecured creditors and counterparties will bear losses.

The Dodd-Shelby Amendment, in conjunction with the Boxer Amendment, ends the idea that any firm can be too big to fail. Under the Dodd-Shelby Amendment, the legislation creates an orderly liquidation mechanism for the FDIC to unwind failing systemically significant financial companies. This mechanism represents a fundamental change in federal law that will protect taxpayers from the economic fallout of the collapse of a systemically significant financial firm (Remarks of Sen. Chris Dodd, Cong Record, May 5, 2010, S3131).

Shareholders and unsecured creditors would still bear losses and management at the failed firm would be removed. In fact, the Dodd-Shelby Amendment empowers regulators to bar culpable management and directors of failed firms from working in the financial sector. According to Senator Dodd, it makes sense that a person involved in a company's mismanagement who caused a disruption in the economy should be banned from engaging in further economic activities (Senator Chris Dodd, Cong Record, May 5, 2010, S3131).

Subject to due process protections, Section 212 authorizes regulators to ban from the financial industry senior executives and directors at failed financial firms upon determining that they: (1) violated a law, regulation, cease-and-desist order or agreement with a federal financial regulator; (2) breached their fiduciary duty; or (3) engaged in an unsafe or unsound practices. In addition, the executive or director must have benefited from the violation or breach, which must also involve personal dishonesty or a willful or continuing disregard for the firm's safety or soundness. The length of the

industry ban is in the regulator's discretion, but must be at least two years.

There would also be clawbacks of excess payments to creditors, such that creditors would have to pay back the government any amounts they received above what they would have received in liquidation.

Congress must approve the use of debt guarantees by the Fed or Treasury. The Fed can only use its Section 13(3) emergency lending authority to help solvent companies.

The Boxer Amendment eliminates any doubt that the legislation would end federal bailouts of financial firms. Specifically, the provision states that all financial companies put into receivership under the legislation must be liquidated and no taxpayer funds can be used to prevent their liquidation. Further, all funds expended in the liquidation must be recovered from the disposition of the firm's assets, or must be the responsibility of the financial sector through assessments (See remarks of Senator Boxer, Cong. Record, May 4, 2010, S3063).

Supervision of Depository Institutions

Title III, "The Enhancing Financial Institution Safety and Soundness Act of 2010," would eliminate the Office of Thrift Supervision (OTS), transferring its regulatory and rulemaking authority to the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (Fed), primarily, with some functions being absorbed by the Federal Deposit Insurance Corporation (FDIC). In addition, no new federal savings association charters would be allowed. The state thrift charter would not be impacted, however, and no new limits would be placed on existing federal thrifts or their owners.

Transfer Date

The Act's provisions would generally take effect one year after the date of enactment of the Act. This effective date is defined in the Act as the "transfer date." The Act allows for the transfer date to be extended up to 18 months past the date of enactment by the Treasury Secretary, in consultation with the heads of the OCC, Fed and FDIC.

OTS Abolished

The Act would abolish the OTS and the position of Director of the OTS. The abolition would be effective 90 days after the transfer date, pursuant to an amendment sponsored by Sen. Kay Bailey Hutchison, R-Texas.

The OTS is responsible for regulating state and federal thrifts and their holding companies. Explaining the reasons for abolishing the agency, the Senate Banking Committee found that savings and loan associations suffered disproportionate losses during the financial crisis, due in part to lax supervision by the OTS. The most serious of these losses were the failures of mortgage giants Washington Mutual and Indy Mac Bank and the near-failure, but for federal assistance, of American International Group. Moreover, from the start of 2008 through the date the Act was introduced, the Committee found that 73 percent of failed institution assets were attributable to thrifts regulated by the OTS, even though the agency only supervised 12 percent of all financial institution assets at the beginning of the period.

Comment: *The House of Representatives version of financial reform also would abolish the OTS and the position of the Director of the OTS, but it would do so by creating a new Division of Thrift Supervision, headed by a new Senior Deputy Comptroller for Thrift Supervision, within the OCC.*

No New Federal Thrift Charters

Under the Act, no new federal thrift charters would be allowed. Regulation for existing federal savings and loan associations and their holding companies would be divided among the OCC, Fed and FDIC.

Comment: *The House version of H.R. 4173 would leave the thrift charter as a viable option for organization as a financial institution.*

OTS Functions Transferred

All functions of the OTS would be transferred to the OCC, Fed and FDIC.

The Act, as originally drafted by Senate Banking Committee Chairman Chris Dodd, D-Conn., called for a shift in the regulation of financial holding companies. The Dodd version called for all national bank and federal savings and loan holding companies with total consolidated assets of less than $50 billion (the threshold for being designated a "systemically significant firm") to be supervised by the OCC, rather than the Fed or OTS, respectively, and for state member banks and thrifts to be supervised by the FDIC, rather than the Fed. Thus, all bank and thrift holding companies with less than $50 billion in total consolidated assets would have experienced a change in their

primary federal regulator at the holding company level. However, the Hutchison amendment restored the Fed's regulatory dominion over financial holding companies. Thus, the major changes with respect to bank supervision in the Senate bill, in addition to provisions for "systemically significant firms," deal with the abolition of the OTS and the transfer of its regulatory and rulemaking authority.

Under the Act, as amended, the Fed would acquire regulatory and rulemaking authority over thrift holding companies, in addition to its present oversight of national and state bank holding companies, state member banks and certain other entities.

The OCC would supervise federal savings associations, adding to its present oversight of national banks and federal branches and agencies of foreign banks. The FDIC would supervise federally insured state nonmember banks, insured branches of foreign banks and state-chartered savings associations.

In addition, all rulemaking authority of the OTS and the Director of the OTS under section 11 of the Home Owners' Loan Act (HOLA) (12 U.S.C. 1468), relating to transactions with affiliates and extensions of credit to executive officers, directors and principal shareholders, and under section 5(q) of HOLA, relating to tying arrangements would be transferred to the Fed. The OCC would receive all rulemaking authority of the OTS and the Director of the OTS relating to savings associations.

Comment: *The House version of H.R. 4173 differs significantly in its restructuring of depository institution supervision. All powers, authorities, rights and duties that were invested in the Director of the OTS would transfer to the OCC under the House version, with three exceptions:*

1. *powers, rights, authorities and duties pertaining to savings and loan holding companies and their affiliates would transfer to the FDIC;*
2. *powers, rights, authorities and duties pertaining to savings and loan holding companies that are, on a consolidated basis, predominantly engaged in the business of insurance would transfer to the Federal Reserve Board; and*
3. *consumer financial protection functions of both the OTS and OCC would shift to the new Consumer Financial Protection Agency.*

Agency Funding

The Hutchison amendment would alter language in the original bill with regard to how each agency is funded. The Comptroller of the Currency would be authorized to collect an assessment, fee or other charge from any entity the OCC supervises as necessary to carry out its responsibilities, including with respect to holding companies, federal thrifts and non-bank affiliates (that are not functionally regulated) that engage in bank permissible activities. In establishing the amount of the assessment, fee or other charge collected from an entity, the OCC may take into account the funds transferred to the OCC, the nature and scope of the activities of the entity, the amount and types of assets held by the entity, the financial and managerial condition of the entity and any other factor that the OCC deems appropriate.

The Fed would be directed to collect assessments, fees and other charges that are equal to the expenses incurred by the Fed to carry out its responsibilities with respect to such companies from: (1) bank holding companies and savings and loan holding companies with assets equal to or greater than $50 billion; and (2) all non-bank financial companies supervised by the Fed under sec. 113.

The FDIC also would be authorized to charge for its supervision of non-bank affiliates.

OTS Regulations Continued

All regulations promulgated by the OTS would remain in effect and be transferred to the Fed, OCC and FDIC, as appropriate. By the transfer date, the Fed, OCC and FDIC, in consultation with one another, would be required to determine the existing OTS regulations that will be enforced by each agency and publish those regulations in the *Federal Register*.

In addition, all orders, resolutions, determinations, agreements, interpretative rules, other interpretations, guidelines, procedures and other advisory materials that have been issued, made, prescribed or allowed to become effective by the OTS that would be transferred by the Act, and that are in effect on the day before the transfer date, would continue in effect according to the terms of those materials and would be enforceable by or against the Fed, OCC or FDIC, as appropriate, until modified, terminated, set aside or superseded in accordance with applicable law by the appropriate agency, by any court of competent jurisdiction or by operation of law.

Federal Deposit Insurance Corporation

Subtitle C to Title III of the Act seeks to address deposit insurance reform and make technical amendments to the provisions of the Federal Deposit Insurance Act (FDIA) relating to the composition of the Board of Directors of the Federal Deposit Insurance Corp. (FDIC).

The Act would repeal a provision in the FDIA that states no institution may be denied the lowest-risk category solely because of its size.

Comment: *H.R. 4173 provides a similar amendment.*

The FDIC also would be directed to amend its regulations to define the term "assessment base" of an insured depository institution for purposes of deposit insurance assessments as the average total assets of the insured depository institution during the assessment period, minus the sum of the average tangible equity of the insured depository institution during the assessment period and the average long-term unsecured debt of the insured depository institution during the assessment period.

Comment: *H.R. 4173 provides a different formula for calculating the "assessment base."*

Although the FDIC would be required to amend the definition of "assessment base" using the statutorily prescribed definition, the agency could submit a written finding to the Senate Banking Committee and House Financial Services Committee indicating that the revised regulatory definition of "assessment base" would reduce the effectiveness of the FDIC's risk-based assessment system or increase the risk of loss to the Deposit Insurance Fund and retain the definition of the term "assessment base," as in effect on the day before the date of enactment of the Act.

Section 332 of the Restoring American Financial Stability Act of 2010 would replace the position of the Director of the Office of Thrift Supervision on the Board of Directors of the FDIC with the Director of the Consumer Financial Protection Bureau.

Hedge Fund Advisers

Title IV of the Senate legislation would subject advisers to hedge funds and other private funds to SEC registration and disclosure requirements. Section 403 would bring private fund advisers under SEC regulation by eliminating the exemption in Advisers Act Section 203(b)(3) for advisers with fewer than 15 clients. Under current law, a hedge fund is counted as a single client, allowing hedge fund advisers to avoid SEC registration.

