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U.S. Senate Banking Committee Approves a Sweeping Financial Regulatory Reform Bill

On March 15, 2010, U.S. Senate Banking Committee Chairman Christopher Dodd (D-Conn.) released his proposed financial regulatory reform legislation. Senator Dodd amended his bill in certain respects on March 22, 2010 and the modified version of the bill was approved by the Senate Banking Committee on that date by a strict party-line vote.[1] Consisting of twelve titles, the proposed legislation – like the broad reform plan passed by the House of Representatives in December – would have a significant impact on the U.S. financial industry. Key areas addressed by the proposed legislation include:

(1) financial stability and "too big to fail" regulation (p.4),
(2) liquidation regime for systemically important financial institutions (p.8),
(3) partial realignment of U.S. bank supervisory responsibility (p.9),
(4) restrictions on banking group activities and size, commonly referred to as the "Volcker Rule" (p.11),
(5) enhancements to the regulation of bank holding companies and depository institutions (p.14),
(6) the creation of a new Bureau of Consumer Financial Protection (p.16),
(7) reform of the markets for derivatives (p.19),
(8) registration of private fund managers and increased reporting obligations for the private fund industry (p.21),
(9) general investor protection efforts (p.22),
(10) executive compensation and corporate governance-related issues (p.25), and
(11) credit rating agency-related reforms (p.26).

1 A complete version of the bill integrating amendments made by Senator Dodd's "manager's amendment", has not yet been made publicly available. The version of the Dodd Bill that was introduced to the Senate Banking Committee can be found at: http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf. The manager's amendment to that version of the bill can be found at http://banking.senate.gov/public/_files/032310MangersAmendmentAYO10627.pdf.

According to Senator Dodd, the legislation approved by the Senate Banking Committee – the Restoring American Financial Stability Act (the "Dodd Bill") – will accomplish each of the following:

- End bailouts, ensuring that failing firms can be shut down without relying on taxpayer bailouts or threatening the stability of our economy,
- Create an advance warning system in the economy, so that there is always someone looking out for the next big problem,
- Ensure that all financial practices are exposed to the sunlight of transparency (with the Senator speaking here primarily about hedge funds and derivatives), and
- Protect consumers from unsafe financial products, such as the subprime mortgages that led to the financial crisis.

This Client Publication begins with a discussion of the significance of the Dodd Bill in the broader context of U.S. financial regulatory reform. It then provides a summary and analysis of key provisions of the Dodd Bill — as modified by Senator Dodd's "manager's amendment" (the "Manager's Amendment"), which was approved by the Senate Banking Committee and incorporated into the Bill on March 22, 2010.

The Dodd Bill in the Broader Context of U.S. Financial Regulatory Reform

Senator Dodd had hoped to introduce a reform bill garnering bipartisan support. After negotiations with key Republicans had reached an "impasse", however, Senator Dodd released the Dodd Bill for Senate Banking Committee consideration without the formal backing of any members of the Republican Party. The Dodd Bill does, however, reflect several political compromises negotiated during months of bipartisan talks.

A week after it was introduced by Senator Dodd, the Senate Banking Committee approved the Dodd Bill (as amended by the Manager's Amendment) with 13 Democrats voting in favor of the Bill and 10 Republicans voting against it. The Dodd Bill was approved after the Republicans withdrew hundreds

Shearman & Sterling has written extensively on the financial regulatory reforms that are now part of the proposed legislation, from their genesis in the proposals the Obama Administration issued this past summer and throughout the legislative process. Previous client alerts posted to our website include (all dates are 2009 except as indicated):

Bank Regulatory and Systemic Risk Reforms:
-Jun. 23, U.S. Financial Regulatory Reform: Implications for Banking Institutions
-Jul. 15, The Consumer Financial Protection Agency Act of 2009
-Jul. 24, Obama Administration Delivers Proposed Bank and Financial Services Reform Legislation to U.S. Congress
-Jul. 29, Obama Administration Submits Additional Legislation to U.S. Congress
-Dec. 22, U.S. House of Representatives Passes Wall Street Reform Bill: A Preliminary Analysis
-Feb. 17, 2010, Understanding the Significance of the Obama Administration's Proposed "Volcker Rules"

