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Capital Markets Reform Group Update

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Senator Dodd Releases Financial Reform Proposal: The Restoring American Financial Stability Act of 2009

Summary and Comparison to House Legislation

On November 10, 2009, Senate Banking Committee Chairman Christopher Dodd (D-CT) released a discussion draft of the "Restoring American Financial Stability Act of 2009" (the "Dodd Draft"). Chairman Dodd has been developing the Senate version of the regulatory reform package over several months. Until recently, the Chairman was working in conjunction with Ranking Member Richard Shelby (R-AL). However, Chairman Dodd recently decided to proceed only with the Democrats on the Committee.

At the time of this writing, the House Financial Services Committee is completing its markup of the House regulatory reform package (please see the K&L Gates alert *Redoubling Efforts on the Financial Reform Debate: House Approaches Floor Vote, While Senate Gets Underway* for additional information on House developments). With the Senate and House taking different approaches in several respects, debate on significant aspects of the regulatory reform package will continue.

Systemic Risk

1. Which Agency Would Regulate?

The Dodd Draft proposes to create the Agency for Financial Stability ("AFS") as an independent agency responsible for identifying, monitoring, and addressing systemic risk. The AFS would be led by an independent chairman and a board of seven financial regulators and an independent board member. The AFS would not have direct supervisory powers over financial companies, but it would have the authority to:

- Subject financial companies whose financial distress would threaten financial stability (*i.e.*, "specified financial companies") to heightened prudential standards;
- Write rules to increase prudential standards for bank holding companies with more than $10 billion in assets;
- Assign otherwise unregulated financial companies that threaten financial stability to be supervised by a federal regulator; and
- Identify and write regulations applicable to systemically important market utilities, which include operators of payment, settlement, and clearing systems.

The House systemic risk proposal is contained in the "Financial Stability Improvement Act of 2009" ("FSIA"; H.R. 3996), the mark up of which is now being completed by the House Financial Services Committee. FSIA would split the

functions of a systemic risk regulator among the Federal Reserve and a new entity called the Financial Services Oversight Council ("FSOC"), which would be a council of regulators chaired by the Secretary of the Treasury.

2. Is the Government Able to Appoint a Receiver for Financial Firms?

The Dodd Draft also would:

- Authorize the Secretary of the Treasury, upon the recommendation of the Financial Institution Regulatory Administration ("FIRA"; described in further detail below) and either the Federal Deposit Insurance Corporation ("FDIC") or the Securities and Exchange Commission ("SEC"), to appoint the FDIC as a receiver;
- Authorize the FDIC, as receiver, to sell some or all of a financial company's assets, lend to a financial company, guarantee a financial company's assets, or acquire an equity interest in the financial company;
- Create a resolution fund for financial companies, funded by post-resolution assessments imposed on financial companies with more than $10 billion in total assets; and
- Authorize the Board of Governors of the Federal Reserve System ("Federal Reserve") to give systemically important market utilities discount and borrowing privileges as if they were depository institutions.

FSIA is similar, but some pending amendments would restrict the types of assistance that the FDIC could give to a financial company when acting as receiver. House Financial Services Committee ("HFSC") Chairman Barney Frank (D-MA) is expected to amend the House version so that a fund for resolving financial companies would be created in advance, rather than recovering the costs after a company fails. Finally, the House version would not give systemically important market utilities Federal Reserve discount and borrowing privileges.

3. Other Features

The Dodd Draft would also limit the Federal Reserve's lender-of-last-resort authority so that it can lend only to facilities "with broad-based participation" or to market utilities that the AFS has deemed systemically important. The Federal Reserve would not have to identify the recipients of such assistance for up to 1 year after the assistance is given. FSIA has no such provision.

Consolidation of Bank Regulation

The Dodd Draft proposes to consolidate all federal bank supervisory powers into FIRA. The Office of the Comptroller of the Currency ("OCC") and the Office of Thrift Supervision ("OTS") would be merged into the FIRA. A division within FIRA would regulate community banks. The FDIC and Federal Reserve would continue to exist, but they would lose their supervisory powers over state banks. The FIRA would be headed by an independent chairperson and a board consisting of the heads of the FDIC and Federal Reserve and two independent members.

In addition, the Dodd Draft would eliminate the thrift charter, but it would do so by attrition. No additional thrift charters could be issued, and section 5 of the Home Owners' Loan Act would be repealed when the last thrift charter ceases to exist.

