

June 2010

K&L Gates includes lawyers practicing out of 36 offices located in North America, Europe, Asia and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information, visit [www.klgates.com](http://www.klgates.com).

## Approaching the Home Stretch: Senate Passes “Restoring American Financial Stability Act of 2010”

**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 May 20, 2010, the Senate passed the “Restoring American Financial Stability Act of 2010” as amended (“Senate Bill”). Congressional leadership has indicated that conference committee proceedings will take place in June, making it likely that the legislation will be passed by the House and Senate before the July 4th Recess and signed into law by the President shortly thereafter.

### Background

By way of background, Senate Banking Committee Chairman Chris Dodd (D-CT) released a draft Senate Bill on March 15. The draft Senate Bill, which had been in development for months, was different in many respects from H.R. 4173, the “Wall Street Reform and Consumer Protection Act of 2009” (“House Bill”), which was passed by the House on December 12, 2009. Although 473 amendments were filed, the Senate Banking Committee’s March 22 markup lasted only 21 minutes. The Committee passed only the Manager’s Amendment and voted along party lines to favorably report the legislation to the full Senate. Please see K&L Gates alerts [Financial Regulatory Reform Legislation Moves to Senate Floor](#), [Senator Dodd Releases Financial Regulatory Reform Legislation: The Home Stretch?](#), and [House Passes Financial Regulatory Reform Legislation](#) for additional information.

The Banking Committee bill was subsequently introduced as original measure S. 3217. Floor consideration began on April 28 and lasted over three weeks. 441 amendments were filed and 33 were adopted. Notably, Chairman Dodd and Senate Banking Committee Ranking Minority Member Richard Shelby (R-AL) were unable to come to an agreement on a package of non-controversial, bipartisan provisions for a comprehensive Manager’s Amendment, leaving many significant issues unresolved. Procedurally, the Senate took up the House-passed H.R. 4173, inserted the text of S. 3217 as amended in lieu of the House’s text, and passed the bill by a vote of 59 to 39. Four Republicans voted for the Senate Bill and two Democrats voted against the Senate Bill.

### Depository Institutions

Both the House and Senate Bills would abolish the Office of Thrift Supervision (“OTS”), giving the Office of the Comptroller of the Currency (“OCC”) supervisory authority over national banks and Federal thrifts. In contrast to the House Bill, the Senate Bill would abolish the Federal thrift charter, with a grandfather provision for existing thrifts.

The Senate Bill does not offer a national mutual bank charter, which was included in the House Bill. During the course of the Senate's consideration of the banking regulatory structure, the Senate Bill moved closer to the House Bill. As such, this is likely not to be an area of significant debate during the conference committee proceedings.

While both Bills modify the exceptions to the Bank Holding Company Act ("BHCA"), they do so differently. The House Bill would significantly narrow the exception to the BHCA for industrial loan companies ("ILCs"), lending companies that are subsidiaries of industrial companies whose primary purpose is to lend to customers, and require most companies that currently own ILCs to either register as bank holding companies or restructure their financial activities. New ILCs would not qualify for the BHCA exception. In contrast, the Senate Bill imposes a three-year moratorium on non-financial firms acquiring control of a credit card bank, ILC, or trust company. During the moratorium, a study would be conducted to evaluate eliminating many of the exceptions to the BHCA.

An area of controversy has been the "Volcker Rule," which would prohibit depository institutions and their holding companies from engaging in proprietary trading and sponsoring hedge funds or private equity funds. It would also impose additional capital requirements and quantitative limits on non-bank financial companies deemed systemically significant by the to-be-created Financial Stability Oversight Council ("FSOC") and prevent companies from merging if the resulting company's liabilities would exceed 10% of the consolidated liabilities of all financial companies. The Volcker Rule, in some form, will likely survive the conference.

### **Systemic Risk & Resolution Authority**

With respect to systemic risk, the Senate and House Bills take a similar approach and, as a result, this is not likely to be an area of significant controversy. However, the specifics of determining which companies can be subjected to stricter standards and the method for supervising them will be issues for conference discussion.