Under Section 404, the SEC must require advisers to private funds to file specific reports, which the Commission must share with the Financial Stability Oversight Council. The filings must describe the amount of assets under management, use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies, types of assets held and other information that the SEC, in consultation with the Council, determines is necessary and appropriate to protect investors or assess systemic risk. Reporting requirements may be tailored to the type or size of the private fund. Frequency of reporting is at the SEC's discretion.

The SEC would have to make available to the Financial Stability Oversight Council any private fund records it receives that the Council considers necessary to assess the systemic risk posed by a private fund. These records must be kept confidential, and the Council must observe the same standards of confidentiality that apply to the SEC. Private fund records, including those containing proprietary information, are not subject to disclosure pursuant to the Freedom of Information Act. The SEC must also report annually to Congress on how it has used information collected from private funds to monitor markets for the protection of investors and market integrity. The Commission may require investment advisers to disclose the identity, investments or affairs of any client, if necessary to assess potential systemic risk.

Section 410 would raise the asset threshold above which advisers must register with the SEC from the $25 million set in 1996 by the National Securities Markets Improvement Act to $100 million. States would have responsibility for regulating advisers with less than $100 million in assets under management. A primary reason for raising the asset-under-management threshold is to allow the SEC to focus its examination and enforcement resources on the largest advisers and thus improve its record in uncovering major cases of investment fraud.

Exemptions and Exclusions

Section 403 would exempt foreign private advisers and provides a limited intrastate exemption. It also contains an exemption for small business investment companies licensed by the Small Business Administration. Section 407 would exempt venture capital fund advisers and also unleveraged private equity funds whose activities do not pose risks to the financial markets through credit or counterparty relationships.

Section 409 codifies the SEC's longstanding position on family offices by excluding them from the definition of "investment adviser" under Advisers Act Section 202(a)(11). Family offices provide investment advice in the course of managing the investments and financial affairs of one or more generations of a single family. Since passage of the Advisers Act, the SEC has issued orders to family offices declaring that they are not investment advisers within the statute's intent and therefore need not

register. Under Section 409, the SEC must adopt rules defining "family offices" for purposes of the exemption that are consistent with the Commission's previous policy and that consider the range of organizational and employment structures used by family offices.

Accredited Investors

A person must have accredited investor status, defined in SEC regulations, to invest in hedge funds and other private securities offerings. Accredited investors are presumed to be sophisticated and therefore not in need of the investor protections afforded by SEC registration and disclosure requirements. Section 412 would raise the net worth needed to attain accredited investor status by making the test $1 million of net worth, *excluding* the person's primary residence. The current test *includes* the primary residence in the net worth threshold and directs the SEC to adjust the figure upward for inflation, if warranted, when the SEC conducts a review in four years and every four years thereafter. For the next four years, the net worth number would remain $1 million.

The provision also directs the SEC, four years after enactment, and once every four years thereafter, to review the definition of accredited investor to determine whether the requirements of the definition should be modified for the protection of investors, in the public interest, and in light of the economy. After completing the review, the SEC may revise the definition.

Office of National Insurance

To promote national coordination in the insurance sector, an Office of National Insurance would be created within the Treasury Department with authority over all types of insurance, other than health insurance, under Title V. The Office would not be accompanied by the establishment of a national insurance charter. Its principal functions would be to:

- monitor the insurance industry, with the authority to gather information and issue reports;
- identify issues or gaps in the regulation of insurers that could contribute to a systemic crisis;
- recommend which insurance companies should be designated as an entity subject to regulation as a nonbank financial company supervised by the Board of Governors pursuant to Title I;
- recommend which insurance companies should be subject to stricter standards;
- assist in the administration of the Terrorism Insurance Program;
- coordinate international insurance issues;
- determine whether state insurance measures are preempted by international insurance measures;
- consult with states regarding insurance matters of national and international importance; and
- conduct a study on ways to modernize insurance regulation and provide Congress with recommendations.

Subpoena power. The Office would have the power to subpoena information from insurers that is required to carry out the functions of the Office. Prior to issuing a subpoena, the Office must coordinate with the relevant state insurance regulator to determine if the information is available from the regulator or publicly available sources.

International agreements. The Treasury Secretary would be authorized to negotiate and enter into International Insurance Agreements on Prudential Measures with foreign entities, subject to consultation with the United States Trade Representative. An "International Insurance Agreement on Prudential Measures" is a written bilateral or multilateral agreement entered into between the United States and a foreign government, authority or regulatory entity regarding prudential measures applicable to the business of insurance or reinsurance.

Preemption. In carrying out its duties that relate to international insurance, the Office would have limited authority to declare that inconsistent state laws or regulations are preempted. A state insurance measure would be preempted if it results in less favorable treatment of a non-United States insurer domiciled in a foreign jurisdiction that is subject to an International Insurance Agreement on Prudential Measures than a United States insurer admitted in that state. Before making any determination of inconsistency, the Office must notify the state, provide interested parties an opportunity for comment and consider the effect of preemption. There would be a minimum 30-day period before a notice of determination of inconsistency becomes effective.

Reports. Issues to be considered as part of the required study will include: systemic risk regulation for insurance; capital standards and an appropriate match between capital allocation and liabilities for risk; consumer protection for insurance products and practices, including gaps in state regulation; the degree of national uniformity of state insurance regulation; regulation of insurance companies and affiliates on a consolidated basis; international coordination of insurance regulation; costs and benefits of potential federal regulation across various lines of insurance; and consequences of subjecting insurance companies to a federal resolution authority. Within 18 months of enactment, a report must be submitted to

Congress containing any legislative, administrative or regulatory recommendations to modernize and improve the system of insurance regulation.

State-Based Insurance Reform

Additional provisions in the Senate bill are intended to streamline the regulation of surplus lines insurance and reinsurance through state-based reforms.

Surplus lines insurance. The Senate measure would give the home state of the insured (policyholder) sole regulatory authority over the collection and allocation of premium tax obligations related to nonadmitted (surplus lines) insurance. States would be authorized to enter into a compact or other agreement to establish uniform allocation and remittance procedures. The insured's home state could require surplus lines brokers and insureds to file tax allocation reports detailing the portion of premiums attributable to properties, risks or exposures located in each state.

Two years after enactment states would not be allowed to collect fees relating to licensing of nonadmitted brokers unless the state participates in the national insurance producer database of the National Association of Insurance Commissioners (NAIC). The measure would also streamline eligibility requirements for nonadmitted insurance providers with the eligibility requirements set forth in the NAIC's Nonadmitted Insurance Model Act.

The Government Accountability Office, in consultation with the NAIC, would conduct a study, within 30 months of enactment, of the nonadmitted insurance market to determine the effect of the new law on the size and market share of the nonadmitted market.

Reinsurance. The measure would prohibit non-domiciliary states from denying credit for reinsurance if the state of domicile of a ceding insurer is an NAIC-accredited state or has solvency requirements substantially similar to those required for NAIC accreditation. It would also prohibit non-domiciliary states from: restricting or eliminating the rights of reinsurers to resolve disputes pursuant to contractual arbitration clauses; from ignoring or eliminating contractual agreements on choice of law determinations; and enforcing reinsurance contracts on terms different from those set forth in the reinsurance contract.

The state of domicile of the reinsurer would be solely responsible for regulating the financial solvency of the reinsurer. Non-domiciliary states could not require a reinsurer to provide any additional financial information other than the information required by state of domicile. Non-domiciliary states would also get copies of the financial information that is required to be filed with the state of domicile.

Holding Company and Bank Regulation

Title VI of the Act seeks to improve the regulation and supervision of bank and savings association holding companies and depository institutions to ensure these financial institutions do not pose a threat to the country's financial stability.

Deposit Insurance and Change in Bank Control Moratorium

The Act would impose a three-year moratorium on the approval of a deposit insurance application by the FDIC. This moratorium applies to deposit insurance applications received after Nov. 10, 2009, for an industrial bank, credit card bank or trust bank that is controlled by a "commercial firm."

The moratorium also provides that the banking agencies cannot approve a change in control of an industrial bank, credit card bank or trust bank that is controlled by a commercial firm. The moratorium on a change of bank control would not apply if the industrial bank, credit card bank or trust bank is in danger of default or results from the merger or whole acquisition of a commercial firm that directly or indirectly controls the industrial bank, credit card bank or trust bank in a bona fide merger with or acquisition by an other commercial firm.

Comment: *The House of Representatives version of financial reform—H.R. 4173—would eliminate the industrial loan company provisions from the Bank Holding Company Act.*

GAO Study of BHCA Exceptions

The GAO would be required to conduct a study to determine whether to eliminate the Bank Holding Company Act (BHCA) exceptions for six specific institutions which are not currently considered to be a bank holding company or bank under the BHCA. This study must be submitted to the House Financial Services Committee and the Senate Banking Committee within 18 months after the enactment of the Restoring American Financial Stability Act of 2010.

***Comment**: H.R. 4173 would remove the industrial bank provisions from BHCA Section 2.*

The GAO's study would: identify the types and number of institutions excepted from the BHCA; describe the size and geographic locations of the institutions; which institutions are held by holding companies that are commercial firms; whether the institutions have any affiliates that are commercial firms; identify the federal banking agency responsible for supervision; determine whether regulatory framework, especially in regards to affiliate transactions, is adequate; and evaluate the potential consequences of subjecting these institutions to the BHCA, with particular attention to credit availability, financial stability and safety and soundness.

In regards to thrift institutions currently excepted from BHCA coverage, the GAO study would look at the adequacy of the federal bank regulatory framework and evaluate the potential consequences of subjecting thrift institutions to the BHCA.

Holding Company Examination Improvements

The Act would make a number of changes to the BHCA examination and the holding company provisions of the Home Owners' Loan Act (HOLA).

The OCC and FDIC would supervise holding companies that have consolidated assets of less than $50 billion and a federally chartered depository institution subsidiary. The Fed would have supervisory authority for holding companies with consolidated assets of more than $50 billion and any non-depository institution subsidiaries. However, an amendment sponsored by Sen. Kay Bailey Hutchison, R-Texas, would retain the Fed's role as supervisor of all financial holding companies.

