

COMPARISON OF HOUSE PASSED FINANCIAL REGULATION REFORM WITH EARLIER TREASURY PROPOSAL

On December 11, 2009, the US House of Representatives passed its version of financial regulatory reform in a bill titled “The Wall Street Reform and Consumer Protection Act of 2009” (H.R. 4173). Although most commentators believe this bill will be “watered down” in the Senate, the House bill reflects criticisms of the Treasury proposal that may also shape any final legislation.

The Treasury’s original proposal identified four major goals for the legislation. We review below, under several subheadings, how the House dealt with those four issues. Under each subheading we identify the title of the Treasury legislative proposal that dealt with the issue (as outlined in our September 9, 2009, client alert describing the proposal) and the portions of the House bill that cover the issue.

I. Promote Robust Supervision and Regulation of Financial Firms

1. Council Directed Stricter Standards in Place of Federal Reserve Designations of Tier 1 FHCs

(Titles I and II of Treasury Proposal. Title I, Subtitles A and B, of House Bill)

The centerpiece of Treasury’s approach to “robust supervision” was the grant of authority to the Federal Reserve to designate, and then impose enhanced regulatory requirements on, Tier 1 financial holding companies (Tier 1 FHCs). A Council of federal financial regulators would have advised and reported recommendations to the Federal Reserve. The Council would not have directly controlled the Federal Reserve’s actions.

The House bill would largely replace the Federal Reserve with the Council of regulators. The Council would identify firms for the Federal Reserve to subject to “stricter standards” based on the Council’s determinations of what firms could pose a threat to financial stability. The Council could override Federal Reserve decisions on stricter standards and impose the Council’s own stricter standards. The Council could also direct the Federal Reserve to limit or even prohibit identified financial practices or activities.

As Treasury proposed, non-bank holding companies designated for stricter standards would be treated as if they were BHCs. Commercial companies designated for “stricter standards” on their financial activities could be required to establish an intermediate holding company for those financial activities. That intermediate company would also be treated as a BHC and could have its interactions with the affiliate commercial business subjected to Section 23A and B limitations.

On the eight member Council only the OCC (for large national banks) and the Federal Reserve (for large bank holding companies and state banks) would have regular supervisory responsibility for large banking organizations that would presumably be the most likely candidates for stricter standards. If the Council were established in that form, it is unclear whether its actions concerning large banking organizations would be controlled by those two regulators with broad knowledge of their activities or by the other six regulators with less knowledge of those activities and different regulatory responsibilities.

The stricter standards described in the House bill are much more detailed and numerous than the enhanced requirements contained in the Treasury proposal. We will describe those standards (including mandatory quarterly stress tests), and also review the proposed make-up of the Council, in a further client update. We will describe the “prompt corrective action” requirements for stricter standards companies in a separate client update that will also describe the special dissolution authority discussed below in part IV. 1. (*enhanced resolution transformed into dissolution powers*).

2. Further Improvements to BHCA and to Depository Institution Regulation

(Titles III and VI of Treasury Proposal. Title I, Subtitles C and D, of House Bill)

Another major Treasury proposal for robust supervision was the expansion of the Bank Holding Company Act’s coverage to include savings bank holding companies and holding companies for “non-bank banks” (i.e. “depository institutions” not covered by the BHCA’s definition of “bank”) such as credit card banks and industrial loan companies. The House bill “watered down” this proposal by retaining exemptions for some credit card banks, insurance company or “fraternal beneficiary society” controlled thrifts, and existing ILCs. The bill would even broaden the existing exemption for credit card banks by expressly permitting small business lending.

Otherwise, the House bill would largely follow Treasury’s proposal, including the elimination of the OTS and its replacement with the OCC or FDIC as the federal regulator of savings banks and with the Federal Reserve as the federal regulator of savings bank holding companies. The OCC, however, would not be replaced by a new National Bank Supervisor. The OCC would be the regulator of both national banks and national thrifts.

The House bill adopts Treasury’s proposals to treat exposures under derivatives and securities lending arrangements as “covered transactions” (i.e. as extensions of credit rather than market price transactions) under Sections 23A and B of the Federal Reserve Act and to limit the Federal Reserve’s authority to grant exemptions under those sections (which regulate transactions between banks and their affiliates). The bill also adopts Treasury’s recommendations to remove the Gramm-Leach-Bliley Act’s limits on Federal Reserve authority to examine bank holding company affiliates (other than banks) examined by another federal regulator (such as SEC examined broker-dealers or investment companies) and to require that all financial holding companies, not solely their bank subsidiaries, be well capitalized at all times.