More controversial have been the liquidation funding provisions. Both Bills would create a fund for future liquidations, and the issue was a source of partisan controversy in both chambers. The conference committee will have to resolve several fiercely contested areas, including what entities should be subject to the new resolution regime and whether the fund should be pre-funded. With respect to the latter point, the final bill will mostly likely adopt the Senate Bill's general approach of abolishing a pre-funded fund and allowing Treasury to borrow as necessary to raise working capital.

### **Consumer Financial Protection**

One of the areas of contention has been the structure of the consumer financial protection entity. The Senate Bill steps back from an independent Consumer Financial Protection Agency ("CFPA"), such as the one to be created by the House Bill. Instead, the Senate Bill would establish a Consumer Financial Protection Bureau ("CFPB") within the Board of Governors of the Federal Reserve System ("Federal Reserve"). Chairman Dodd adopted the CFPB structure, in part, with the unsuccessful objective of attracting Republican support in March. Since that time, issues such as over-the-counter ("OTC") derivatives have eclipsed Senate Republicans' focus on consumer financial protection. Another area of debate during the conference will likely be the contours of supervision, examination, and enforcement authority over consumer finance. At end, the conference committee is likely to adopt an approach resulting in stronger consumer financial protection.

Surprisingly, the Senate adopted an amendment offered by Senator Dick Durbin (D-IL) regulating interchange fees, the fees paid by merchants to banks for card transactions using electronic payment networks. Although there has been a major lobbying effort against the controversial amendment, the provision is in a strong position to survive the conference committee proceedings. The staff of House Financial Services Committee Chairman Barney Frank (D-MA) has indicated that modifications may be made to ameliorate drafting and definitional issues; however, the provisions are likely to remain in the final legislation in some form.

Another significant amendment, offered by Senator Jeff Merkley (D-OR), modifies the Senate Bill to set minimum standards for residential mortgage loans. Specifically, the Senate Bill would prohibit lenders from providing mortgages without verified and documented information and would prohibit yield spread premiums, the compensation paid by a lender for higher-rate loans.

### Private Funds

Both the Senate and House Bills would require investment advisers to private funds, with certain exceptions, to register with the Securities and Exchange Commission ("SEC"). Both bills also would require that advisers to private funds maintain records and reports, including records of the types of assets held and other confidential financial information, which would be subject to inspection by the SEC.

Several carve-outs exist in the respective bills. The Senate Bill would not require SEC registration for advisers to private equity funds. The House Bill would not exempt private equity funds from registration with the SEC; rather a carve-out is included for advisers who advise solely private funds and have assets under management in the United States of less than \$150 million. Both bills include a narrow carve-out for "foreign private advisers" who have fewer than 15 clients in the United States and aggregate assets under management attributable to clients in the United States, and to investors in the United States in private funds advised by the adviser, of less than \$25 million, and who do not hold themselves out as advisers in the United States, although the bills differ in how they compute the number of clients and investors in satisfying the 15 or fewer requirement. Another area of debate is the treatment of family offices. Although excluded from the definition of "adviser" and as a result not required to register with the SEC by the Senate Bill, family offices would not be exempt from SEC registration under the House Bill.

### OTC Derivatives

The OTC derivatives title has been one of the most controversial aspects of the Senate Bill and represents a departure from the House Bill in a number of respects. One of the most contentious

provisions in the Senate Bill has been the Lincoln Rule, which would prohibit "swaps entities" from receiving Federal assistance, including access to Federal Reserve liquidity facilities and Federal deposit insurance. This provision would force banks that meet the definition of a swap dealer, security-based swap dealer, major swap participant or major security-based swap participant to divest their swap trading operations or house their swap trading operations in a separate, fully-capitalized affiliate. There has been broad opposition to this provision, making it likely that the provision will be struck or modified in conference.

An additional area of debate has been a provision in the Senate Bill that would authorize regulators to impose initial and variation margin requirements on bilateral swap agreements. Because there is no explicit ban on applying this grant of authority retroactively, this could force end-user counterparties who entered into swaps before enactment of the Senate Bill to post cash collateral, even though the contracts are not required to be cleared.

