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# Financial Regulatory Reform - The Next Chapter: Unprecedented Rulemaking and Congressional Activity

**K&L Gates published this alert prior to July 21, 2010, the date on which President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. However, this alert discusses the final version of the bill that would eventually be signed into law.**

On June 30, 2010, the House adopted the conference report on H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Bill" or "Bill"). The Senate is expected to follow suit when it returns from recess later in July. This alert provides a high-level summary and analysis of the significant aspects of the Bill. In the days ahead, K&L Gates will be issuing alerts addressing in detail the various provisions of the Bill.

## Background

The conference committee proceedings began on June 10. The conferees worked arduously over a two-week period and, after working through the night, approved the conference report early in the morning of June 24. However, early last week, it became clear that the Senate did not have the 60 votes necessary to adopt the conference report. Senator Robert Byrd's (D-WV) death resulted in the loss of a vote. Additionally, Senator Scott Brown (R-MA), who had previously voted for the measure, came out in opposition due to the financial crisis assessment that was added toward the end of the conference in order to comply with statutory pay-as-you-go requirements. The conference committee reconvened on June 29 in order to substitute that provision by raising the deposit insurance fund's minimum reserve ratio from 1.15 percent to 1.35 percent and by ending the Troubled Asset Relief Program early in an effort to address Senator Brown's concerns and garner his vote. Additionally, memorial services for Senator Byrd resulted in a truncated work week, deferring further action by the Senate until after the July 4th Recess.

Please see K&L Gates alerts *Approaching the Home Stretch: Senate Passes "Restoring American Financial Stability Act of 2010"* and *House Passes Financial Regulatory Reform Legislation* for additional information.

## Systemic Risk

The Bill establishes a regulatory framework for monitoring the nation's financial stability and managing systemic risks. The Bill creates a Financial Stability Oversight Council ("FSOC"), consisting of ten voting members who will be the heads of the federal financial regulators, charged with identifying and monitoring systemic risks to financial markets. The FSOC has the authority to require, by a 2/3 vote, that nonbank financial companies (including foreign nonbank financial companies) whose failure would pose systemic risk be placed under the supervision of the Board of Governors of the Federal Reserve System ("Federal Reserve").

Among the factors the FSOC must consider in making this determination are: the company's leverage; the extent and nature of off-balance sheet exposures; relationships with other significant nonbank financial companies and significant bank holding companies; the nature, scope, size, and scale; concentration, interconnectedness and mix of the company's activities; and any other risk-related factors the FSOC deems appropriate. The FSOC's authority to subject nonbank financial companies to heightened regulation by the Federal Reserve is limited to nonbank financial companies that are "predominantly engaged in financial activities." A company is "predominantly engaged in financial activities" if at least 85 percent of its consolidated annual gross revenues or 85 percent of its consolidated assets are related to activities that are financial in nature.

Under the Bill's provisions, the FSOC has the authority to recommend that the Federal Reserve adopt more stringent prudential standards and reporting and disclosure requirements for nonbank financial companies supervised by the Federal Reserve and "large interconnected bank holding companies" (those with assets greater than $50 billion). The standards may be increased in stringency depending on a variety of factors, including the company's size and total liabilities. The bill also authorizes the FSOC to make recommendations to the Federal Reserve on various other matters, including requiring such firms to submit resolution plans, mandating credit exposure reports, establishing concentration limits, and limiting short-term debt. Further, FSOC may also recommend that other Federal financial regulators impose more stringent regulation upon, or ban altogether, financial activities of any financial firm that poses significant risks to the financial system.

### Enhanced Federal Reserve Authority

As discussed above, the Bill requires that nonbank financial institutions designated as systemically significant by the FSOC, and large bank holding companies, be regulated by the Federal Reserve. Once these entities are designated, the Bill requires the Federal Reserve to impose more stringent prudential standards and reporting and disclosure requirements, taking into consideration differences among them. Notably, given the Bill's significant expansion of the Federal Reserve's oversight of nonbank financial companies, the Bill also allows the Federal Reserve, in conjunction with the FSOC, to create a safe harbor exempting certain types of nonbank financial companies from its supervision.