The OCC, Fed and FDIC would be required to use the reports and other supervisory information that the bank holding company or any subsidiary has been required to provide to other federal or state regulatory agencies. The agencies would also be required to use, to the fullest extent possible, externally audited financial statements and any other information available from other federal or state regulatory agencies.

The examination provisions found in BHCA Section 5(c)(2) would be amended to provide that one of the goals of an examination is to inform the agencies whether the financial, operational and other risks of the holding company and subsidiary may pose a threat to the financial stability of the United States. The agencies would also be required to use examination reports made by other federal and state regulators relating to the holding company and subsidiary.

Functionally Regulated Subsidiaries

The Act would remove two provisions found in BHCA Section 5(c) regarding the supervision of functionally regulated subsidiaries. The first provision is the general prohibition in imposing capital requirements on registered investment advisers and licensed insurance agents. The second provision is the regulation of securities and insurance activities of a depository institution's functionally regulated subsidiaries.

The Act also would remove the "back-door" enforcement provision found in BHCA Section 10A which limited the Federal Reserve Board's rulemaking and enforcement authority with respect to functionally regulated subsidiaries.

Acquisitions

The factors to be considered for bank acquisitions under BHCA Section 3 and the nonbank acquisitions under BHCA Section 4 would be amended by the Act. In each acquisition, any risks to the stability of the U.S. banking or financial system must be considered.

The Act would retain the "no prior approval" provisions of BHCA Section 4(k)(6) whenever a financial holding company (FHC) acquires a company that engages in an activity that is financial in nature. The FHC would now need prior approval from the Fed if the acquisition exceeds $25 billion in total consolidated assets.

Finally, the Bank Merger Act provisions, found in Section 18 of the Federal Deposit Insurance Act (FDIA), also would be amended by the Act to require that the reviewing banking agency consider whether the transactions conducted under the Bank Merger Act pose any risk to the stability of the U.S. banking or financial system.

Oversight of Subsidiary Activities

The Act adds a new Section 6 to the BHCA to assure consistent oversight of permissible activities of holding company subsidiaries.

It should be noted that H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009, would add a new Section 6 to the BHCA. The House version of BHCA Section 6 would create a "special purpose holding company" to provide consolidated supervision of these financial companies by the Fed and thereby

close off a number of loopholes in the BHCA regarding unitary savings and loan holding companies and industrial loan companies.

The "lead Federal banking agency" for each "depository institution holding company" would be required to examine of the activities of the holding company's nondepository institution subsidiaries. These activities are the same types that are permissible for the holding company's depository institution subsidiaries. These examinations are to determine, among other things, whether the nondepository institution subsidiaries' activities present safety and soundness risks to any of the holding company's depository institution subsidiaries.

The BHCA Section 6 examination authority would not apply to the holding company's functionally regulated subsidiaries.

Enhanced Capitalization and Management

Several provisions of the Act would strengthen the operations of holding companies and the standards for interstate acquisitions under the BHCA.

A bank holding company must be "well capitalized and well managed" before undertaking certain activities permissible for financial holding companies, limited non-financial activities and affiliations, or grandfathered commodities activities.

The Act also would require a bank holding company to be "well capitalized and well managed" before seeking control of a bank located in another state.

Finally, the Act amends the BHCA and the savings and loan holding company provisions of the HOLA. In each instance, the supervision and administration of bank holding companies and savings and loan holding companies must take into consideration regulations relating to capital requirements.

Transactions with Affiliates and Insiders

There would be several important changes to the transactions with affiliate requirements found in Sections 23A and 23B of the Federal Reserve Act (FRA) and the insider lending restriction found in FRA Section 22(h). Each of the amendments made by the Act recognizes the role derivatives and other credit exposures played in the financial crisis.

An amendment to FRA Section 22(h), dealing with loans to insiders, explicitly provides that an "extension of credit" would have occurred between a member bank to a person if the member bank has credit exposure to the person arising from a derivatives transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction between the member bank and the person.

Finally, the Act would amend the FDIA by imposing an insider lending restriction on insured depository institutions.

Lending Limits

The National Bank Act (NBA) lending limits would be amended by revising the definition of "loans and extensions of credit" to include credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction between a national bank and the person.

Comment: *H.R. 4173 provides a similar amendment to the NBA lending limits, but also requires that the OCC issue regulations to carry out the amendment.*

The Act also would amend the FDIA by applying the NBA's lending limits to insured state banks "in the same manner and the same extent" as if the state bank were a national bank.

Charter Conversions

Charter conversions by national banks, state banks and savings associations would be impacted by amendments made by the Act. In each instance, if the converting institution was subject to an enforcement action initiated by its primary state or federal regulator, the conversion transaction would be prohibited. In essence, this would end the use of regulatory arbitrage and allow the institution "no place to hide" by switching charters.

Comment: *H.R. 4173 provides similar restrictions on charter conversions.*

Source of Strength

The Act would amend the FDIA by statutorily requiring a bank holding company or savings and loan holding company to serve as a source of financial strength for any depository institution subsidiary.

Comment: *H.R. 4173 does not have a source of strength requirement.*

The term "source of strength," under the Act, means "the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution."

Investment and Securities Holding Companies

The Act would eliminate the investment bank holding company supervisory framework found in Section 17 of the Securities Exchange Act of 1934. The creation of the investment bank holding company supervisory scheme was one of the many hallmark elements of the Gramm-Leach-Bliley Act (GLB Act).

Comment: *H.R. 4173 would also eliminate the investment bank holding company supervisory framework.*

In place of the investment bank holding company supervisory framework, the Act creates a securities holding company supervisory framework. Under the new supervisory framework, a "securities holding company" can register with the Federal Reserve Board if the securities holding company is required by a foreign regulator or provision of foreign law to be subject to comprehensive consolidated supervision.

Restrictions on Capital Market Activities

The Act would place restrictions on the capital market activities, namely "proprietary trading" and "sponsoring" and investing in "hedge funds" and "private equity funds," by banks and bank holding companies. These restrictions are commonly referred to as the "Volcker Rule" after former Federal Reserve Board Chairman Paul Volcker, who has strongly advocated that beneficiaries of the federal financial safety net—deposit insurance guarantees and discount window borrowing—should be prohibited from engaging in high-risk activities.

Comment: *H.R. 4173 does not have a similar provision.*

For the bans on proprietary trading and sponsoring and investing in hedge funds and private equity funds to take effect, the federal banking agencies would be required to issue regulations jointly prohibiting the activities.

There are a number of exceptions to the prohibitions on proprietary trading and sponsoring and investing in hedge funds and private equity funds. A depository institution, subsidiary or bank holding company can invest in obligations guaranteed by the United States; obligations issued and guaranteed by the government-sponsored enterprise—Ginnie Mae, Fannie Mae and Freddie Mac—and any obligation issued by a state or one of its political subdivisions. In addition, certain foreign and grandfathered activities permitted under Section 4(c) of the Bank Holding Company Act are not subject to the proprietary trading prohibition, provided the company carrying out these activities is not controlled by a company based in the United States.

Concentration Limits

The Act also would provide that a "financial company" cannot merge or consolidate with, acquire the assets of or otherwise acquire control of another company if the total consolidated "liabilities" of the acquiring financial company upon consummation of the transaction would exceed 10 percent of the aggregate consolidated liabilities of all financial companies at the end of the calendar year preceding the transaction.

Comment: *H.R. 4173 does not have a similar provision.*

The concentration limits would not apply to acquisitions of a bank in the danger of default, assisted transactions under the FDIA and if the acquisition only results in a *de minimis* increase in the financial company's liabilities.

In order to avail itself of any of these exceptions, the financial company must obtain the Fed's written approval prior to undertaking the acquisition.

Derivatives

Title VII, Subtitle A, would subject derivatives to greater oversight. Designed to address the systemic risk to financial markets posed by derivatives, the Senate legislation would mandate their regulation under a dual SEC-CFTC regime that emphasizes transparency. The CFTC would regulate swaps and the SEC would regulate security-based swaps.

Section 712 requires the CFTC and SEC to consult with each other and with the prudential regulators on the development of rules and orders implementing the derivatives title. The commissions must, for example,

consult with each other and adopt rules regarding the maintenance of records of all activities pertaining to uncleared swaps and share with each other information regarding swaps or security-based swaps under their respective jurisdictions. The CFTC or the SEC must individually, not jointly, promulgate rules required by the derivatives title within 180 days. The CFTC and SEC may use emergency and expedited procedures to implement the derivatives title if, in their discretion, they deem it necessary.

Unless specifically mentioned in legislation, The CFTC will not have jurisdiction over security-based swaps or associated entities and the SEC will not have jurisdiction over other swaps or associated entities. Similarly, no CFTC-registered futures association will have authority over any security-based swap and no SEC-registered national securities association will have jurisdiction over any swap. The SEC and the CFTC may appeal to the D.C. Circuit Court if either determines that the other has issued a rule or order that conflicts with its authority.

Under Section 714, the CFTC and SEC may investigate and report on any swap or security-based swap found to be detrimental to the stability of financial markets or their participants. The CFTC and SEC may by rule or order collect any information they find necessary to conduct these investigations. Section 715 provides that the CFTC and SEC, in consultation with the Secretary of the Treasury, can generally ban foreign entities from participating in U.S. swaps or security-based swaps markets if it is determined that the regulation of those derivatives in the foreign entity's country undermines the U.S. financial system.

End-User Exemption

Commercial end users are exempted from mandatory swap clearing under Section 723. These end users are defined by the nature of their primary business activity. Financial entities may not claim this exemption. These end users can opt out of the clearing requirement for the swaps only if they are hedging commercial risk. If they opt to clear, they can choose which derivatives clearing organization at which the swap will be cleared. An affiliate of a commercial end user may opt out of the clearing requirement for swaps if the affiliate is using the swap to hedge risk of the parent or affiliates of the parent. Affiliates cannot use the parent exemption if they are themselves swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, issuers that would be investment companies but for certain exemptions in the Investment Company Act, a commodity pool, a bank holding company with over $50 billion in consolidated assets, or affiliates of certain of these entities.

