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## Senator Dodd Releases Financial Regulatory Reform Legislation: The Home Stretch?

### Introduction

On Monday, March 15, 2010, Senate Banking Committee Chairman Chris Dodd (D-CT) released a [Chairman's Mark](#) of the "Restoring American Financial Stability Act of 2010" (the "Bill"). The Bill, which has been in development for months, is intended to replace the [Discussion Draft](#) previously circulated by Chairman Dodd on November 10, 2009 ("Discussion Draft") and is different in many respects from [H.R. 4173](#), the "Wall Street Reform and Consumer Protection Act of 2009," which was passed by the House on December 12, 2009 (please see the K&L Gates alerts [Senator Dodd Releases Financial Reform Proposal: The Restoring American Financial Stability Act of 2009](#) and [House Passes Financial Regulatory Reform Legislation](#) for additional information). The Senate Banking Committee is scheduled to begin marking up the legislation on March 22.

### Depository Institutions & Their Holding Companies

The Bill would shuffle the responsibilities of the Federal banking regulators and abolish the Office of Thrift Supervision ("OTS"), leaving the Office of the Comptroller of the Currency ("OCC") to oversee national banks, Federal thrifts, and holding companies of such depository institutions.

Supervision of state banks that are members of the Federal Reserve System would be transferred from the Board of Governors of the Federal Reserve System ("Federal Reserve") to the Federal Deposit Insurance Corporation ("FDIC"). The FDIC would continue to supervise Federally-insured state banks and thrifts. The FDIC would also supervise depository institution holding companies that have more state-insured deposits than Federally-insured deposits and have total assets of less than \$50 billion. The Federal Reserve would have rulemaking authority over depository institution holding companies of all sizes, but it would only directly supervise holding companies with consolidated assets of over \$50 billion.

Contrary to H.R. 4173, the Federal thrift charter would be abolished, with a grandfather provision for existing thrifts. The Bill would prevent a commercial firm from acquiring control of an FDIC-insured credit card bank, industrial loan company, or trust company during a three-year moratorium. During the moratorium, a study would be conducted to evaluate the consequences of subjecting a broader range of companies to the restrictions of the Bank Holding Company Act.

The assessment base used as a starting point to calculate FDIC insurance premiums would change. Rather than paying based on the sum of insured deposits, depository institutions would pay based on their total consolidated assets, minus the sum of tangible equity and long-term unsecured debt.

Among many increased restrictions that would apply to bank holding companies, the Bill most notably includes a version of the Volcker Rule, which would direct the Federal banking regulators to issue rules prohibiting depository institutions and their holding companies from engaging in proprietary trading and from sponsoring or investing in hedge funds or private equity funds. The Volcker Rule would also direct the Federal banking regulators to impose additional capital requirements and quantitative limits on nonbank financial companies deemed systemically significant and prevent companies from merging if the resulting company's liabilities would exceed 10% of the aggregate consolidated liabilities of all financial companies.

### Systemic Risk

The Bill would create a Financial Stability Oversight Council ("FSOC"), similar to the one established in H.R. 4173, charged with identifying and monitoring systemic risks to the nation's financial markets. The nine-member FSOC could require, by a two-thirds, that nonbank financial companies posing a systemic risk to the country's financial stability be placed under the Federal Reserve's supervision.

Under the Bill's provisions, nonbank financial institutions designated as systemically significant by the FSOC and bank holding companies with assets in excess of \$50 billion would be regulated by the Federal Reserve. The Bill would mandate that the Federal Reserve impose more stringent prudential standards and reporting and disclosure requirements upon the designated entities.

The Bill requires large bank holding companies and systemically significant nonbank financial companies to periodically submit plans for their "rapid and orderly resolution." If the Federal Reserve determines a financial institution poses a "grave threat" to the financial system, the Federal Reserve may, upon an affirmative two-thirds vote of the FSOC, require the company to stop engaging in an activity or to sell some of its assets.

### Liquidation Authority

The Chairman's Mark would also establish a Liquidation Authority. Under the provisions, the Treasury Department, FDIC, and Federal Reserve would have the authority, with 2/3 votes of both the

Federal Reserve and the FDIC, 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. The Bill would establish an Orderly Liquidation Authority Panel in the U.S. Bankruptcy Court for the District of Delaware, a three-member panel, which would rule on the recommendation within 24 hours.

The bill would also create an Orderly Liquidation Fund to fund future liquidations. The fund size would be \$50 billion and would be pre-funded through assessments on bank holding companies with consolidated assets over \$50 billion and on nonbank financial companies supervised by the Federal Reserve. The Bill allows the FDIC to borrow from the Treasury Department in the case working capital is needed. Any shortfalls are to be covered through assessments on bank holding companies with consolidated assets over \$50 billion, nonbank financial companies supervised by the Federal Reserve, and other financial companies with consolidated assets over \$50 billion.

### Consumer Financial Protection Bureau

The Bill would establish the Consumer Financial Protection Bureau ("Bureau") within the Federal Reserve System. The Bureau would have broad rulemaking authority for consumer protections regarding financial products and services offered by both banks and non-banks. The Bureau would be granted some discretion, as the Bill provides the Bureau with the authority to define covered financial products and services, while at the same time having the authority to exempt entities or financial products and services. However, the FSOC would have the ability to review and set aside Bureau rules by a two-thirds vote.