### Minimum Leverage and Risk-Based Capital Requirements (Collins Amendment)

One of the Bill's most significant reforms, and a source of significant debate, is the establishment of minimum capital requirements advocated by Senator Susan Collins (R-ME). The Bill establishes minimum leverage and risk-based capital requirements determined on a consolidated basis for insured depository institutions, depository institution holding companies (including U.S. holding companies owned by foreign companies), and nonbank financial companies supervised by the Federal Reserve. Thus, bank holding companies and large nonbank financial companies supervised by the Federal Reserve will face the same capital and risk requirements that apply to banks. Further, in order to mitigate any threat posed by such an institution that engages in risky financial activities as determined by FSOC, the Bill directs Federal banking agencies to impose additional capital requirements.

Trust-preferred securities ("TRuPS") will no longer count as Tier 1 capital and will be phased out. The Bill provides an exemption, however, for depository institution holding companies with less than $15 billion of assets, allowing them to grandfather existing TRuPS as Tier 1 capital. Larger depository institution holding companies and systemically significant nonbank financial firms have three years to phase out existing TRuPS beginning on January 1, 2013 and to replace them with common stock or other securities.

## Resolution

### Liquidation Authority

The Bill establishes a Liquidation Authority for winding down "covered financial companies." Under the provisions, the Treasury Secretary, upon a written recommendation approved by 2/3 votes of the boards of both the Federal Reserve and the Federal Deposit Insurance Corporation ("FDIC"), may decide to appoint the FDIC as a receiver for a financial company that is in danger of default and such default would have a systemically significant

impact. Covered financial companies that may be subject to the Liquidation Authority include (1) bank holding companies, (2) nonbank financial companies supervised by the Federal Reserve, and (3) companies that are "predominantly engaged" in activities that are financial in nature under section 4(k) of the Bank Holding Company Act.

### Orderly Liquidation Fund

The Bill would create an Orderly Liquidation Fund ("Fund") to fund future liquidations. Instead of being pre-funded, the Fund would be financed through the FDIC's issuance of debt securities to the Treasury Department, up to a maximum amount, subsequent to the FDIC's appointment as receiver. Further, the FDIC must submit acceptable orderly liquidation and repayment plans to the Treasury before it can use any money from the Fund.

In the event the FDIC is unable to repay the government within 60 months, the Bill requires the FDIC to impose assessments upon creditors who received payments from the government in excess of amounts they would have otherwise received in liquidation. If the FDIC cannot recoup its losses through assessments on creditors then, as a last resort, the FDIC can impose risk-based assessments on bank holding companies with consolidated assets over $50 billion, financial companies with consolidated assets over $50 billion, and nonbank financial companies supervised by the Federal Reserve. The FDIC will determine assessments based upon a risk matrix it has established, after taking into consideration recommendations from the FSOC.

## Depository Institutions & Bank Holding Companies

Under the Bill, depository institutions and their holding companies face new supervisory regulators, increased activities restrictions and capital requirements, and numerous other fundamental changes in how they are regulated.

### Changes to Supervisory Authority

Within one year to 18 months after enactment, the Office of Thrift Supervision ("OTS") will be abolished. Its authority over Federal thrifts will be transferred to the Office of the Comptroller of the Currency ("OCC"), where a Deputy Comptroller will be appointed to oversee Federal thrifts. OTS authority over state thrifts will be transferred to the FDIC, and the Federal Reserve will gain supervisory authority over savings and loan holding companies. All existing OTS regulations and orders will remain in effect, but they will be enforceable by the agencies receiving the relevant authority.

The Bill also increases the OCC's autonomy, giving it the discretion to set fees and keep the resulting revenue, which is not subject to the appropriation process.

The Federal Reserve will have increased authority over bank holding companies and savings and loan holding companies, including increased examination and reporting authority over subsidiaries. If the Federal Reserve fails to conduct examinations of a nonbank subsidiary, the relevant banking agency has back-up authority to examine and take enforcement action against the nonbank subsidiary. Financial holding companies will have to seek prior Federal Reserve approval for transactions involving the acquisition of assets worth $10 billion or more. In order to pay for its additional supervisory authority over holding companies, the Federal Reserve is authorized to assess fees from large bank holding companies, as well as systemically significant nonbank financial companies.