Disruptive Trading

Section 747 would prohibit any person from engaging in disruptive derivatives trading practices, including violating bids or offers, recklessly disregarding the orderly execution of transactions, or spoofing. The provision also makes it unlawful to enter a swap knowing that a counterparty could use the swap as a device to defraud a third party or the public. These provisions are augmented by the Cantwell Amendment, which added a new and versatile standard for deceptive and manipulative practices under the Commodity Exchange Act, allowing the CFTC to prosecute manipulation and attempted manipulation in the swaps and commodities markets. It also addresses false reporting and authorizes private rights of action that will aid the CFTC in its enforcement effort (Cong. Record, May 6, 2010, p. S3349).

Bank Trading of Derivatives

Section 716 would prohibit federal assistance, including federal deposit insurance and access to the Fed discount window to swap entities in connection with their trading in swaps or securities-based swaps. This section would effectively require most derivatives activities to be conducted outside of banks and bank holding companies.

According to Senator Lincoln, Section 716 has two goals. The first goal is getting banks back to performing the duties they were meant to perform, such as taking deposits and making loans for mortgages, small businesses and commercial enterprise. The second goal is separating out the activities that put these financial institutions in peril. Section 716 makes clear that engaging in risky derivatives dealing is not central to the business of banking (Cong. Record, May 5, 2010, p. S3140).

Senator Lincoln refuted the suggestion that this provision will push derivatives trading off into the dark without oversight. The legislation makes it abundantly clear that all swaps activity will be vigorously regulated by the SEC and CFTC. Removing these swaps desks from FDIC oversight, the Senator reasoned, does not mean they will escape strong regulation by the SEC and CFTC under Title VII. Similarly, Senator Lincoln refuted the suggestion that Section 716 would prevent banks from using swaps to hedge their risks. Banks

that have been acting as banks will be able to continue doing business as they always have under the reform legislation, she assured, and banks using swaps will still be allowed to hedge their interest rate risk on their loan portfolio. Most importantly, Congress wants them to do so. Banks offering swaps in connection with a loan to a commercial customer are also still in the business of banking and will not be affected.

Clearing

Section 763 would require clearing of all swaps that are accepted for clearing by a CFTC-registered derivatives clearing organization unless one of the parties qualifies for an exemption. Similarly, the provision would require clearing of all security-based swaps that are accepted for clearing by an SEC-registered clearing agency unless one of the parties to the swap qualifies for an exemption.

The legislation requires any clearinghouse that clears non-security-based swaps to register as a derivatives clearing organization. A derivatives clearing organization must register with CFTC even if it is a bank or an SEC-registered clearing agency. However, existing banks and clearing agencies are deemed registered to the extent that before enactment the banks cleared swaps as multilateral clearing organizations or the clearing agencies cleared swaps. Any clearinghouse that clears swaps not required to be cleared by the CFTC may voluntarily register as a derivatives clearing organization.

The CFTC may exempt conditionally or unconditionally a clearing agency from registration as a derivatives clearing organization if it finds that the clearing agency is subject to comparable, comprehensive supervision and regulation and is registered as a clearing agency with the SEC under the Exchange Act.

Swap Data Repositories

Section 728 would prescribe requirements for swap data repositories, which must register with the CFTC and are subject to inspection and examination. The Commission will set standards for data identification, collection and maintenance. The data standards for swap data repositories must be comparable to the standards for derivatives clearing organizations that clear swaps. In addition, the swap data repository must accept data, confirm data to both counterparties, maintain that information according to standards set by the CFTC, provide direct electronic access to the CFTC in form and frequency as determined by the CFTC, establish systems for monitoring and analyzing data, maintain privacy and make data available to regulators. The swap data repository must also abide by core principles including antitrust considerations, governance arrangements, and conflict-of-interest and public-information considerations.

Each data repository must have a chief compliance officer who will report directly to the board or a senior officer of the repository. The chief compliance officer must review compliance with the core principles, resolve conflicts of interest in consultation with the board, administer policies and procedures, and establish procedures for the handling, remediation and closing of non-compliance issues identified through office review, internal or external audit, look-back, self-reported error or validated complaint.

The chief compliance officer must also annually prepare, sign and certify as accurate a report describing the swap data repository's compliance and the policies and procedures of the repository, including its code of ethics and conflict-of-interest policies. The report will accompany the financial statements that the swap data repository must file with the CFTC.

Public Reporting of Transaction Data

Section 727 authorizes and requires the CFTC to adopt rules for the public release of swap-transaction and pricing data in as close to real-time as is technologically possible after execution for swaps subject to the mandatory clearing requirement, swaps that are not subject to the mandatory clearing requirement but are cleared by a DCO, and swaps that partake of the commercial end-users exemption from mandatory clearing. In fact, the legislation defines "real-time reporting" as the reporting of data on a swap transaction as soon as technologically practicable after its execution. For their part, the parties to a swap transaction and their agents must timely report swap transaction information to the proper registered entity under CFTC rules.

The CFTC must include provisions in the rules to ensure that participants are not identified and must specify criteria for determining what constitutes a large notional swap transaction for particular markets, with appropriate time delays of the reporting of such large notional swap transactions. Additionally, the CFTC must take into account when promulgating the rule whether the public disclosure would materially reduce market liquidity. For swaps that are not cleared by a derivatives clearing organization but are reported to a swap data repository or the CFTC, the Commission must make available to the public aggregate data on the trading volumes and positions, but without disclosing

the business transactions or market positions of any person. The CFTC may require registered entities to publicly disseminate swap transaction and pricing data information required by this section.

Segregation and Bankruptcy Treatment

Section 724 would require any person that holds assets to guarantee swaps cleared by a derivatives clearing organization for other customers to register as a futures commission merchant. It would also impose segregation requirements for cleared and uncleared swaps, and restrict use and investment of segregated funds subject to rules, regulations or orders that the CFTC may promulgate. It would deem swaps cleared by a derivatives clearing organization to be commodity contracts for bankruptcy purposes and would give counterparties the option in the case of uncleared swaps to require segregation of customer assets with independent third parties. If the counterparty chooses not to require third-party segregation of customer assets, the swap dealer or major swap participant must report back-office procedures and collateral requirements to the counterparty.

Swap Execution Facilities

Swap execution facilities would have to be registered with the SEC for security-based swaps and with the CFTC for swaps under an oversight regime of governance and core principles. A security-based swap execution facility must register with the SEC regardless of whether it is also registered with the CFTC as a swap execution facility. However, the SEC can exempt a security-based swap execution facility from registration upon a finding that the facility is subject to comparable, comprehensive regulation on a consolidated basis by the CFTC.

Under both SEC and CFTC oversight, the swap execution facility must establish self-regulatory core operational principles addressing compliance with rules, swaps not readily susceptible to manipulation, monitoring of trading and trade processing, ability to obtain information, position limits or accountability, financial integrity of transactions, emergency authority, timely publication of trading information, recordkeeping and reporting, antitrust considerations, conflicts of interest, financial resources and system safeguards. The legislation also requires the swap execution facility to appoint a chief compliance officer and imposes duties to be carried out by that officer, including annual reporting.

International Aspects

Section 752 would promote international harmonization of standards. The Senate recognized the need for global monitoring of system stability and regulation of cross-border, systemically-important institutions. For the proper regulation of cross-border institutions that can affect systemic risk, there must also be strong international cooperation and clear rules. At the same time, it is also evident that sovereignty will prevent a mandatory, international regulatory regime made by treaty. Some form of international harmonization is necessary, however, if for no other reason than to prevent regulatory arbitrage.

In this spirit, the legislation seeks to promote effective and consistent global regulation of swaps and security-based swaps by directing the SEC and CFTC to consult and coordinate with foreign regulatory authorities on setting consistent international standards for regulating those swaps. The SEC and CFTC may also enter into any information-sharing arrangements with foreign regulators they deem necessary or appropriate in the public interest or for the protection of investors and swap counterparties.

Clearing and Settlement

Title VIII would reform the clearance and settlement activities of financial institutions. To mitigate systemic risk in the financial system and promote financial stability, Section 805 gives the Financial Stability Oversight Council a role in identifying systemically important financial market utilities and gives the Federal Reserve Board an enhanced role in supervising risk-management standards for systemically important financial market utilities and for systemically important payment, clearing and settlement activities conducted by financial institutions.

The Fed may, in consultation with the Council and the SEC or other appropriate regulator, prescribe risk-management standards governing the operations of designated financial market utilities and the conduct of designated payment, clearing and settlement activities by financial institutions. The statute sets out the objectives, principles and scope of those standards.

Under Section 806, the Fed may maintain an account for a designated financial market utility and modify or provide an exemption from reserve requirements that would otherwise apply to the utility. A designated financial market utility must provide advance notice of and obtain approval of material changes to its rules, procedures or operations.

Section 807 would require the supervisory agency to conduct safety and soundness examinations of a designated financial market utility at least annually and authorizes it to take enforcement actions against the utility. The Fed can participate in the examinations and is also authorized to take enforcement actions against a designated financial market utility if there is an imminent risk of substantial harm to financial institutions or the broader financial system.

Under Section 808, the SEC or other primary financial regulator may examine a financial institution engaged in designated payment, clearing or settlement activities and may enforce the legislation provisions and the Fed rules against such an institution. The Fed must collaborate with the primary financial regulator to ensure consistent application of the rules. The Fed has back-up authority to conduct examinations and take enforcement actions if it has reasonable cause to believe a violation of its rules or of the Act has occurred.

Credit Rating Agencies

Title IX, Subtitle C, would institute reforms to the governance and operations of the credit rating industry. Section 932 would establish an independent office within the SEC dedicated to improving the quality of regulation of credit rating agencies. The Office of Credit Ratings, headed by a person reporting directly to the SEC Chair, would promote accuracy in credit ratings and keep conflicts of interest from unduly influencing ratings.

The Office of Credit Ratings must also conduct annual examinations of each credit rating agency, including a review of: (1) whether the rating agency follows its policies, procedures and rating methodologies; (2) the management of conflicts of interest; (3) the implementation of ethics policies; (4) the agency's internal supervisory controls; (5) the agency's governance; (6) the activities of its compliance officers; (7) the processing of complaints; and (8) the agency's policies governing the post-employment activities of former staff.