The House bank regulation consolidation proposal is also contained in FSIA. The House proposal has more modest goals for consolidation. FSIA would only dissolve the OTS, transferring its bank supervisory powers to a division within the OCC and transferring its holding company supervisory powers to the Federal Reserve. FSIA would not phase out new thrift charters; instead, the OCC would have the authority to make issuances.

Bank Holding Companies

The Dodd Draft would transfer the Federal Reserve's power to supervise bank holding companies to the FIRA. It would also impose a three-year moratorium on insuring the deposits of or authorizing the change of control of certain non-bank banks, *i.e.*, industrial loan companies, credit card banks, and trust companies. During the moratorium, a study would be conducted on whether to eliminate the corresponding exceptions to the Bank Holding Company Act.

FSIA would repeal the current exceptions to the Bank Holding Company Act for industrial loan companies (ILCs) and credit card banks going

forward, and "sunset" the existing institutions. Unlike the Dodd Draft, the House version would also require that current ILCs create an intermediary "section 6" holding company, and there would be significant limits on transactions between the holding company and affiliates. The House version, as amended, retains the exception to the Bank Holding Company Act for credit card banks.

Consumer Financial Protection Agency

The Dodd Draft proposes to create a Consumer Financial Protection Agency ("CFPA"), similar to the House legislation, the "Consumer Financial Protection Act" (H.R. 3126), which was reported favorably by the HFSC on October 22 and the House Energy and Commerce Committee on October 29. The CFPA would have significant authority over rule-writing, supervision, and enforcement for consumer protection. For additional information on the House legislation, please see the recent K&L Gates Alert *Analysis of Consumer Financial Protection Agency Legislation: Top Ten Issues*.

Similar to the House legislation, the Dodd Draft would roll back federal preemption of state laws, allowing states to enact more stringent consumer protections than those in place under federal law. This remains a significant area of controversy in the House, and will likely continue to be so in the Senate.

Another area of remaining controversy is the structure of the CFPA. In the bill reported by the House Financial Services Committee, the CFPA would be headed by an independent director. In the bill subsequently reported by the House Energy and Commerce Committee, the CFPA would be led by a five-member board; HFSC Chairman Frank has stated that such an approach would "weaken the capacity of the agency to provide consumer protection." The Dodd Draft, however, takes the five-member board approach.

Private Funds

The Dodd Draft would require registration of investment advisers to hedge funds with the SEC. The Dodd Draft exempts from SEC registration advisers to private equity funds, subject to SEC definition of the term. In addition, the Dodd Draft excludes family offices from the definition of "investment adviser," raises the federal investment adviser registration threshold to $100 million, requires investment advisers to use an independent custodian to hold client assets, and defines "private fund" as an issuer rather than an investment fund.

The House version, the "Private Fund Investment Advisers Registration Act" (H.R. 3818), has several key differences, which include:

- An exemption for private fund advisers who manage assets under $150 million;
- A requirement that advisers to family offices register with the SEC;
- No change in the asset threshold for SEC registration;
- An exemption from registration for Small Business Investment Companies; and
- Defining "private fund" as an investment fund.

For more information, see K&L Gates' Global Financial Market Watch Blog posting Private Funds and Broker-Dealers Under Dodd's Restoring American Financial Stability Act and the next issue of the K&L Gates Private Equity Newsletter.

Derivatives

The relevant provisions of the Dodd Draft are similar to the House version, the "Over-the-Counter Derivatives Markets Act" (H.R. 3795), except for two key differences (the House Agriculture Committee favorably reported its own version of the legislation on October 21—as a result of some differences, the Rules Committee will likely issue a rule seeking to reconcile the areas of difference). One difference is that, in the Senate bill, the SEC and Commodity Futures Trading Commission ("CFTC") would be required to pre-approve contracts before clearinghouses can clear them. This has been controversial because in the House legislation there is no requirement that the SEC or CFTC decide, rather it is up to the clearinghouse. On November 3, 2009, HFSC Chairman Frank wrote a letter to CFTC Chairman Gary Gensler seeking assistance in drafting language that would give the CFTC and the SEC the authority to make the initial decision rather than the clearinghouse. Chairman Gensler, however, believes the

clearinghouses should have the first say, not federal regulators. The initial decider is important because there is a potential conflict of interest because derivatives dealers have a stake in some clearinghouses and may not push for a swap to be cleared.