### Proprietary Trading and Hedge Fund Activities

Another area of controversy during Congress' deliberations has been the provisions known as the "Volcker Rule," named after the provisions' main advocate, former Federal Reserve Chairman Paul Volcker. The Volcker Rule generally prohibits banks from engaging in proprietary trading or sponsoring or owning an equity interest in a hedge or private equity fund. The FSOC has six months to conduct a study on implementing the Volcker Rule, after which the Federal banking agencies, the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") will have nine months to coordinate the promulgation of regulations. The Volcker Rule applies to insured depository institutions, their holding companies, companies treated as bank holding companies, and any subsidiary of these companies. It would not apply to qualifying non-

depository trust companies. Despite the broad, general prohibition, the Volcker Rule lists numerous activities that, subject to certain conditions, are nonetheless permitted.

The Volcker Rule also imposes a general concentration limit on all financial companies, prohibiting any acquisition that would result in a financial company having more than 10 percent of the aggregate consolidated liabilities of all financial companies. The Bill imposes similar concentration limits with respect to insured deposits. Interstate merger transactions are generally prohibited if they would result in the applicant having more than 10 percent of all deposits held by insured institutions in the U.S.

### Deposit Insurance

The Federal deposit insurance limit was temporarily increased to $250,000 in the fall of 2008, and the Bill makes that increase permanent. Unlimited insurance on all noninterest bearing transaction accounts has been extended only through the end of 2012, despite considerable efforts to make such insurance permanent.

As part of the accommodation to Senator Brown with respect to the funding provisions discussed above, the Bill raises the deposit insurance fund's minimum reserve ratio from 1.15 percent to 1.35 percent, but instructs the FDIC to "offset the effect" of the increase on institutions with assets of less than $10 billion.

## Private Funds

The Bill generally requires advisers to private funds, with certain exceptions, to register with the SEC if the adviser has assets under management of $100 million or more. The Bill subjects advisers to private funds to recordkeeping and reporting requirements related to the private funds they advise and subjects those advisers (with some exceptions) to SEC examination.

As noted above, the Bill also places severe limitations on the ability of U.S. and certain non-U.S. financial institutions regulated by the Federal Reserve to sponsor or invest in a "hedge fund" or "private equity fund."

### Significant Carve-Outs

The inclusion of carve-outs has been the most controversial portion of the private fund title. The significant carve-outs from SEC registration are advisers to venture capital funds, advisers to mid-sized private funds, advisers to family offices and foreign private advisers. Advisers who solely advise one or more venture capital funds (to be defined by rulemaking) will be exempt from SEC registration but are subject to the Bill's recordkeeping and reporting requirements for advisers to private funds. Advisers to mid-sized private funds will be exempt from SEC registration, but will be subject to recordkeeping and reporting requirements if the adviser solely advises private funds and has assets under management of less than $150 million. Advisers to family offices (also to be defined by rulemaking) are excluded from the term "investment adviser" under the Investment Advisers Act of 1940 and, as a result, will not be required to register with the SEC or be subject to recordkeeping and reporting requirements, but, generally, will be subject to the anti-fraud provisions of the Advisers Act. Advisers that have no place of business in the United States and have in total fewer than 15 U.S. clients and investors in the funds they advise, if the total amount of assets managed by such advisers for their clients and funds is less than $25 million, are exempt from registration, provided that they do not hold themselves out as an investment adviser and do not advise a registered investment company or a business development company.

### Federal Registration Threshold

The Bill raises the threshold for adviser registration with the SEC to $100 million for certain advisers. An adviser is prohibited from registering with the SEC if it: (1) is required to be registered as an adviser with a securities commissioner (or any agency or office performing like functions) of the State in which it maintains its principal office and place of business and, if registered, would be subject to examination as an adviser by the State's commissioner, agency or office; and (2) has assets under management between $25 million and $100 million (or a higher amount if the SEC deems appropriate) unless it (a) is an adviser to an investment company or a business development company that has not withdrawn its election, or (b) would be required to register in 15 or more states.