Derivatives Overhaul:
-Jun. 22, U.S. Financial Regulatory Reform: Implications for Derivatives
-Aug. 14, Obama Administration Submits Final Legislation to U.S. Congress Regarding Over the Counter Derivatives
-Oct. 13, Congress' Proposals for Over the Counter Derivatives Legislation

Investment Advisory Reform:
-Jun. 23, U.S. Financial Regulatory Reform: Investment Advisory Proposals
-Jul. 22, Obama Administration Proposes Investment Adviser Legislation to U.S. Congress
-Oct. 6, New Developments on U.S. Legislative Proposals for the Registration of Advisers to Private Funds

Investor Protection Act:
-Oct. 13, U.S. Legislative Proposal: House Committee on Financial Services Releases Draft Investor Protection Act

Implications for Real Estate Fund Managers:
-Dec. 14, U.S. Legislative Update: Why Real Estate Fund Managers Should Monitor Congressional Bills Targeted at Hedge Funds

International Comparison of Financial Regulatory Reforms:
-Mar. 24, 2010, Global Financial Regulatory Reform Proposals: An Overview

of proposed amendments to the Bill. Senator Richard Shelby, the ranking Republican on the Senate Banking Committee, decided that it would not be constructive to delay the Committee's proceedings by offering the amendments as the Republicans would not have had a sufficient number of votes to either defeat or amend the Dodd Bill at the Committee level.[2]

The Bill is now headed to the Senate floor for further consideration and full debate. This will take place at some point following the Senate's Easter recess (scheduled to end on April 12); however, the exact timing for this next step in the legislative process has yet to be set.

Up to this point, the Dodd Bill has not received the formal backing of any Republican members of the Senate. Particularly since the Democrats have lost their filibuster proof majority in the Senate (and thus, any bill would need to garner at least some Republican support in order to be passed by the Senate), it is anticipated that Senator Dodd will seek to find some Republicans to support the Bill and/or "compromise" positions on the most controversial areas. Indeed, heading in to the Senate's Easter recess, key Democrats and Republicans alike pledged to continue to work with each other to resolve areas of continued disagreement.

In his remarks at the Senate Banking Committee's mark-up of the Dodd Bill, Senator Shelby identified several areas of the Bill that are of particular concern to the Republicans. Significantly, these areas, which are set out below, will likely be the subject of continued debate and negotiation over the next few weeks particularly if Republicans fall in line behind the Republican leadership.

- <u>"Too Big to Fail"/Systemic Risk</u>: Senator Shelby believes that the Dodd Bill has fallen short of its objectives of ending bailouts and the associated "too big to fail" problem. For example, in a letter to Treasury Secretary Timothy Geithner, dated March 25, 2010, Senator Shelby identified the following aspects of the Dodd Bill as being particularly problematic in this regard (because, in his view, they leave open the possibility of a "back door" bailout and/or identify those firms that the government may believe are "too big to fail").
  - The emergency lending authority of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). (p.7)
  - The ability of the Federal Deposit Insurance Corporation (the "FDIC") and the Treasury Department to grant debt guarantees. (p.8)
  - The pre-funded "Orderly Liquidation Fund". (p.9)
  - The identification of systemically important financial institutions to be placed under Federal Reserve supervision. (p.5)
- <u>Customer Protection</u>: Senator Shelby insists on the integration of safety and soundness considerations in consumer-protection related rule-writing and enforcement. It appears as though he does not believe that the procedures established by the Dodd Bill in this regard are sufficient. (p.16)
- <u>Derivatives</u>: Senator Shelby has expressed concern that commercial companies which use derivatives for hedging purposes could be subject to requirements (<u>e.g.</u>, putting up cash collateral for central clearing) under the Dodd Bill that would (i) make it more burdensome for companies to hedge their risks, and (ii) divert valuable resources away from other more productive uses. (p.19)
- <u>Corporate Governance, Credit Rating Agencies, Securitization and Securities and Exchange Commission ("SEC") Funding</u>: Senator Shelby has stated that certain corporate governance measures proposed in the Dodd Bill would impose additional unnecessary costs on shareholders and empower special interests. Senator Shelby also singled out proposed reforms included in the Dodd Bill relating to credit rating agencies, securitization and SEC funding as issues that need to be addressed. (p.25)

[2] In a statement made on March 22, 2010, Senator Shelby stated that "Chairman Dodd has made it clear that he intends to move forward without Republican support which is his prerogative. It is not our intention to turn this mark-up into a long march, offering hundreds of amendments that will inevitably be defeated. We don't think that would be constructive or productive."