The other key difference is that in the Dodd Draft, if the SEC and CFTC are unable to establish joint rules, then the AFS would make the decision. In the House version, the decision would be made by the Secretary of the Treasury. The House version also gives the SEC and the CFTC the authority to ban access to the U.S. financial system if it is determined that an entity in a foreign country poses a risk to the U.S. system, prohibits government assistance from being given to a clearinghouse, and gives the SEC and CFTC authority to ban abusive swaps.

Investor Protection

The Dodd Draft makes a number of additional reforms aimed at investor protection, including:

- Creating an Office of the Investor Advocate within the SEC, which would analyze the impact of SEC actions on investors, recommend changes to statutes and regulations, and assist investors in their interactions with the SEC;
- Requiring securitizers to retain at least 10 percent of the credit risk for any asset that is bundled into an asset-backed security; and
- Authorizing the SEC to fund itself through industry assessments, freeing it from dependence on the Congressional appropriations process.

The House versions of these provisions are contained in both the Investor Protection Act of 2009 ("IPA"; H.R. 3817) and FSIA. The House versions differ in that they would:

- Create an Investment Advisory Committee authorized only to "advise and consult with" the SEC, which is notably less power than the Dodd Draft would give to the Office of the Investor Advocate;
- Require securitizers to retain at least 5 percent, rather than 10 percent, of the credit risk for any asset that is bundled into an asset-backed security; and
- Increase the funding that could be appropriated to the SEC, but not authorize the SEC to fund itself through industry assessments.

Both the Dodd Draft and the House version would:

- Authorize the SEC to restrict or prohibit pre-dispute arbitration agreements;
- Provide for monetary awards to whistleblowers and prohibitions against employer retaliation; and
- Extend liability for aiding and abetting "to the same extent as the person to whom such assistance is provided."

Broker-Dealers

The Dodd Draft would remove the exemption applicable to broker-dealers from the Investment Advisers Act of 1940 ("Advisers Act"), meaning that broker-dealers would be considered investment advisers to the extent that they give investment advice, even if only incidental to their brokerage activities. The House's approach, contained in the IPA, is distinct, keeping the exemption to the Advisers Act while imposing a fiduciary duty on broker-dealers "no less stringent" than the one applicable to investment advisers under the Advisers Act.

The Dodd Draft also would subject broker-dealers to auditing requirements that currently apply to security issuers under the Sarbanes-Oxley Act. The House version has no such provision. For more information, see K&L Gates' Global Financial Market Watch Blog posting Private Funds and Broker-Dealers Under Dodd's Restoring American Financial Stability Act.

Credit Ratings Agencies

The Dodd Draft proposes to enhance oversight of credit rating agencies by establishing a new Office of Credit Rating Agencies, housed within the SEC. The Dodd Draft would require Nationally Recognized Statistical Ratings Organizations ("NRSROs") to: (1) establish internal controls over processes for determining credit ratings; (2) separate ratings from sales and marketing activities; (3)

disclose their methodologies, their use of third parties for due diligence efforts, and their ratings track record; and (4) consider credible information from sources other than the issuer. The SEC would be required to examine NRSROs once a year and will have the authority to fine and deregister agencies. In addition, investors could bring private rights of action against ratings agencies under facts giving rise to a strong inference of a knowing or reckless failure to investigate or to obtain analysis from an independent source.

The House version, contained in the "Accountability and Transparency in Rating Agencies Act" (H.R. 3890), was reported favorably by the HFSC on October 28. The legislation also calls for establishing an office to administer the SEC's enhanced authorities with respect to practices of NRSROs. The legislation also includes provisions, albeit slightly different from the Senate approach, aimed at enhanced internal controls, mitigation of conflicts of interest, and disclosure. The House version also provides a private right of action, allowing investors to sue agencies that "knowingly or recklessly" fail to review key information in their ratings.

Insurance

The Dodd Draft would create an Office of National Insurance ("ONI") within the Treasury Department. The ONI would be authorized to monitor the insurance industry and make recommendations to the AFS about possible sources of systemic risk. The ONI would be required to study ways to modernize insurance regulation and provide Congress with recommendations, due within 18 months of the enactment of the legislation. The Dodd Draft would provide limited preemption authority in instances when a state treats foreign insurers subject to an international insurance agreement less favorably than domestic insurers and would provide the Treasury Secretary with the authority to negotiate and enter into international insurance agreements.