The Bill would also provide the Bureau with consumer protection supervision, examination, and enforcement powers over banks and credit unions with assets over \$10 billion and businesses that originate, broker, or service mortgage loans. A bank or credit union with assets of \$10 billion or less would be examined by its Federal regulator. The Bill specifically exempts certain entities and activities from the purview of the Bureau.

On the issue of preemption, states would be allowed to adopt more stringent consumer protections than those adopted by the Bureau. The Bill, however, would provide the OCC with the authority to preempt if it determines that a state law would significantly interfere with a Federally regulated institution's ability to engage in banking. Importantly, the OCC would only be able to make such determinations on an *ad hoc* basis; it could not issue blanket preemption determinations. Specific procedures for challenging or upholding any such determinations are included in the Bill.

### Private Funds

The Bill would require investment advisers to hedge funds and other private funds to register with the Securities and Exchange Commission ("SEC"). Private funds are broadly defined to include non-U.S. domiciled funds without regard to percentage of securities held by U.S. persons. Exempt from SEC registration would be investment advisers to small business investment companies, venture capital funds (to be defined), and private equity funds (to be defined); private equity fund advisers would still be subject to recordkeeping and reporting requirements. "Family offices" would also be excluded from the definition of "investment adviser," and a narrow exemption would apply to non-U.S. domiciled advisers.

The Bill would also: (1) not subject business development companies to the assets under management threshold for SEC registration, (2) raise the SEC investment adviser registration threshold to \$100 million, and (3) require investment advisers to take steps to safeguard client assets, including verification of such assets by an independent public accountant. Records and reports are required to be maintained and are subject to inspection by the SEC. The SEC would be able to obtain information from advisers regarding the identity, investments, or affairs of any client for purposes of assessing systemic risk. The Bill would require that records and reports include types of assets held, side arrangements or side letters, and other information that the SEC, in consultation with the FSOC, determines are necessary and appropriate in the public interest and for the protection of the investor.

### OTC Derivatives

The treatment of over-the-counter derivatives in the Bill largely tracks the Discussion Draft and H.R. 4173. An amendment in the nature of a substitute will likely be offered by Senators Jack Reed (D-RI) and Judd Gregg (R-NH) during the Senate Banking Committee markup of the legislation. The Bill differs from H.R. 4173 in that the Bill would:

- Exclude from the swap definition any sale of a nonfinancial commodity or any security, if such transaction is physically settled, while H.R. 4173 provides an exclusion as long as such transaction is intended to be physically settled;
- Define a "major swap participant" in part based upon a failure to perform that causes significant credit losses to counterparties, while H.R. 4173 looks to substantial net counterparty exposure that could adversely affect financial stability;
- Preserve Section 2(g) of the Commodity Exchange Act, one of the principal provisions added in 2000 to permit the off-exchange trading of derivatives, although a separate exemption appears to be necessary to avoid being required to clear such a transaction;
- Define "alternative swap execution facility" as an electronic trading system (rather than a "person or entity") with pre-trade and post-trade transparency in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by other participants that are open to multiple participants in the system, but which is not an exchange; and
- Not limit the ownership ability of financial holding companies with respect to acquiring ownership directly or indirectly in a derivatives clearinghouse. H.R. 4173 prohibited this if, after the transaction, the financial holding company would hold more than 20% ownership in the derivatives clearinghouse.

### Investor Protection

The Bill contains an assortment of provisions designed to protect investors and enhance enforcement by the SEC. The SEC Chairman

would appoint an Investor Advocate, who would lead a committee of investors that would “advise and consult with” the SEC. The SEC would conduct studies on financial literacy and mutual fund advertising and would be empowered to write regulations to set aside mandatory pre-dispute arbitration clauses in agreements between customers and brokers, dealers, and municipal securities dealers.

The Bill would not impose on broker-dealers fiduciary duties to their customers, but the SEC would conduct a study on the impact of such a requirement. As under H.R. 4173, whistleblowers could receive cash rewards and the SEC would be authorized to bar individuals from the entire securities industry after misconduct in one segment of the industry.

Structural reforms at the SEC would include: (1) granting the SEC power over its own budget and fees; (2) adding staffs of compliance examiners to the Divisions of Investment Management and Trading and Markets; and (3) mandating a series of regular reports to Congress.

The Bill would also expand the authority of the Public Company Accounting Oversight Board (“PCAOB”) to include auditors of registered broker-dealers. The PCAOB would also be authorized to share information with foreign auditor oversight authorities.

### **Municipal Securities**

The Bill would make wholesale changes to the municipal securities regulatory regime. The changes include:

- Requiring that the Municipal Securities Rulemaking Board (“MSRB”) establish rules for financial advisers, swap advisers, and investment brokers;
- Giving investors and public representatives a majority on the MSRB;
- Requiring the MSRB to serve as a repository of information from municipal market participants required by the Federal financial regulator or self-regulatory organization;

- Dividing equally between the SEC and the MSRB fines collected by the SEC or its designee for rules violations;
- Requiring a registered securities association to account for fines related to rules violations separately from other fines collected, and to allocate the fines between the regulatory securities association and the MSRB at the direction of the SEC; and
- Requiring the registered securities association to request guidance from the MSRB and provide information to the MSRB about enforcement actions and examinations of the registered securities association.