Another significant provision in the Senate Bill is the exemption from the swap clearing requirements for a commercial end-user who, as its primary business activity, owns, uses, produces, processes, manufactures, distributes, merchandises, or markets goods, services, or commodities, either individually or in a fiduciary capacity. However, "financial entities" (as defined in the Senate Bill) do not qualify for the commercial end-user exemption. The commercial end-user exemption that is ultimately adopted by the conferees will likely be closer to the House version, which is broader and contains an exemption from the clearing requirements if one of the counterparties to the swap is "using swaps to hedge or mitigate commercial risk, including operating or balance sheet risk."

Unlike the House Bill, the Senate Bill would create a fiduciary duty for any swap dealer that advises, offers to enter into, or enters into a swap with governmental entities, pension plans, or endowments. The prospect of such a duty may cause swap dealers to reconsider whether they will engage in any swap activity with these entities.

### Investor Protection

The Senate Bill contains an assortment of provisions designed to protect investors and enhance enforcement by the SEC. While many of the provisions have not been overly controversial, some have been the source of debate.

For example, under the Senate Bill, the SEC would be empowered to write regulations to set aside mandatory pre-dispute arbitration clauses in agreements between a customer and a broker, dealer, or municipal securities dealer. The arbitration provision of the House Bill is narrower in the sense that it would preserve arbitration clauses in existing agreements, but it is broader in the sense that it would apply to anyone involved in a financial activity involving a consumer.

Another area where the House and Senate Bills take different approaches is the question of whether to impose fiduciary duties on broker-dealers. The House Bill would impose a duty on broker-dealers who offer personalized investment advice about securities to a retail customer “no less stringent than” the duty applicable to investment advisers under the Investment Advisers Act of 1940. The Senate Bill does not impose a fiduciary duty on broker-dealers. Instead, it requires the SEC to conduct a study on the effectiveness of existing standards of care for broker-dealers and investment advisers.

### Municipal Securities

The Senate Bill makes wholesale changes to the municipal securities regulatory regime, while the House Bill takes a narrower approach. The Senate Bill makes significant changes to the relationship between the SEC, the Financial Industry Regulatory Authority (“FINRA”), and the Municipal Securities Rulemaking Board (“MSRB”) with respect to fine collecting, guidance regarding MSRB rules and the sharing of information relating to enforcement actions and examinations undertaken by a registered securities association. The House Bill establishes a framework outside of the MSRB, whereby the SEC is given the power to exempt specific advisers, classes of advisers and employees of municipal financial advisers from SEC registration, as well as establishing a fiduciary duty for certain municipal financial advisers.

### Securitization

The Senate Bill’s securitization provisions, similar to those in the House Bill, would require Federal regulators and the SEC to jointly prescribe regulations requiring risk retention by securitizers of asset-backed securities (“ABSs”). The regulations must require that a securitizer generally retain not less than 5% of the credit risk for any securitized asset that is transferred, sold, or conveyed through issuance of an ABS. However, the Federal regulators and the SEC would have the authority to require less than 5% risk retention if certain underwriting and due diligence standards are met; additionally, the Federal regulators and the SEC would be able to provide a total or partial exemption in certain cases. As an aside, these provisions represent a compromise position that is likely to survive conference, as previous versions of the Senate legislation contained a 10% risk retention requirement.

Notably, the Senate passed an amendment sponsored by Senator Mary Landrieu (D-LA), creating a “qualified residential mortgage” carve-out. Under the carve-out, securitizers would not be required to retain any part of the credit risk if all of the underlying assets are qualified residential mortgages, which would generally be high quality mortgages. The House Bill does not contain a similar provision, but it may survive conference because the carve-out addresses concerns about the impact of the requirements on the still-recovering real estate market by creating a safe harbor for “good” mortgages, while aligning risks and incentives of investors and securitizers with respect to other underlying assets.

### Credit Rating Agencies (“CRAs”)

The Senate Bill would enhance oversight of CRAs. Among other things, the Senate Bill would increase internal controls and require disclosure of rating procedures and methodologies. The Senate Bill would also establish a new Office of Credit Ratings, housed within the SEC, which would be required to examine each Nationally Recognized Statistical Rating Organization (“NRSRO”) once a year and would have the authority to impose fines and other penalties for violations. Although the House and Senate Bills are quite similar in their approach to oversight of CRAs, unlike the House Bill, the

Senate Bill would not require SEC registration of CRAs as NRSROs. It is unclear how the conference committee will deal with this issue, but considering the ongoing attention on the role of the CRAs in the financial crisis, there may be support for the House's approach.