The SEC will annually publish the essential findings of all examinations, including the responses of rating agencies to material regulatory deficiencies identified by the SEC and to recommendations made by the SEC.

Section 932 would mandate that each nationally recognized statistical rating organization must establish, enforce and document an effective internal control structure governing the implementation of policies and methodologies it uses to determine credit ratings. Further, the SEC must adopt rules requiring credit rating agencies to submit to the Commission an annual internal controls report, containing a description of the responsibility of the management of the rating agency in establishing and maintaining effective internal controls. In addition, the rating agency must assess the effectiveness of the internal controls and the CEO must attest to it.

The legislation would authorize the SEC to fine a rating agency for violations of law or regulations. Section 932 would eliminate the effect of the inherent conflict of interest in the much criticized "issuer pays" model in the credit rating industry. The conflict of interest arises because rating agencies want to provide the highest rating to keep the issuer's business and are less willing to publish a lower rating. The provision addresses this conflict by directing the SEC to write rules preventing sales and marketing considerations from influencing the production of ratings. Violation of these rules will lead to suspension or revocation of rating agency status if the violation affects a rating.

The legislation promotes sound corporate governance by prohibiting compliance officers at rating agencies from participating in the production of ratings, the development of ratings methodologies and the setting of compensation for agency employees.

Also, rating agencies must consider information about an issuer that they receive from a source other than the issuer and that the agency finds credible and potentially significant to a rating decision. The measure does not, however, require a rating agency to initiate a search for that information.

The Franken Amendment further attacks the conflict-of-interest problem by creating a board overseen by the SEC that will assign credit rating agencies on a rotating basis to provide initial ratings. The SEC would create a credit rating agency board, a self-regulatory organization, tasked with developing a system in which the board assigns a rating agency to provide a product's initial rating. Requiring an initial credit rating by an agency not of the issuer's choosing will put a check on the accuracy of ratings, in the Senator's view. The amendment does not prohibit an issuer from then seeking a second or third or fourth rating from an agency of their choosing. The amendment leaves flexibility to the board to determine the assignment process. Thus, the new board may design the assignment process it sees fit, which can be random or based on a formula, provided that it does not allow the issuer to choose its rating agency (Cong. Record, May 10, 2010, S3465).

The SEC must also adopt rules separating the ratings from sales and marketing. Specifically, the rules must

prevent the sales and marketing considerations of a rating agency from influencing the production of ratings. The SEC rules must provide for exceptions for small rating agencies when the Commission determines that the separation of the production of ratings and sales and marketing activities is not appropriate.

The Credit Rating Agency Reform Act of 2006 ordered rating agencies to name a compliance officer to ensure compliance with the securities laws and regulations. Section 932 of the Senate legislation would prohibit these compliance officers from working on ratings, methodologies or sales and marketing, as well as from establishing compensation levels except for employees working for them. The SEC may exempt a small rating agency from these limitations upon a finding that compliance with these limitations would impose an unreasonable burden on the agency.

The legislation mandates that compliance officers must establish procedures for the receipt and treatment of complaints regarding ratings and the methodologies used to set the ratings, as well as a system to deal with confidential, anonymous complaints from employees or users of credit ratings.

Further, compliance officers must submit to the rating agency an annual report on the agency's compliance with the securities laws and its own policies, including a description of any material changes to its code of ethics and conflict-of-interest policies and a certification that the report is accurate and complete. The rating agency must then file the compliance officer's report with the SEC.

The SEC must adopt rules requiring rating agencies to ensure that credit ratings are determined using procedures and methodologies that are approved by the board of directors or senior credit officer. The SEC rules must require that material changes to ratings procedures and methodologies be applied consistently and publicly disclosed. Such changes must be applied to all credit ratings to which they apply within a reasonable time period, to be determined by the SEC. The rules will also require rating agencies to notify users of credit ratings when a material change is made to a procedure or methodology, and when a significant error is identified in a procedure or methodology that may result in credit rating actions.

Section 933 provides that the enforcement and penalty provisions applicable to statements made by a credit rating agency must apply in the same manner and to the same extent as to statements made by a registered public accounting firm or a securities analyst, and those statements will not be deemed forward-looking statements. For purposes of passing the state-of-mind pleading test of the Private Securities Litigation Reform Act, a plaintiff need not plead that the rating agency knowingly or recklessly engaged in a deceptive misrepresentation or omission in communicating with investors. Instead, the plaintiff need only plead that the rating agency knowingly or recklessly failed to conduct a reasonable investigation of factual elements or to obtain reasonable verification of those elements. Although the legislation enables plaintiffs to survive a motion to dismiss more easily, as noted in the Senate Banking Committee Report, it does not change the ultimate standard used by a fact-finder in determining whether the basic elements of fraud claim have been met.

The LeMieux-Cantwell Amendment eliminates statutory protections and references to national credit rating agencies in a number of federal acts, including the Exchange Act and Investment Company Act, thereby essentially removing the federal government's seal of approval from investment rating agencies. The amendment also requires the SEC to evaluate and make recommendations to Congress regarding how credit ratings can be standardized and better used as one of many tools for evaluating general investment risk.

Securitization

Title IX, Subtitle D, would reform the process of securitization by requiring companies that sell asset-backed securities to retain a portion of the risk. Section 941 would require companies that sell products like mortgage-backed securities to keep some "skin in the game" by retaining at least five percent of the credit risk. Thus, if the investment collapses, the company that made, packaged and sold the product would lose out right along with the buyers. Section 942 would require issuers to disclose more information about the assets underlying asset-backed securities and to analyze the quality of the underlying assets.

The federal banking agencies and the SEC must jointly prescribe regulations to require any securitizer to retain a material portion of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells or conveys to a third party. Although the legislation sets a baseline risk-retention amount of five percent in any securitized asset, the regulators may increase that figure at their discretion, or they may reduce it below five percent when the securitized assets meet standards of low credit risk to be established by rule for the various asset classes. The legislation allows flexibility in setting risk-retention

levels to encourage the recovery of the securitization markets and to accommodate future market development and innovation.

The regulations would prohibit securitizers from hedging or otherwise transferring the credit risk they are required to retain. However, the prohibition does not extend to hedging risks other than credit risk, such as interest rate risk, associated with the retained assets or position. Originators would come under increasing market discipline because securitizers who retain risk would be unwilling to purchase poor-quality assets. Thus, the Act does not require that the regulations impose risk-retention obligations on originators. In addition, risk retention may be divided between securitizers and originators only if the regulators consider that assets being securitized do not have characteristics of low credit risk, that conditions in securitization markets are creating incentives for imprudent origination, and that allocating part of the risk-retention obligation to originators would not prevent consumers and businesses from obtaining credit on reasonable terms.

Based on a congressional belief that implementation of risk-retention obligations should recognize the differences in securitization practices for various asset classes, the legislation requires that the joint rulemaking include separate components addressing individual asset classes such as home mortgages, commercial mortgages and auto loans, and any other asset class that regulators deem appropriate. The Senate expects that these regulations will recognize differences in the assets securitized, in existing risk-management practices, and in the structure of asset-backed securities, and that regulators will make appropriate adjustments to the amount of risk retention required (See Senate Banking Committee Report on S 3217, p. 108).

In addition, the risk-retention rules may provide an exemption for any securitization, as may be appropriate in the public interest and for the protection of investors. The Senate expects that asset-backed securities backed by the full faith and credit of the United States, or where the underlying assets were guaranteed by an agency of the United States, would qualify for such an exemption (See Senate Banking Committee Report on S 3217, p. 108).

The SEC must adopt regulations under the Securities Act requiring issuers of asset-backed securities to disclose for each tranche or class of security information regarding the assets backing that security. In adopting these regulations, the SEC must set standards for the format of the data provided by issuers of an asset-backed security, which must, to the extent feasible, facilitate comparison of the data across securities in similar types of asset classes.

To help investors perform independent due diligence, the SEC regulations must require issuers of asset-backed securities, at a minimum, to disclose asset-level or loan-level data, including data having unique identifiers relating to loan brokers or originators. The issuer must also disclose the nature and extent of the compensation of the broker or originator of the assets backing the security; and the amount of risk retained by the originator or the securitizer of those assets.

Under Section 943, the SEC must also adopt regulations on the use of representations and warranties in the market for asset-backed securities. The regulations must require each credit rating agency to include in any report accompanying a credit rating a description of the representations, warranties and enforcement mechanisms available to investors and a description of how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities.

The SEC must issue regulations relating to the registration statement required to be filed by any issuer of an asset-backed security requiring them to perform a due diligence analysis of the assets underlying the asset-backed security and disclose the nature of that analysis.

Section 941 defines "asset-backed security" as a fixed-income or other security collateralized by any type of self-liquidating financial asset, including a loan, a lease, a mortgage or a secured or unsecured receivable, that allows the holder of the security to receive payments depending primarily on cash flow from the asset, including collateralized mortgage or debt obligations. The term "asset-backed security" does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

Corporate Governance and Compensation

Title IX, Subtitles E and G, would institute an array of corporate governance reforms. As discussed below, the provisions would help rein in excessive compensation and shift management's focus from short-term profits to long-term growth and stability by, among other measures, giving shareholders a "say on pay" and proxy access to nominate directors, ensuring the independence of compensation committees, and requiring companies to set "clawback" policies to recover compensation payouts based on inaccurate financial statements.

Say on Pay

Section 951 would enhance corporate governance and mandate increased transparency of executive compensation. Shareholders would have the right to a non-binding vote on executive compensation. The advisory vote is designed to give shareholders a powerful opportunity to hold executives accountable and to disapprove misguided incentive schemes that threaten individual companies and, in turn, the broader economy.

The shareholder advisory vote on executive pay will not overrule a decision by the company or the board, or create or imply any change to, or addition to, the fiduciary duties of the directors, or restrict the ability of shareholders to make inclusions in proxy materials related to executive compensation.

Director Elections

Section 972 would authorize, but not require, the SEC to grant shareholders proxy access to nominate directors. Section 971 would require directors to win by a majority vote in uncontested elections, which should help shift management's focus from short-term profits to long-term growth and stability.