### **Securitization**

The Bill’s securitization provisions would require the OCC, FDIC, and SEC to jointly prescribe regulations requiring risk retention by securitizers of asset-backed securities (“ABSs”). The regulations would have to 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, which risk may not be directly or indirectly hedged. The regulations could provide a total or partial exemption of any securitization “as may be appropriate in the public interest or for the protection of investors.” The rules would also be required to establish the allocation of risk retention between the securitizer and originators, with separate rules associated with different classes of underlying assets.

The Bill’s securitization provisions would change disclosure and periodic reporting, including the disclosure of due diligence of underlying assets and of contingent repurchase obligations. Of particular significance, the Bill would eliminate for ABSs the ability of issuers or depositors to suspend reporting obligations under the Securities Exchange Act of 1934, which would increase the risk of ABS sponsors becoming ineligible to use shelf registration statements for certain ABSs. The Bill also would eliminate the exemption from registration for mortgage obligations, which would likely reduce unregistered offerings of ABSs backed by mortgage-related assets.

### Credit Rating Agencies

The Bill proposes to enhance oversight of credit rating agencies (“CRAs”) by establishing a new Office of Credit Ratings, housed within the SEC. As a condition of being registered with and recognized by the SEC, Nationally Recognized Statistical Ratings Organizations (“NRSROs”) would be required to establish, maintain, and enforce written policies and procedures to use universal rating symbols. The Bill would also require NRSROs to consider credible information from sources other than the issuer and to disclose their methodologies, use of third parties for due diligence efforts, and ratings track record.

The SEC would be required to examine NRSROs once a year and would have the authority to fine and de-register agencies for providing bad ratings over time. In addition, the Discussion Draft would provide investors with a private right of action against CRAs for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source.

### Insurance

The Bill would create the Office of National Insurance (“ONI”) within the Treasury Department to monitor all lines of insurance (except health insurance) and to receive, collect, and require information from the insurance industry, insurers, and state and Federal insurance regulators. The ONI’s information-gathering authority would not apply to small insurers that met a minimum size threshold to be established by the Office. The Bill also would require the Director of the ONI to conduct a study within 18 months of the Bill’s enactment on ways to modernize insurance regulation and provide Congress with recommendations.

The Bill also contains several state-based insurance reforms, including:

- Limiting to the home state of the insured state regulatory authority over nonadmitted insurance and premium taxes;
- Imposing uniform standards for surplus lines eligibility; and

- Providing requirements for the regulation of credit and solvency for reinsurance.

### Executive Compensation and Corporate Governance

The Bill would require public companies to provide shareholders with a non-binding vote on executive pay and would mandate that compensation committees consist only of independent directors. Public companies would be required to set clawback policies for inaccurate financial statements.

Notably, the Bill also would provide the Federal Reserve with the authority 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 Bill would provide the SEC with the authority to grant shareholders proxy access to nominate directors. For the election of directors of public companies, the Bill would require that, in an uncontested election, a director must receive a majority of the votes to be elected, and in a contested election, each director must receive a plurality of the votes to be elected. Additionally, public companies would be required to disclose in the annual proxy if the positions of chairperson and CEO are the same individual.

### Looking Ahead

Chairman Dodd has stated that amendments to the Bill are due by Friday, March 19. The Senate Banking Committee is scheduled to markup the legislation the week of March 22. Chairman Dodd has stated that he would like to complete the markup by the end of the week, before the Senate departs for the Easter Recess.

Although passage of financial regulatory reform in the 111th Congress was considered probable when Chairman Dodd first released the Discussion Draft in November 2009, the year has brought changes that have and will continue to significantly impact the effort. In early January, Chairman Dodd, facing a difficult race, announced that he would no longer be seeking re-election. In mid-January, Senate Democrats lost their 60-vote filibuster-proof majority with the election of Scott Brown (R-MA)

to replace Senator Edward Kennedy. Despite continued efforts at bipartisan negotiation, first with Ranking Member Richard Shelby (R-AL) and then with Senator Bob Corker (R-TN), the Bill was released without Republican support. Finally, with the legislative year truncated by the midterm elections, the number of legislative days available for consideration is limited.

As such, the timing and likelihood of Senate floor consideration and conferencing with the House are unclear. Chairman Dodd has previously maintained that the deadline for Senate floor consideration is the Memorial Day recess. However, in the case that the legislation continues to progress without Republican

support, it is uncertain whether Chairman Dodd will be able to garner the 60th vote necessary to move forward with Senate consideration. Notably, many Senators in both parties have expressed a desire to vote for a reform bill. Moreover, even if the Senate passes a bill, there is likely to be a contentious conference with the House, as the Senate bill's provisions are likely to be less stringent than H.R. 4173 in many respects.

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.

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