Both the Senate and House Bills provide investors with private rights of action against CRAs. The standard contained in the Senate Bill is knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source. In the House Bill, the standard is gross negligence.

### Insurance

The House and Senate Bills' insurance provisions are nearly the same and, as a result, are relatively noncontroversial. The Senate Bill would create an Office of National Insurance within the Treasury Department to monitor all lines of insurance (except health insurance) and to receive, collect, and require information on and from the insurance industry, insurers, and State and Federal insurance regulators; the House Bill would create a similar entity called the Federal Insurance Office. Both Bills also contain several state-based reforms.

### Executive Compensation and Corporate Governance

The Senate Bill's executive compensation provisions are largely the same as those in the House Bill. The Senate Bill, like the House Bill, would direct the SEC to promulgate guidance requiring public companies to provide shareholders with a nonbinding vote on executive pay and requiring that compensation committees include only independent directors. Notably, the Senate Bill also would require the Federal Reserve to establish standards prohibiting as an "unsafe and unsound practice" any compensation plan of a bank holding company that provides "excessive executive compensation" or that could lead to "material loss." The House Bill takes a slightly different approach, requiring the Federal regulators to issue and enforce joint compensation rules applicable to financial institutions.

One area of moderate debate has been the Senate Bill's corporate governance provisions. Some

Senators have questioned the appropriateness of including provisions pertaining to all public companies, when the legislation is geared primarily toward financial institutions. Similar to the House Bill, the Senate Bill would clarify that the SEC has authority to grant shareholders proxy access to nominate directors. However, there are Members on the other side of the debate who support requiring the SEC, rather than merely clarifying the SEC's authority, to grant shareholder proxy access, so the provision is likely to remain in its current form.

### Next Steps

In terms of the next steps, the Senate has requested a conference with the House to reconcile the differences between the two chambers' versions of the legislation. The Senate has named the following conferees: Chairman Dodd; Senator Tim Johnson (D-SD); Senator Jack Reed (D-RI); Senator Charles Schumer (D-NY); Senator Blanche Lincoln (D-AR); Senator Patrick Leahy (D-VT); Senator Tom Harkin (D-IA); Ranking Member Shelby; Senator Bob Corker (R-TN); Senator Judd Gregg (R-NH); Senator Saxby Chambliss (R-GA); and Senator Mike Crapo (R-ID).

Chairman Frank has circulated a list of possible Democratic conferees, including Congressman Paul Kanjorski (D-PA); Congresswoman Maxine Waters (D-CA); Congresswoman Carolyn Maloney (D-NY); Congressman Luis Gutierrez (D-IL); Congressman Melvin Watt (D-NC); Congressman Gregory Meeks (D-NY); and Congressman Dennis Moore (D-KS). House Republican conferees will likely include House Financial Services Committee Ranking Member Spencer Bachus (R-AL); Congressman Scott Garrett (R-NJ); and Congressman Jeb Hensarling (R-TX). Other probable Republican conferees include Congresswoman Shelley Moore Capito (R-WV) and Congresswoman Judy Biggert (R-IL). House Speaker Nancy Pelosi (D-CA) is expected to appoint conferees on June 8.

Chairman Frank is expected to serve as the chair of the conference committee and will likely dominate the conference. As discussed above, the Senate Bill was not amended in Committee, and efforts to essentially write the bill on the Senate Floor have

resulted in a number of shortcomings and internal inconsistencies. In contrast, Chairman Frank will be able to point to the House Bill that is the product of extensive Committee consideration in “regular order” and that is supported by a robust legislative history. Additionally, Chairman Dodd is retiring, while it is a near certainty that Chairman Frank will continue to serve as the Chairman of the House Financial Services Committee in the 112th Congress if Democrats retain the Majority.