**Investor Standards**

The Bill raises the financial threshold for a natural person to qualify as an "Accredited Investor," as defined in Regulation D under the Securities Act of 1933, and requires subsequent reviews by the SEC of such definition and adjustments to this financial threshold. The Bill also requires the SEC to index for inflation the dollar amount measures in any test it establishes to determine who is a "qualified client" for purposes of permitting the assessment of a performance fee by a registered investment adviser and rounding such amount to the nearest $100,000 when making such determinations.

## Over-the-Counter ("OTC") Derivatives

The Bill establishes a new regulatory regime for the OTC derivatives market. The CFTC and the SEC are authorized to write rules for the swaps and security-based swaps markets respectively and are required to coordinate to the extent possible. The CFTC and the SEC are both given the authority to ban abusive swaps if they believe the swaps or security-based swaps would be detrimental to the stability of a financial market or participants in a financial market.

The Bill requires the clearing of swaps and security-based swaps that have been accepted to be cleared by a clearinghouse and approved by the CFTC and/or SEC. Swaps and security-based swaps that are currently listed for clearing by a derivatives clearing organization will be reviewed by the CFTC or the SEC to determine whether the swap or security-based swap should be required to be cleared. New swaps and security-based swaps will have to be approved by the CFTC or the SEC before the swap or security-based swap will be required to be cleared. If a swap or security-based swap cannot be cleared, then it must be reported to a swap data repository or security-based swap data repository, or, if there is no swap data repository or security-based swap data repository to accept the swap or security-based swap then it must be reported to the CFTC or the SEC.

If a swap or security-based swap is required to be cleared, it must be exchange-traded if a designated contract market, swap execution facility, national securities exchange or security-based swap execution facility will accept it for trading. The Bill also requires public reporting of swap and security-based swap transaction and pricing data. The Bill gives the CFTC, the SEC and banking regulators the authority to impose capital and initial and variation margin requirements on dealers and major participants with respect to uncleared swaps and security-based swaps. The Bill also authorizes regulators to establish position limits on certain contracts and prohibits market manipulation.

**Lincoln Rule**

During conference committee consideration, the most controversial aspect of the OTC derivatives title was section 716 (the "Lincoln Rule"). The conference committee report represents a significant departure from the original Lincoln Rule. Banks will now be able to retain swap trading desks involving interest rates or reference assets that are permissible for investment by a national bank or hedging and other similar risk mitigating activities with respect to the bank's own risk. Riskier derivatives such as metals (excluding gold and silver) would have to be traded through a separate, capitalized affiliate. The new Lincoln Rule does not apply to (1) an insured depository institution containing a "swaps entity" affiliate, if the insured depository institution is part of a bank holding company or savings and loan holding company that is supervised by the Federal Reserve; or (2) an insured depository institution that limits its swap product activities to hedging and similar risk mitigating activities directly related to the insured depository institution activities.

**End-User Exemption**

The Bill's end-user exemption is available if one of the counterparties to a swap or security-based swap (1) is not a financial entity (defined in the Bill); (2) is using swaps or security-based swaps to hedge or mitigate commercial risk; and (3) notifies the CFTC or SEC, in a manner set forth by the respective Commission, how it generally meets its financial obligations associated with entering into uncleared swaps or security-based swaps. Affiliates (including affiliated entities predominantly engaged in providing financing for the purchase of the merchandise or manufactured goods of the person) may take advantage of the exemption only if the affiliate, acting on behalf of the person and as an agent, uses the swap or security-based swap to hedge or mitigate the commercial risk of the person

that is not a financial entity. Affiliates may not use the exemption if they are a prohibited entity (defined in the Bill). If the end-user is a publicly-traded company, its board must approve operating in accordance with the exemption.

**Retroactive Collateral**

Another controversial provision dealt with the potential retroactive imposition of initial and variation margin on pre-existing bilateral swap agreements. After the conference report was agreed to, Senate Banking Committee Chairman Chris Dodd (D-CT) and Senate Agriculture Committee Chairman Blanche Lincoln (D-AR) allayed this concern in a letter sent to House Financial Services Committee Chairman Barney Frank (D-MA) and House Agriculture Chairman Collin Peterson (D-MN) clarifying the legislative intent with respect to the derivatives title, particularly that it was not intended to apply retroactively or to close the forward contract exclusion from the swap definition.