The Dodd Draft also contains several state-based reforms which, among other items, include:

- With respect to nonadmitted insurance, providing that the home state of the insured has exclusive authority to regulate and require any premium tax payment;
- Imposing uniform standards for surplus lines eligibility; and
- Providing requirements for the regulation of credit and solvency for reinsurance.

The HFSC is considering similar legislation, the Federal Insurance Office Act (H.R. 2609), which is expected to be marked up following the Thanksgiving recess. Similar to the Dodd Draft, the Federal Insurance Office would monitor the insurance industry, including in the area of systemic risk, and coordinate international insurance issues. The House bill does not contain the state-based reforms contained in the Dodd Draft.

Municipal Securities

The Dodd Draft takes a holistic approach to changing the municipal securities regulatory regime. The changes in the Dodd Draft include:

- Requiring that the Municipal Securities Rulemaking Board ("MSRB") establish rules for financial advisers, swap advisers and investment brokers;
- Giving investor and public representatives a majority on the MSRB;
- Requiring the MSRB to serve as a repository of information from municipal market participants required by FIRA;
- Dividing equally between the SEC and the MSRB fines collected by the SEC or its designee for violations of the rules; and
- Requiring the Registered Securities Association ("RSA") to request guidance from the MSRB and provide information to the MSRB about enforcement actions and examinations of the RSA.

The House legislation is more limited in its impact on municipal securities. It does not call for changes with the respect to the MSRB. The House's IPA, however, included an amendment offered by Congressman Steve Driehaus (D-OH) that would require the registration of municipal financial advisers. Other key provisions of the Driehaus amendment include:

- Giving the SEC the power to exempt specific advisers or classes of advisers from registration;
- Exempting employees of municipal financial advisers from registration with the SEC if the adviser is registered and not a natural person;
- Prohibiting violations of rules and regulations the SEC establishes regarding conflicts of interest and fair practices (including but not limited to political contributions);
- Establishing a fiduciary duty to any municipal securities issuer for whom a municipal financial adviser acts as an adviser; and
- Defining municipal financial adviser as a person who provides advice to a municipal securities issuer for compensation, including those who prepare disclosure documents (attorneys are excluded), assist in selecting or negotiating guaranteed investment contracts or other investment products, and assist the issuer in a primary offering that is not a public offering.

Executive Compensation and Corporate Governance

The Dodd Draft contains a number of executive compensation and corporate governance provisions, balancing the approach taken by the House-passed "Corporate and Financial Institution Compensation Fairness Act of 2009" (H.R. 3269) and Senator Schumer's "Shareholder Bill of Rights Act of 2009" (S. 1074). The Dodd Draft would require:

- Shareholders of public companies to have a non-binding vote on executive pay and golden parachutes (similar to provisions in H.R. 3269 and S. 1074);
- Public companies to set clawback policies for inaccurate financial statements;
- Public companies to have independent compensation committees (similar to H.R. 3269);
- The SEC to promulgate regulations providing shareholder proxy access to nominate directors (similar to S. 1074);
- Directors in uncontested elections to receive a majority of votes in order to be elected (similar to S. 1074);
- Disclosure if the positions of chairperson and CEO are the same individual (S. 1074 would prohibit the same person from serving in both positions); and
- Shareholder ratification of staggered terms of directors (S. 1074 would have prohibited staggered terms).

Looking Ahead

The Senate Banking Committee is expected to begin substantive markup of the Dodd Draft after the Thanksgiving recess, working through much of December. However, in light of competing priorities, Senate floor action is not likely to occur until January 2010 at the earliest.

The HFSC is expected to complete its markup of the regulatory reform legislation, which was considered as several separate bills, by November 20. Full House consideration is likely in December.

Please see previous K&L Gates updates, including *Redoubling Efforts on the Financial Reform Debate: House Approaches Floor Vote, While Senate Gets Underway* and *Congress Builds on Obama Financial Regulatory Reform Approach, as Reform Efforts Proceed* for additional information about the reform effort. In addition, please see the K&L Gates Global Financial Market Watch Blog for detailed analysis on many of the Obama proposals and future updates.

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