The formal conference may begin as early as June 9, with votes beginning on issues as early as June 15, and approval as early as June 24. Leadership’s timeline suggests final passage by the House and Senate the week of June 28, with the President’s signature shortly thereafter. Chairman Frank has called for televising the conference committee proceedings to enhance transparency. However, the public conference committee proceedings will likely be a mere formality, with most of the negotiations taking place informally, behind closed doors, and at the staff level. In fact, staffs of the House Financial Services Committee and the Senate Banking Committee have already started to informally “pre-

conference” certain issues. This process will continue over the next few weeks, providing a window of opportunity for interested parties to weigh in on and advocate modifications to certain aspects of the legislation.

It is important to note that enactment will mark the beginning of a process that will take months, if not years. In addition to the dozens of study provisions and rulemaking requirements, there will inevitably be a need for subsequent legislation, including technical corrections, substantive modifications, and issue areas that have yet to be addressed, most significantly reform of the government-sponsored enterprises. Therefore, it is to be expected that whatever is finally enacted into law will remain potentially subject to modification and improvement going forward.

Please see K&L Gates updates and the K&L Gates [Global Financial Market Watch Blog](#) for additional background and detailed analysis about the reform effort.

For more information, please contact the following members of the Capital Markets Reform Group:

Diane E. Ambler  
diane.ambler@klgates.com  
+1.202.778.9886

Philip M. Cedar  
phil.cedar@klgates.com  
+1.212.536.4820

Daniel F. C. Crowley  
dan.crowley@klgates.com  
+1.202.778.9447

Vanessa C. Edwards  
vanessa.edwards@klgates.com  
+44.(0)20.7360.8293

Edward G. Eisert  
edward.eisert@klgates.com  
+1.212.536.3905

David H. Jones  
david.jones@klgates.com  
+1.704.331.7481

Steven M. Kaplan  
steven.kaplan@klgates.com  
+1.202.778.9204

Sean P. Mahoney  
sean.mahoney@klgates.com  
+1.617.261.3202

J. Matthew Mangan  
matt.mangan@klgates.com  
+1.415.249.1046

Philip J. Morgan  
philip.morgan@klgates.com  
+44.(0)20.7360.8123

Mary C. Moynihan  
molly.moynihan@klgates.com  
+1.202.778.9058

Anthony R.G. Nolan  
anthony.nolan@klgates.com  
+1.212.536.4843

Clair E. Pagnano  
clair.pagnano@klgates.com  
+1.617.261.3246

Lawrence B. Patent  
lawrence.patent@klgates.com  
+1.202.778.9219

Other alert authors:

Collins R. Clark  
collins.clark@klgates.com  
+1.202.778.9114

Margo Dey  
margo.dey@klgates.com  
+1.202.778.9322

Akilah Green  
akilah.green@klgates.com  
+1.202.661.3752

Justin D. Holman  
justin.holman@klgates.com  
+1.202.778.9317

Karishma Shah Page  
karishma.page@klgates.com  
+1.202.778.9128

Anchorage Austin Beijing Berlin Boston Charlotte Chicago Dallas Dubai Fort Worth Frankfurt Harrisburg Hong Kong London Los Angeles Miami Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh Research Triangle Park San Diego San Francisco Seattle Shanghai Singapore Spokane/Coeur d'Alene Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of 36 offices located in North America, Europe, Asia and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information, visit [www.klgates.com](http://www.klgates.com).

K&L Gates is comprised of multiple affiliated entities: a limited liability partnership with the full name K&L Gates LLP qualified in Delaware and maintaining offices throughout the United States, in Berlin and Frankfurt, Germany, in Beijing (K&L Gates LLP Beijing Representative Office), in Dubai, U.A.E., in Shanghai (K&L Gates LLP Shanghai Representative Office), in Tokyo, and in Singapore; a limited liability partnership (also named K&L Gates LLP) incorporated in England and maintaining offices in London and Paris; a Taiwan general partnership (K&L Gates) maintaining an office in Taipei; a Hong Kong general partnership (K&L Gates, Solicitors) maintaining an office in Hong Kong; a Polish limited partnership (K&L Gates Jamka sp. k.) maintaining an office in Warsaw; and a Delaware limited liability company (K&L Gates Holdings, LLC) maintaining an office in Moscow. K&L Gates maintains appropriate registrations in the jurisdictions in which its offices are located. A list of the partners or members in each entity is available for inspection at any K&L Gates office.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2010 K&L Gates LLP. All Rights Reserved.