Most public companies currently elect directors using the plurality standard, by which shareowners may vote for, but not against, a nominee. If shareowners oppose a particular nominee, they may only withhold their votes. As a consequence, a nominee only needs one "for" vote to be elected and unseating a director is virtually impossible. Majority voting, in contrast, ensures that shareholders' votes count and makes directors more accountable to them.

Under Section 971, the SEC must adopt rules providing that in an uncontested election a director receiving a majority of the votes cast must be deemed to be elected. If a director fails to win a majority vote in an uncontested election, the director must tender his or her resignation to the board. Upon accepting the director's resignation, the board must set a date on which the resignation will take effect and publish that date within a reasonable period of time as established by SEC rule. If the board declines to accept the resignation, the board must disclose specific reasons for its decision and why that decision was in the best interest of the company and its shareholders.

The Commission may exempt a company from any or all of these requirements based on the company's size, its market capitalization, the number of shareholders of record or any other criteria that the Commission deem necessary and appropriate in the public interest or for investor protection.

Dual Roles

Section 973 would encourage bifurcation of the roles of board chairman and CEO. The SEC would have to adopt rules requiring a company to disclose in the annual proxy sent to investors the reasons why it has chosen the same person to serve as chairman of the board and chief executive officer or why it has chosen different individuals to serve in those roles.

Compensation Committees

Section 952 would mandate independent board compensation committees. The SEC must adopt rules for exchange listing requiring that compensation committees include only independent directors and have authority to hire compensation consultants. This provision is designed to strengthen their independence from the executives they are rewarding or punishing. In determining the independence of compensation committee members, the SEC rules must require exchanges to consider the source of compensation and any affiliation with the company or any of its subsidiaries.

The compensation committee would have sole discretion to hire and obtain the advice of a compensation consultant and would be directly responsible for the consultant's oversight and compensation. However, the provision cannot be construed to require a compensation committee to implement or follow the consultant's recommendations, or to affect the committee's ability or the obligation to exercise its own judgment.

Further, proxy or consent solicitation materials for an annual or special shareholders meeting must disclose whether the compensation committee retained or obtained the advice of a compensation consultant. The materials must also disclose whether the committee's work has raised any conflict of interest and, if so, the nature of the conflict and how it is being addressed.

Clawbacks

Section 954 would require public companies to set policies to claw back executive compensation if it was based on inaccurate financial statements that did not comply with accounting standards. The measure also directs the SEC to clarify disclosures relating to compensation, including requiring companies to provide charts that compare their executive compensation with stock performance over a five-year period.

Compensation Disclosure

Under Section 953, the SEC must amend Regulation S-K Item 402 to mandate disclosure of: the median of the annual total compensation of all employees (except the CEO), the annual total compensation of the CEO, and the ratio of the two. The annual total compensation of an employee must be determined by reference to Item 402. This disclosure is required in annual reports and proxy statements, among other filings.

Voting by Brokers

Section 957 would require exchange rules to prohibit members that are not beneficial owners of a security from granting a proxy to vote the security in connection with a shareholder vote for the election of directors, executive compensation or any other significant matter as the SEC may determine by rule, unless the beneficial owner of the security has instructed the member to vote the proxy in accordance with the beneficial owner's instructions.

Other Securities Reforms

Title IX contains various other measures designed to improve enforcement of the securities laws, impose greater regulatory oversight and strengthen investor protections. As discussed below, these include: SEC authority to impose collateral bars; PCAOB oversight of broker-dealer auditors; greater protections for whistleblowers; senior investor protection initiatives; and the creation of a council of federal financial agency inspectors general.

Collateral Bars

Section 925 authorizes the SEC to impose collateral bars against regulated persons. The Commission would have the authority to bar a regulated person who violates the securities laws in one part of the industry, such as a broker-dealer who misappropriates customer funds, from access to customer funds in another part of the securities industry, for example, as an investment adviser. By expressly empowering the SEC to impose broad preventative relief in the first instance, this provision would enable the Commission to protect investors and the markets more effectively and efficiently.

Fair Fund

The Fair Fund provisions of the Sarbanes-Oxley Act take the civil penalties levied by the SEC as a result of an enforcement action and direct them to a disgorgement fund for harmed investors. Section 929B would increase the money available to compensate defrauded investors by revising the Fair Fund provisions to permit the SEC to use penalties to compensate victims of the fraud even if the SEC does not obtain an order requiring the defendant to disgorge ill-gotten gains. Currently, in some cases, a defendant may engage in a securities law violation that harms investors, but the SEC cannot obtain disgorgement from the defendant because the defendant did not personally benefit from the violation.

SIPA Amendments

Section 929C would update the Securities Investor Protection Act, including provisions on increasing the borrowing limit, and the distinction between securities and cash insurance, portfolio margin and liquidation. The line of credit has not been increased since SIPA was enacted in 1970, and an increase is necessary to provide the Securities Investor Protection Corporation with sufficient resources in the event of the failure of a large broker-dealer. This line of credit is used in the event that SIPC asks for a loan from the SEC and the SEC determines that such a loan is necessary for the protection of customers of brokers or dealers and the maintenance of confidence in the U.S. securities markets.

PCAOB Oversight

The Madoff fraud revealed that the Public Company Accounting Oversight Board lacked the powers it needed to examine the auditors of broker-dealers. Thus, the legislation brings broker-dealers under PCAOB oversight. Section 982 would give the Board authority over audits of registered brokers and dealers comparable to its existing authority over audits of issuers. This authority permits the PCAOB to write standards for, and inspect, investigate and bring disciplinary actions arising out of any audit of a registered broker or dealer. The PCAOB could use its inspection and disciplinary processes to identify auditors that lack expertise or fail to exercise care in broker-dealer audits, identify and address deficiencies in their practices and, where appropriate, suspend or bar them from conducting those audits.

The PCAOB must allocate, assess and collect its support fees among brokers and dealers as well as issuers. The Board must reasonably estimate the amounts required to fund the portions of its programs devoted to the oversight of brokers-dealer audits, in contrast to the oversight of issuer audits, in deciding the total amounts

to be allocated to, assessed on and collected from all brokers and dealers. The implementation of a program for PCAOB inspections of broker-dealer auditors is not intended to, and should not, affect the PCAOB's program for the inspections of issuer auditors. Cost accounting for each program is not required (Senate Banking Committee Report, Apr 30, 2010).

Section 981 authorizes the PCAOB to share confidential inspection and investigative information with foreign audit oversight authorities under specified circumstances. Information sharing may occur if: (1) the Board determines that the sharing is necessary to accomplish the purposes of the Sarbanes-Oxley Act or to protect investors in U.S. issuers; (2) the foreign authority has provided the assurances of confidentiality requested by the PCAOB, described its information systems and controls, and described its jurisdiction's laws and regulations that are relevant to information access; and (3) the Board determines that it is appropriate to share this information.

The information about controls and relevant law is to assist the PCAOB in making an independent determination that the foreign authority has the capability and authority to keep the information confidential in its jurisdiction. The Board may rely on additional information in determining that the information will be kept confidential and used no more extensively than it is used by federal and state authorities.

Whistleblower Protections

Section 922 would allow the SEC to reward whistleblowers who provide the Commission with information on securities law violations. The provision, found in new Exchange Act Section 21F, applies to any judicial or administrative action brought by the SEC under the securities laws that results in monetary sanctions exceeding $1 million. Whistleblowers will also enjoy more protections from retaliation.

Currently, the SEC may reward individuals for providing information leading to the recovery of civil penalties for insider trading. New Section 21F will allow the payment of rewards for information that leads to the successful enforcement of any judicial or administrative action brought by the SEC under all provisions of the securities laws. For example, whistleblowers in financial fraud and Foreign Corrupt Practices Act cases, which often generate substantial civil penalties, would be eligible for awards.

The Senate measure, unlike the House bill, provides a minimum award of 10 percent of the funds collected as sanctions. Both bills cap awards at 30 percent of collected funds. Whistleblowers may appeal the SEC's award decision to the appropriate circuit court for review under an abuse of discretion standard. The statute prohibits payments to specified administrative and law enforcement personnel, auditors and individuals convicted of a crime connected to the judicial or administrative action in question.

The Act expands the whistleblower protections in the Sarbanes-Oxley Act. Although the two statutes prohibit similar conduct, there are significant differences in both the scope of the measures and in the available relief.

Section 929A would amend Sarbanes-Oxley Act Section 806(a) to clarify that the whistleblower protections apply to both parent companies and their subsidiaries and affiliates if their financial information is included in the consolidated financial statements of the parent company. Victims of retaliatory discrimination may also immediately and directly file suit against the employer in federal district court. Under current Section 806, claimants must file a complaint with the Department of Labor, and can only seek district court review if the Secretary of Labor fails to reach a determination within 180 days. Both statutes provide for reinstatement and for the recovery of lost wages and costs. Under the Senate bill, however, injured persons may recover twice their lost wages, while the Sarbanes-Oxley Act allowed only recovery of actual wages lost.

The Cardin-Grassley Amendment extended whistleblower protection to employees of credit rating agencies, which are the nationally recognized statistical rating organizations that issue credit ratings that the SEC permits other financial firms to use for certain regulatory purposes.

Municipal Securities

Section 979 would establish an Office of Municipal Securities in the SEC to administer the Commission's rules with respect to municipal securities dealers, advisors, investors and issuers. The Director of the Office would report to the SEC Chair. The Office would have to coordinate with the MSRB for rulemaking and enforcement actions, and would have to be sufficiently staffed to carry out its duties. The staff would have to include individuals with knowledge and expertise in municipal finance.

Senior Investors

Section 989A would offer protections for senior investors. The North American Securities Administrators Association (NASAA) has long voiced concerns with the use of misleading professional designations that convey an expertise in advising seniors on financial matters. Many of these designations in reality reflect no such expertise but rather are conveyed to individuals who pay to attend weekend seminars and take open book, multiple choice tests. NASAA has adopted a model rule designed to curb abuses in this area.