## Payment Clearing and Settlement Supervision

The Bill also authorizes the Federal Reserve, in consultation with the FSOC and the Supervisory Agencies, to prescribe standards regulating (1) the risk management of systemically important financial market utilities ("FMU"), and (2) systemically important payment, clearing and settlement activities conducted by financial institutions. Supervisory Agency refers to the Federal agency that has primary jurisdiction over the FMU, including the Federal Reserve, the SEC, or the CFTC. The FSOC would determine which FMUs or activities are systemically important by a 2/3 vote.

## Investor Protection

The Bill contains numerous provisions designed to reform the SEC and to protect investors. Under the Bill, the SEC gains additional enforcement powers, including the ability to issue rules restricting or prohibiting mandatory pre-dispute arbitration clauses in agreements with customers. The Bill establishes whistleblower protections, including a whistleblower office, monetary awards for whistleblowers, and a prohibition against employer retaliation. The SEC is authorized to bar individuals from the entire securities industry, rather than just a particular segment of the industry, and the SEC is required to issue rules barring felons and other bad actors from participating in Regulation D offerings. Subpoenas may be issued nationwide in proceedings initiated by the SEC.

Liability under the securities laws is expanded to include anyone who "knowingly or recklessly provides substantial assistance" in violating the statute or regulation. The SEC may impose civil money penalties in cease-and-desist proceedings, and the U.S. courts have jurisdiction over any violation of the antifraud provisions of the securities laws, provided that a "significant step" in furtherance of the fraud took place in the U.S. The Bill does not create a private right of action against people who aid or abet violations of the securities laws, but it does call for a study of such an expansion.

**Broker-Dealer Fiduciary Duty**

One of the most controversial investor protection measures is the possibility of imposing a fiduciary duty on broker-dealers. In its final form, the Bill calls for a study by the SEC of the standards of care for brokers, dealers, and investment advisers for providing personalized investment advice to retail customers. The study will also examine the effectiveness of enforcement and compliance mechanisms and consider alternative means of imposing a fiduciary duty on broker-dealers. When the study is complete, the SEC is authorized to issue rules imposing a fiduciary-like duty on broker-dealers in providing advice to retail customers. The permissible standard of conduct is to act "in the best interest of the customer" without regard to the financial interest of the broker, dealer, or investment adviser.

## Securitization

The Bill requires securitizers to retain an economic interest in the credit risk for any asset that securitizers transfer, sell, or convey to a third party. Under these requirements, securitizers must retain not less than five percent of the credit risk for any asset that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security. The risk retained may be less than five percent in the case that the originator of the asset meets certain underwriting standards, as established by the OCC,

Federal Reserve, and FDIC. The regulations may provide for total or partial exemptions of any securitization that may be in the public interest and for the protection of investors, including an asset issued or guaranteed by the Federal government or subdivision thereof.

The Bill also contains the "qualified residential mortgage carve-out," based in part on a proposal by Senator Mary Landrieu (D-LA). Under this provision, the securitizer is not required to retain any risk in the case that all of the assets that collateralize the asset-backed security are qualified residential mortgages.

## Credit Rating Agencies

The Bill puts in place an entirely new framework to govern and regulate nationally recognized statistical rating organizations ("NRSROs"). The Bill establishes an Office of Credit Ratings ("OCR") within the SEC. The OCR is required to examine NRSROs and make reports on key findings annually. Additionally, the Bill provides the SEC/OCR with broad rulemaking authority.

The Bill provides OCR with the authority to deregister an NRSRO for providing bad ratings over time. Additionally, the Bill creates a private right of action against credit rating agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source.

Notably, the Bill removes several statutory references to credit ratings, credit rating agencies, and NRSROs. Additionally, there is a provision requiring all Federal agencies to review their regulations and modify them by striking these references.