3. SEC Registration of Advisers to Private Capital Pools

(Title IV of Treasury Proposal. Title V, Subtitle A, of House Bill)

Treasury proposed elimination of exemptions from registration for any adviser to private pools of capital of \$30 million or more. The House bill follows this recommendation, but requires the SEC to

establish exemptions for advisers to private funds with less than \$150 million in assets and permits the SEC to exempt advisers to “mid-sized private funds” based on SEC determinations of the level of “systemic risk posed by such firms.” Reflecting a widespread criticism of Treasury’s proposal, the House bill would also require the SEC to issue a rule exempting “venture capital funds.”

4. Stronger Capital and Other Prudential Standards for all Financial Firms

(Title V, Title IX, Subtitle D, and Other Provisions of Treasury Proposal. Title I, Subtitles C and D, and Title II of House Bill)

Although the ambitious goal seems to be for these standards to apply to all companies engaged in financial activities, both the Treasury proposal and the House bill effectively limit their coverage in most areas to banks or to banks and other regulated entities such as brokers and insurance companies.

The House bill’s requirement to establish “countercyclical” capital requirements applies to bank (including bank holding company) capital requirements.

The House bill’s broader requirement that all “covered financial institutions” with assets of \$1 billion or more detail to their “primary Federal regulator” all incentive compensation plans would require such reports from banks, brokers, credit unions, investment companies, Fannie Mae, Freddie Mac, and any other “financial institution” that the regulators (i.e. the Federal Reserve, OCC, SEC, NCUA, and FHFA) for the listed companies determine should be covered.

The popular subject of executive compensation is dealt with in a provision that would apply to all public companies (not only financial companies). The House bill would require all public companies to hold non-binding shareholder votes on executive compensation and “golden parachute” arrangements. It would also regulate the independence of compensation committees of public company boards.

The House bill would require all financial companies with assets greater than \$10 billion to conduct semiannual stress tests and report the results to their “primary federal regulator” and the Federal Reserve. In the House bill, a primary federal regulator only exist for regulated entities such as banks, brokers, other SEC or CFTC regulated entities, federal credit unions, and (although they are state regulated) insurance companies. It is not clear what this requirement would mean for a company engaged in financial activities that did not own such a regulated company and that had not been required to become a bank holding company or to be treated as one under the House bill’s provisions for “stricter standards.”

II. Establish Comprehensive Regulation of Financial Markets

1. Enhanced Regulation of Securitization Markets

(Title IX, Subtitle E, of Treasury Proposal. Title I, Subtitle F, of House Bill)

Treasury proposed a minimum “risk retention” requirement for originators or securitizers of assets included in a securitization eligible for Regulation AB public sale (whether in fact sold privately or publicly). The House bill follows this recommendation, but lowers the standard retention requirement to 5%.

The House bill, however, greatly expands Treasury's proposal by applying the risk retention requirement to any sale of a loan. Treasury's proposal, and the House bill's risk retention requirements for securitizations of non-loan assets, would only apply to securitizations eligible for public sale under Regulation AB. It is not clear the House understood its broad coverage of all loan transfers would cover traditional bank loan sale or syndication transactions. The federal banking regulators would be required to issue exemptions and regulations jointly with the SEC and the National Credit Union Administration (NCUA) in this area. Bank regulators could not unilaterally deal with traditional bank practices.

The remaining disclosure, reporting, and credit rating agency requirements imposed by the House bill would apply to Regulation AB eligible transactions, not all securitizations. We will describe in more detail the securitization provisions of the House bill in a future client update.

2. Comprehensive Regulation of OTC Derivatives

(Title VII of Treasury Proposal. Title III of House Bill)

The House bill provides an exemption from the Treasury's proposed exchange trading and clearing requirements for an "end user" that enters into a swap transaction to hedge commercial risk (even if it does not meet FAS 133 hedge accounting requirements), so long as the end user is not a "major swap participant." Otherwise, the exchange trading, clearing, and reporting requirements proposed by Treasury for swap dealers and major swap participants were largely adopted. The House bill adds a requirement that swap dealers and major swap participants not control swap clearinghouses or execution facilities so that they do not control whether swaps are accepted for clearing or execution (although existing ownership interests could be retained).