The provision recognizes the harm to seniors posed by the use of such misleading designations and establishes a mechanism for providing grants to states as an incentive to adopt the NASAA model rule. The grants are designed to give states the flexibility to use funds for a wide variety of senior investor protection efforts, such as hiring additional staff to investigate and prosecute cases, funding new technology, equipment and training for regulators, prosecutors and law enforcement, and providing educational materials to increase awareness and understanding of designations.

Council of Inspectors General

The Senate approved an amendment that would create a council of federal financial agency inspectors general, including the IGs at the SEC, CFTC, FDIC and the Fed. Under Section 989E, the council would meet quarterly and discuss their investigations to ensure that they are not duplicating each other's work. They would also discuss collective approaches to systemic risk. Further, the council would have to submit an annual report to Congress recommending improvements to financial oversight.

The Grassley-McCaskill Amendment, in Section 989D, also requires the SEC and CFTC inspectors general to report to the full Commission rather than only to the SEC or CFTC Chair. It will additionally require that two-thirds of the Commission must vote for cause to fire the inspector general. According to Senator Grassley, the two-thirds for-cause vote ensures that any political attempt to remove an agency inspector general will be met by dissent from some Commission members (Cong Record, May 18, 2010, S3877).

Section 989C requires the SEC and other inspectors general to disclose the results of all their peer reviews to Congress, thereby making them public. Also, the SEC and other financial regulators would have to respond when inspectors general identify deficiencies in their agencies, either by taking corrective action or by explaining to Congress why they chose not to act.

Bureau of Consumer Financial Protection

Title X is the "Consumer Financial Protection Act of 2010." The title's first substantive provision creates the Bureau of Consumer Financial Protection (the BCFP or Bureau) within the Federal Reserve System. The task of the Bureau is to "regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws."

Earlier proposals contemplated an independent office, such as the Consumer Financial Protection Agency that was described in the bill passed by the House of Representatives in December 2009 (H.R. 4173). The Senate bill attempted to strike a compromise between those who objected to an independent agency (or, indeed, to any agency at all) and those who wanted complete independence. Although the BCFP is placed in the Fed, its Director is to be appointed by the President of the United States, not by the Fed Governors or Fed president. The appointment is subject to Senate confirmation. Also, the title includes specific restrictions on the ability of the Fed Governors to interfere with the BCFP's activities.

The BCFP's funding is also essentially protected from interference by the Fed. The Bureau's Director has the authority to designate periodically how much of the Federal Reserve System's earnings are to be transferred to the Bureau, subject to a statutory maximum that rises to 12 percent beginning in fiscal year 2013. The Fed has no authority over the Bureau's budget or financial operations.

Authority of the Bureau

The bill directs the BCFP to enforce the federal consumer financial protection laws consistently so that "markets for consumer financial products and services are fair, transparent, and competitive." Enumerated goals include seeing that consumers receive timely and understandable disclosures and are protected from unfair, deceptive or abusive acts and practices and from discrimination. The Bureau also is to identify and address regulations that place an "unwarranted burden" on market participants.

Six primary functions are listed for the BCFP. The most important of these are adopting rules and guidance to implement the federal consumer financial protection laws; supervising and enforcing those laws against some

financial institutions and companies; developing and publishing information on risks to consumers and to the markets; and addressing consumer complaints.

Rulemaking authority. The Bureau is given nearly exclusive authority to adopt rules implementing the federal consumer financial protection laws (nearly exclusive because, under an amendment to the bill, the Federal Trade Commission retains some authority to adopt rules under the Federal Trade Commission Act). It also can issue orders and guidance in the same manner that the existing regulators do.

The Bureau's power to make rules is, to some degree, checked by authority granted to the Fed, Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation. It must consult with other relevant federal agencies both before proposing a rule and during the public comment phase to consider whether the rule is consistent with the other agencies' prudential, market and systemic objectives. If another regulator objects to a proposed rule in writing, the BCFP must include that objection, and its response, in its formal proposal.

Additionally, the other regulators have the ability to ask the Financial Stability Oversight Council to set aside any regulation the Bureau adopts. Any Council member could make such a request if it believes the rule would put the safety and soundness of the banking system or the stability of the financial system at risk.

Supervisory authority. The Bureau is given the authority to supervise many nonbank companies that provide financial products or services. Its authority extends to all nonbank consumer mortgage loan originators, brokers and servicers, and to mortgage loan modification and foreclosure relief service providers. Also, the BCFP has supervisory authority over any company that is "a larger participant of a market for other consumer financial products or services. . ." This latter category is to be defined by a rule to be adopted after consultation with the FTC.

Nonbank subsidiaries of insured depository institutions would be subject to the Bureau's supervisory authority under this provision. Providers of services to supervised entities also are subject to the BCFP's supervisory authority.

The Bureau's supervisory and enforcement authority over these entities is exclusive, displacing the other federal regulators. There are two exceptions—an amendment to the bill preserves the FTC's authority to enforce rules adopted under the FTC Act, which generally prohibits unfair or deceptive acts or practices, and the authority of the Farm Credit Administration is explicitly preserved.

In carrying out its supervisory tasks, the BCFP is to require periodic reports and conduct examinations. It also has a right to have access to reports of examination and other information from the other federal financial regulators (who have a reciprocal right of access to the Bureau's reports), and it is instructed to rely on that information to the extent possible in order to reduce the burden on the entities it supervises. It also is to coordinate its examinations with other federal and state regulators.

The Bureau also has supervisory authority over some insured depository institutions—banks, thrifts and credit unions. The extent of that authority is determined by the size of the institution. The Bureau has primary supervisory and enforcement authority over larger institutions—those with total assets of more than $10,000,000,000. However, supervisory and enforcement authority over institutions that do not reach that threshold (which will be the large majority of institutions) remains with those institutions' prude ntial regulators.

The BCFP is to require periodic reports and conduct consumer compliance examinations of the larger institutions. In doing so, it is to coordinate with the prudential regulators' examination activities, and it is to use their reports to the extent possible.

The prudential regulators are permitted to retain a back-up consumer compliance enforcement authority. They may recommend that the Bureau begin an enforcement action against a large institution and, if the Bureau does not act within 120 days, they may take enforcement action.

In the case of a smaller institution, the Bureau may require periodic reports and include examiners in the examinations of the prudential regulators "on a sampling basis." The prudential regulators will have exclusive enforcement authority over smaller institutions; the BCFP is not granted any back-up enforcement authority.

Exemptions and exclusions. The bill includes limits on the authority of the Bureau that benefit a number of specific types of businesses and activities. There also is a general size-based limitation that is intended to answer concerns that small businesses and professional offices that offer credit to customers would fall under the authority of the Bureau.

The size-based limitation addresses the worries of some Senators that merchants or other small businesses who offered payment plans to customers could be determined to be "engaged significantly in offering or providing consumer financial products or services." Under an amendment to the bill, a merchant or other small business will not be covered if it:

- extends credit directly to a consumer to allow the consumer to purchase a nonfinancial product or service from the merchant;
- does not sell the debt unless it becomes delinquent; and

- meets the relevant industry size standard to be considered a small business under the Small Business Act.

A business that meets these criteria also is shielded from enforcement actions by state authorities.

Full or partial business-specific exemptions apply to:

- real estate brokerages;
- manufactured and modular home sales;
- accountants and tax-return preparation services;
- attorneys;
- state-regulated insurance agencies;
- employee benefit and compensation plans;
- state-regulated securities brokerages;
- Securities and Exchange Commission-regulated agencies;
- Commodities and Futures Trading Commission-regulated agencies;
- Farm Credit Administration-regulated entities;
- insurance; and
- charitable contributions.

An amendment that would have exempted automobile dealers was withdrawn. However, the reform bill passed by the House in December 2009 included that exemption, so it will at least be considered by the conference committee.

The bill also explicitly denies the BCFP the authority to impose a national usury limit. However, the Bureau is given the power to restrict or prohibit the pre-dispute use of mandatory arbitration agreements.

Specific Powers of the Bureau

In addition to its general authority to adopt regulations and enforce the federal consumer financial protection laws, the BCFP is given a series of specific powers.

To begin with, the Bureau will share with the FTC the ability to adopt and enforce regulations against unfair or deceptive acts or practices. It also will be able to act against abusive acts or practices—those that interfere with a consumer's ability to understand a financial transaction or that take "unreasonable advantage" of a consumer's lack of understanding or belief that the financial company will act in the consumer's best interest.

The Bureau is specifically empowered to require specified disclosures and to draft model disclosure forms. Just as with the current forms created by the Fed, use of the proper model form would be deemed to satisfy the relevant regulatory disclosure requirements. The BCFP is directed to create a combined Truth in Lending/Real Estate Settlement Procedures Act form unless another agency has already done so.

The bill includes a requirement that those who sell financial products or services must provide consumers with information about the products or services they have purchased. This includes information on transactions, costs and usage. However, sellers only are required to provide information they have—there is no requirement that any specific information be maintained.

Preemption and State Enforcement

Subtitle D of the bill begins by declaring that state laws are preempted only to the extent that they are inconsistent with federal law and that state laws offering higher degrees of protection to consumers are not considered to be inconsistent. However, it also establishes that different preemption standards will apply for national banks and federal savings associations.

State attorneys general are given the power to enforce the bill and the Bureau's regulations in either federal or state court. State regulators also have enforcement authority, but only over state-chartered institutions. However, the authority of a state attorney general to act against a national bank or federal thrift is limited to enforcing the bill and its rules and obtaining the specified remedies. Civil suits to benefit the citizens of a state—referred to during the debate on the bill as "class-action-like suits"—are not permitted.

Additionally, unless an emergency exists, state authorities are required to provide advance notice to the Bureau of any planned enforcement action against any financial market participant. The notice is to include the identity of the company and the facts that underlie the enforcement action. The BCFP may intervene in any enforcement action and thereafter be treated as a party.

Separate sections of the bill amend the preemption provisions of the National Bank Act and the Home Owners Loan Act for national banks, federal savings associations and their subsidiaries. The application of a state consumer financial protection law to a national bank is preempted only if:

- application of the state law would discriminate against the national bank in favor of a state-chartered institution;
- the preemption complies with the standards of the U.S. Supreme Court in *Barnett Bank v. Nelson*, either by a court or by the OCC on a case-by-case basis; or
- the state law is preempted by a provision of federal law other than Title X.