## Executive Compensation and Corporate Governance

The Bill directs the SEC to promulgate several rules pertaining to the executive compensation practices of public companies. Significantly, the Bill directs the SEC to promulgate rules providing shareholders of public companies with an advisory vote on executive compensation ("say on pay") and, in certain cases, golden parachute arrangements. Additionally, under this provision, institutional investment managers must disclose their say on pay vote. The Bill also prohibits brokers who are not beneficial owners from voting by proxy unless the beneficial owner has instructed the broker to vote on the owner's behalf. The Bill requires the SEC to promulgate rules prohibiting the listing of issuers that do not have independent compensation committees; however, the SEC will have the authority to exempt certain issuers, taking into account issuer size.

Notably, the Bill directs the Federal Reserve, OCC, FDIC, OTS, National Credit Union Administration, SEC, and Federal Housing Finance Agency to promulgate and enforce rules requiring financial institutions to disclose the structure of incentive-based compensation arrangements and to prohibit any arrangement deemed to provide "excessive compensation, fees, or benefits" or that "could lead to material financial loss." The Bill exempts financial institutions with assets less than $1 billion.

The Bill authorizes the SEC to determine the terms and conditions of proxy access and to exempt certain issuers from the provisions.

## Municipal Securities

The Bill prohibits a municipal advisor from providing advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or, with respect to the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, unless the municipal advisor is registered with the SEC. The Bill prohibits municipal advisors from providing advice, or from acting on behalf of an obligated person engaging in fraudulent, deceptive, or manipulative acts or practices. The Bill reconstitutes the Municipal Securities Rulemaking Board ("MSRB") to give investors and public representatives a majority on the MSRB. The Bill imposes a fiduciary duty on advisors who advise a municipal entity and prohibit municipal advisors from engaging in any act, practice, or course of business which is not consistent with the municipal advisor's fiduciary duty or that is in contravention of any rule of the MSRB. The Bill also establishes an Office of Municipal Securities at the SEC.

## Consumer Financial Protection

One of the areas of contention during the development of the legislation has been the issue of consumer financial protection. The Bill addresses this issue by establishing a Bureau of Consumer Financial Protection ("CFPB") that will be housed within the Federal Reserve. The CFPB will be headed by a Director who is nominated by the President, with the advice and consent of the Senate. Notably, the Bill explicitly states that no CFPB rule or order shall be subject to approval or review by the Federal Reserve. The CFPB will, however, be funded through a transfer from the Federal Reserve for amounts reasonable to carry out the CFPB's authorities; in the case such sums are insufficient, the CFPB may request appropriations.

The CFPB would have authority for consumer protection with respect to financial products and services offered by both banks and nonbanks. The CFPB has broad rulemaking authority, which it must exercise in consultation with appropriate Federal government entities. Notably, the CFPB's rulemaking authority includes the ability to exempt classes of covered persons, providers, and financial products or services. Moreover, upon petition of a member agency of the FSOC and subject to a 2/3 vote of the FSOC, the FSOC may set aside a CFPB regulation.

The Bill establishes the CFPB as the Federal agency with examination and enforcement authority over large depository institutions and nonbank financial institutions for compliance with the consumer protection laws. The prudential regulators will retain this authority for insured depository institutions and credit unions with assets of $10 billion or less. Notably, the Bill excludes from supervision and enforcement numerous financial service providers. These include: merchants, retailers, and sellers of nonfinancial goods or services; real estate brokerage activities; manufactured home retailers and modular home retailers; accountants and tax preparers; persons regulated by state insurance regulators; employee benefit and compensation plans; persons regulated by state securities commissions, the SEC, or the CFTC; activities related to charitable contributions; and auto dealers.

### Preemption

The Bill's preemption provisions make clear that Federal consumer financial protection law is the floor and states have the authority to enact more stringent requirements. The Bill revises the standard the OCC will use to preempt state consumer protection laws. Specifically, the Bill allows for preemption of state consumer financial law, only if: (1) its application would have a discriminatory effect on national banks, in comparison with banks chartered by that State; (2) the preemption determination, made by OCC or a court on a case-by-case basis, is in accordance with the legal standard in *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner, et al.*, 517 U.S. 25 (1996); or (3) it is preempted by another Federal law.