The House bill would also revise eligibility requirements for individuals and municipal entities to enter into OTC derivatives transactions.

We will describe in more detail the OTC derivatives provisions of the House bill in a future client update.

3. New Authority for the Federal Reserve to Oversee Payment, Clearing, and Settlement Facilities

(Title VIII of Treasury Proposal)

The House bill does not include this proposed legislation. This issue would be covered by the Council under its authority to reach any risk to financial stability.

III. Protect Consumers and Investors from Financial Abuse

1. Consumer Financial Protection Agency Only Examines Largest Banks

(Title X of Treasury Proposal. Title IV of House Bill)

The House bill would limit the CFPAs examination and enforcement jurisdiction to banks and thrifts with assets over \$10 billion (or credit unions with assets over \$1.5 billion). The scope of the exemptions for non-banks (based on whether they are subject to SEC, CFTC, or state insurance regulation)

is not clear in some cases. Most observers believe the CFPB's examination and enforcement powers would be limited to the roughly 100 banks that would meet the \$10 billion threshold. The CFPB would still have general rule making authority under federal banking laws for all banks.

The House bill preserves some ability for federal preemption of state consumer laws beyond what Treasury proposed. The preemption could continue where the OCC determines state law would impair the banking powers of national banks.

2. SEC Expanded Power Over Investment Providers and Products

(Title IX, Subtitles A-C, of Treasury Proposal. Title V, Subtitles B-C, of House Bill)

The House bill expands on Treasury's recommendations in this area in many ways, including by requiring the SEC to adopt qualified custodian rules for customer assets, imposing requirements on short selling and the related securities lending market, and establishing SEC regulation of municipal finance advisers.

The House bill includes Treasury's recommendations to impose fiduciary standards on brokers.

The House bill would give the SEC new authority over credit rating agencies, as requested by Treasury. It would also eliminate references to credit ratings in federal statutes and require regulators to eliminate the numerous references to credit ratings in federal regulations.

IV. Provide Tools to Manage Financial Crises

1. Enhanced Resolution Transformed Into Dissolution Powers

(Title XII of Treasury Proposal. Title I, Subtitle G, of House Bill)

One of the most controversial issues in the House was whether Treasury's proposed legislation strengthened the perceived "too big to fail" doctrine. In part this was addressed through the stricter standards approach for systemic risk firms described above in part I.1. (*council directed stricter standards in place of Federal Reserve designations of Tier 1 FHC*). The House bill's procedures for dissolution of troubled systemic firms are also intended to undercut "too big to fail" by requiring that firms subject to its procedures be liquidated within one year (subject to separate 1 year extensions up to a maximum 3 year receivership) rather than allowing such firms to remain alive through a conservatorship process.

The House bill, however, preserves the FDIC's authority to "stabilize" a systemic firm if necessary to maintain financial stability. An emergency dissolution fund of up to \$150 billion for such purpose would be funded by assessments on financial firms with assets over \$50 billion and hedge funds larger than \$10 billion.

The scope of the special dissolution authority would be even broader than the Treasury proposal by potentially covering non-bank holding companies that had not been designated as being subject to stricter standards. We will describe the dissolution authority in more detail in a future client update.

2. New Limits on Emergency Federal Reserve Lending Authority

(Title XIII of Treasury Proposal. Title I, Subtitle H, of House Bill)

Although Treasury only proposed that emergency lending (Section 13(3) lending) by the Federal Reserve be subject to Treasury Secretary approval, the House bill would limit such lending to widely

available programs (i.e. not specific “bailouts” as in the case of AIG or Bear Stearns) and limit the total dollar amount.

Related to the bill’s constraint on Federal Reserve emergency lending powers, a provision in the “stricter standards” sections of the House bill would prohibit the FDIC from establishing guarantee programs for bank or financial company obligations (such as the Temporary Liquidity Guarantee Program established in October 2008) except for solvent banks and financial companies on a widely available basis and in a limited total dollar amount.

Additional Items

The Treasury proposal and House bill also include directions to work for international cooperation and consistency in standards. The House bill would change the basis for FDIC assessments from deposit amounts to total assets minus tangible equity. The bill states this is a risk-focused assessment standard. It would impose higher assessments on banks that more heavily fund themselves from non-deposit sources.

If you would like to discuss any of the issues addressed in this Client Update or would simply like to find out more about Chapman, please contact Bob Lockner at lockner@chapman.com or Tim Mohan at mohan@chapman.com.

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