The bill goes on to provide that non-bank affiliates and subsidiaries do not enjoy this protection. State laws apply to them in the same way the laws would apply to any other non-bank entity. Additionally, the bill makes explicit that it does not intend to completely "occupy

the field" in any area of law, removing one of the standard bases for a preemption determination.

However, it also provides that federal law permitting national banks to charge interest at the rate allowed in any state where the bank is located is not affected.

A following section of the bill states simply that the preemption standards for federal thrifts are the same as those for national banks.

The bill also adopts the visitorial powers decision of the Supreme Court in *Cuomo v. Clearing House Assn*. by saying the bill does not restrict the ability of state attorneys general to enforce any applicable law against national banks or federal thrifts.

Enforcement Powers

The BCFP is given standard investigative and enforcement powers. These include the ability to launch investigations, require the production of information, subpoena witnesses and enforce these demands. It can proceed through administrative hearings or, in appropriate circumstances, through litigation.

Remedies available to the Bureau include contract rescission, refunds or restitution, damages and civil money penalties. In the case of a knowing violation of a federal consumer financial protection law, the BCFP can impose a civil money penalty of as much as $1,000,000 per day. The Bureau also has the power to place limits on a person's future activities, such as excluding someone from participation in the financial services industry.

The BCFP can refer appropriate cases to the Attorney General for criminal prosecution. It also has the right to provide the Internal Revenue Service with information about potential tax law violations that it finds during the course of its examinations.

The bill provides whistleblower protections for financial market participant employees who provide it with information.

Amendments to Other Laws

Title X includes changes to some existing federal consumer financial protection laws, including the Truth in Lending Act (TILA), Electronic Fund Transfer Act (EFTA) and Fair Credit Reporting Act.

The EFTA would be amended to allow the Fed to adopt rules on interchange fees charged by debit card networks, which also are referred to as "swipe fees." The Fed would be instructed to require that these fees be "reasonable and proportional" to the cost incurred by the debit card network. Small issuers—those with consolidated assets of less than $10,000,000,000—will be exempt from the Fed's rule. This provision would take effect one year after Title X is passed.

Title X also would seek to end what are seen as anticompetitive restrictions often imposed by debit card and credit card networks. Debit card network rules that prevent merchants from offering consumers discounts or incentives for choosing to use a card issued by a different network would be prohibited. Similarly, rules that prevent merchants from offering discounts or incentives to induce the use of a different payment method—such as using cash instead of a credit card—would be prohibited. Another provision would ban rules that prohibit merchants from setting minimum (or maximum) transaction limits.

TILA would be amended to prohibit the payment to mortgage brokers of what are called "yield spread premiums"—payments based on bringing in mortgage loans at higher interest rates. Any compensation to a broker based on the terms of a loan, other than the principal amount, would be banned.

Also, mortgage loan originators would generally be prohibited from arranging for a consumer to finance any fee or cost other than bona fide settlement charges of third parties.

Another TILA amendment would require mortgage lenders to obtain "verified and documented information" establishing that a consumer has a reasonable ability to repay the loan according to its terms, as well as to pay all taxes, insurance and assessments. A lender who knows that a consumer will be receiving more than one loan secured by the same property must determine that the consumer will be able to make all of the required payments. Lenders are instructed that they must obtain tax forms, payroll receipts, bank records and other third-party documents. In the case of adjustable rate mortgages, a consumer's ability to repay is to be based on the maximum interest rate allowed during the first five years and a payment schedule that would fully amortize the loan.

Additionally, Title X would restrict the use of mortgage loan prepayment penalties. The restriction would ban prepayment penalties for mortgages that do not satisfy the criteria to be defined as "qualified mortgages" and limit prepayment penalties for qualified mortgages to the first three years after the loan is made. Even in the case of qualified mortgages, a lender that offers a consumer a loan with a prepayment penalty also must offer a loan without the penalty feature.

There are 10 criteria for what is a qualified mortgage. These include that the loan must:

- have a fixed interest rate, be fully amortizing and not have a large balloon payment;

- have an interest rate that does not exceed maximum limits specified in the bill;
- meet described underwriting standards;
- have total points and fees of no more than 2 percent of the loan amount;
- be for no longer than 30 years.

Some reverse mortgages also will be qualified mortgages.

The Fair Credit Reporting Act would be amended to require that an adverse action notice provide the affected consumer with any numerical credit score that was considered by the lender, insurer or employer. The amendment would not require disclosure of credit scores as part of the routine credit report disclosures to which consumers have a right.

Title X also creates a new data collection requirement intended to facilitate the enforcement of fair lending laws as they apply to loans to woman- and minority-owned small businesses.

Effective Dates

Much of Title X would take effect on the "designated transfer date." This is a date to be selected by the Secretary of the Treasury for the transfer of the consumer protection functions to the Bureau. It is to be at least 180 days, but not more than 18 months, after the date of Title X's enactment. The outside date can be extended for an additional six months, if necessary.

Some provisions have other effective dates:

- Subtitle A, which creates and describes the BCFP, would be effective on the date of enactment. There also are a number of conforming amendments set out in Subtitle H that are effective on enactment.
- The mandated interchange fee limit rules would be due nine months after the date of enactment, and the limits would be effective one year after enactment.
- No effective date is specified for the amendments intended to prevent anti-competitive practices, making them effective on enactment of the bill.
- Also, no effective date is specified for the provisions on yield spread premiums, mortgage repayment ability verification, prepayment penalties or credit scores, making them effective on the date of enactment.

Federal Reserve System

With an increased role in supervising larger, more complex holding companies with assets over $50 billion and other systemically significant financial firms, Title XI of the Act—Sections 1151-1159—would strengthen the Federal Reserve System, increase transparency and eliminate conflicts of interest.

Emergency Lending Authority

Given the nearly $2 trillion that the Federal Reserve Board lent under Section 13 of the Federal Reserve Act to address the credit and financial crisis that occurred in late 2008 and early 2009, the Act would require the Fed to establish policies and procedures to ensure that any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company, and that the collateral for emergency loans is of sufficient quality to protect taxpayers from losses.

Following the establishment any new lending program or facility, the Fed would also be required to submit a report to the Senate Banking Committee and the House Financial Services Committee providing information on the identity of the recipient receiving the assistance, the date and amount of the assistance and material terms of the assistance.

GAO Review of Credit Facilities

The Act would expand the GAO's ability to review credit facilities established by the Fed or a Federal Reserve Bank. Currently, 31 USC 714(e) allows the GAO to conduct an onsite examination of "any action taken by the Board under the third undesignated paragraph of Section 13 of the Federal Reserve Act (12 U.S.C. 343); with respect to a single and specific partnership or corporation."

The review of a credit facility is to assess: the facility's operational integrity, accounting, financial reporting and internal controls; the effectiveness of the facility's collateral policies that mitigate risk to the relevant FRBank and taxpayers; whether the credit facility inappropriately favors one or more specific participants over other institutions; and the policies governing the use, selection or payment of third-party contractors by or for any credit facility.

One-Time GAO Audit

Section 1159 of the Act, which was added as an amendment offered by Sen. Bernard Sanders, I-Vt., would require the GAO to conduct a one-time audit of all loans and other financial assistance provided by the Fed between Dec. 1, 2007, and the date of enactment of the Act.

The review of the Fed programs is to assess: the programs' operational integrity, accounting, financial reporting and internal controls; the effectiveness of the programs' collateral policies that mitigate risk to the relevant FRBank

and taxpayers; whether the programs inappropriately favor one or more specific participants over other institutions; the policies governing the use, selection, or payment of third-party contractors by or for any of the programs; and whether any conflicts of interest existed.

Public Access to Fed Information

The Fed also would be required place on its homepage a link entitled "Audit," which links to a webpage that will serve as a repository of information made available to the public. The information to be posted includes reports prepared by the Comptroller General, annual financial statements and reports submitted to the Senate Banking Committee relating to the Fed's emergency lending authority.

Liquidity Event Guarantees

Sections 1154, 1155 and 1156 of the Restoring American Financial Stability Act of 2010 would establish a mechanism in which the FDIC creates a program to guarantee obligations of solvent insured depository institutions or solvent depository institution holding companies during times of severe economic distress.

A "liquidity event" is defined as a reduction in the usual ability of financial market participants to either sell a type of financial asset without a significant reduction in price or to borrow using that type of asset as collateral without a significant increase in margin. A significant reduction in the usual ability of financial and nonfinancial market participants to obtain unsecured credit is also considered to be a "liquidity event."

Federal Reserve Governance

The Act also would make a number of amendments to the Federal Reserve Act relating to governance on the Federal Reserve Banks (FRBanks) and the supervisory and regulatory policies of the Federal Reserve Board.

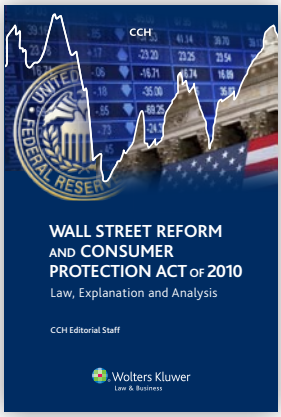
The Federal Reserve Bank of New York president, who is currently appointed by the district board of directors, would be appointed by the president, with the advice and consent of the Senate.

In addition, no company or subsidiary or affiliate of a company that is supervised by the Fed would be able to vote for FRBank directors. Moreover any officer, director and employees of these Fed-supervised companies and their affiliates would be prohibited from serving as FRBank directors. This intent of these provisions is to eliminate potential conflicts of interest at FRBanks.

A member of the Fed's Board of Governors would be required to serve as Vice Chairman for Supervision. This Vice Chairman would be designated by the president, with the advice and consent of the Senate. The Vice Chairman for Supervision would develop policy recommendations regarding supervision and regulation for the Fed and would appear before Congress semi-annually to report on the efforts, objectives and plans of the Fed with respect to the conduct of supervision and regulation.

Finally, the Act would provide that the Fed may not delegate to a FRBank its functions for the establishment of policies for the supervision and regulation of depository institution holding companies and other financial firms supervised by the Fed.

Be Prepared for Historic Financial Reform



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