### Interchange Fees

Significant controversy occurred around the interchange fee debate. Surprisingly, the Senate adopted an amendment offered by Senator Dick Durbin (D-IL) regulating debit interchange fees. Although there has been a major lobbying effort against the controversial amendment, interchange fee provisions were included in the final version, though they were modified to ameliorate drafting and definitional issues. Among other things, the provision provides that the Federal Reserve cannot regulate network fees except to ensure that the fees are not used to circumvent interchange fee regulation and permits consideration of fraud prevention costs in the calculation of reasonable and proportional interchange rates.

## Mortgage Reform and Anti-Predatory Lending

Lax standards for mortgages and imprudent lending practices that led to the "housing market crash" are widely attributed as a primary contributor to the financial crisis that the reform Bill is intended to address. Most notably, the Bill establishes minimum national standards that are designed to require lenders to ensure that a borrower is able to repay a home loan at the time the loan is made. Under the Bill, a lender's determination that a borrower is able to repay a loan must be based on verified and documented information, including the borrower's income and credit history, current obligations, debt-to-income ratio, and employment

status. A lender may presume that a borrower will be able to repay a loan if the loan has certain low-risk characteristics that meet the title's definition of a "qualified mortgage." Similarly, refinancings are exempted from the minimum mortgage standards if they exhibit certain low-risk characteristics. However, the Bill prescribes additional requirements for "nonstandard" loan products.

Additionally, the Bill prohibits many of the practices perceived as "predatory" that lenders used to entice borrowers into taking out costly loans that they were ultimately unable to pay over the life of the loan. For instance, the Bill prohibits mortgage originators from receiving compensation that varies based on the terms of the loan. The Bill specifically prohibits "yield spread premiums," which historically incentivized lenders and mortgage brokers to steer borrowers into risky mortgages.

The Bill also establishes appraisal independence requirements that prohibit a person with an interest in the underlying mortgage transaction from compensating, coercing, bribing, or intimidating a person or entity conducting an appraisal with the purpose of influencing the appraisal value.

**Government Sponsored Enterprise ("GSE") Reform**

This title includes a "Sense of the Congress" that expresses the importance of reforming Fannie Mae and Freddie Mac. Throughout consideration of the financial reform bill, Republican members of Congress repeatedly called for inclusion of reforms to these entities; however, the Obama Administration and Democratic leadership have insisted on keeping GSE reform separate – largely due to concern about disrupting the GSEs' current role in propping up the fragile housing market. As a result, Congress is expected to address GSE reform next year.

## Federal Insurance Office

The Bill creates a new Federal Insurance Office ("FIO") within the Treasury Department, ushering in a new era of Federal involvement in the U.S. insurance industry, which has historically been dominated by the states. The FIO will: (1) monitor the U.S. insurance industry, (2) coordinate Federal efforts and policy relating to international insurance matters, (3) determine which state insurance measures are preempted by international agreements, (4) report to Congress annually on the state of the insurance industry, and (5) identify insurers that could pose a threat to financial stability. Health insurance, long-term care insurance, and crop insurance are excluded from the FIO's authority. The FIO has authority over all other lines of insurance. Notably, the FIO Director will have the authority to determine when state insurance measures are inconsistent with international agreements relating to prudential measures for insurance or reinsurance. Additionally, the Bill contains reforms to nonadmitted insurance and reinsurance.

## Next Steps

At the time of this writing, it appears most likely that the conference report will be adopted in its current form by the Senate in mid-July and signed into law by the President shortly thereafter. It is important to note that enactment will mark the beginning of a process that will take months, if not years. The Bill contains rulemaking requirements and study provisions on a multitude of issues, and the Bill is the most far-reaching financial services law ever enacted. Congress necessarily left many of the most contentious policy decisions to rulemaking or study by various administrative agencies. Congress retains a vested interest in the outcome of those processes. Therefore, Congressional oversight of the implementation of the Dodd-Frank Bill is expected to be unprecedented in terms of scope and the impact it will have on the promulgation of rules. Additionally, there will inevitably be subsequent legislation, including technical corrections, substantive modifications, and issue areas that have yet to be addressed. Chairman Frank has already indicated there will be follow-up legislation.

*This client alert is part of a series of alerts focused on monitoring financial regulatory reform.*