(corporate governance), p.23 (SEC self-funding), p.23 (securitization) and p.26 (credit ratings).

Looking at the larger picture, if the Senate passes a bill it would then need to be considered by the House, or a House-Senate conference, to reconcile differences between the House and Senate bills and arrive at a single piece of legislation for additional Congressional, and ultimately Presidential, consideration. While there are several important differences between the Dodd Bill and the bill passed by the House – the Wall Street Reform and Consumer Protection Act of 2009 (the "House Bill") – they both are intended to achieve the same basic objectives and both attempt to do so through use of a similar (and, in some cases, the same) approach in a number of areas.[3] In order to facilitate the reconciliation process should components of the Dodd Bill be included in a final Senate bill, Senator Dodd and Congressman Barney Frank, the Chairman of the House Financial Services Committee, have reportedly already begun discussing how to meld the Dodd Bill and the House Bill into one piece of legislation.[4]

In light of the procedural and political dynamics described above, it is almost certain that the Dodd Bill will not emerge from the legislative process in its precise current form. Nonetheless, the Bill may serve as a template for a final Senate bill and many of the components of the Dodd Bill may survive House-Senate conference committee proceedings.

Senator Dodd has indicated that he believes the momentum is shifting in favor of passage of financial regulatory reform with the recent passage of healthcare reform; a feeling which several Republicans have also acknowledged. Last week, Senator Dodd and Congressman Frank told reporters that a final bill will be enacted into law later this year. Meanwhile, an Obama Administration official recently indicated that the Administration expects that financial reform will be finished "certainly by the time we mark the second anniversary of the financial collapse in the early fall."

Developments relating to U.S. financial regulatory reform legislation appear to be moving ahead at an accelerated pace. By this summer, we may know whether this renewed sense of optimism was well-founded.

Financial Stability and Too-Big-To-Fail Regulation

The Creation of the Financial Stability Oversight Council and the Office of Financial Research

It is widely believed that existing U.S. financial supervisory agencies – which, by design, principally focus on the health of individual regulated institutions that fall within their jurisdiction – failed to adequately monitor emerging system-wide risks in the years prior to the financial crisis. As a result, there has been increasing calls for the establishment of a "systemic risk" regulatory body to focus on the well-being of the U.S. financial system as a whole. Under the Dodd Bill, a Financial Stability Oversight Council ("FSOC") would be created to serve in that role.[5]

The FSOC would be established as a nine–member council principally populated by the heads of the major U.S. financial regulatory agencies and chaired by the Secretary of the Treasury.[6] The key purposes of the FSOC include:

[3] The House Bill is discussed in our earlier publication (dated December 22, 2009) available at: http://www.shearman.com/us-house-of-representatives-passes-wall-street-reform-bill-a-preliminary-analysis-12-22-2009/.

[4] Congressman Frank has objected to certain elements of the Dodd Bill in the area of consumer protection (e.g., he is not in favor of placing a consumer protection bureau within the Federal Reserve as called for under the Dodd Bill).

[5] The FSOC – as envisioned by the Dodd Bill – would be broadly comparable to the Financial Services Oversight Council that would be created under the House Bill (although they differ in areas such as membership and voting rules).

[6] The members of the FSOC would consist of: The Secretary of the Treasury, who would chair the FSOC; the Chairman of the Federal Reserve, the Comptroller of the Currency; the Chairperson of the SEC; the Chairperson of the FDIC; the Chairman of the Commodity Futures Trading Commission ("CFTC"); the Director of the Federal Housing Finance Agency; the Director of the new Bureau of Consumer Financial Protection; and an independent member appointed by the President, with the consent of the Senate, having expertise in insurance.

Some have questioned whether the Secretary of the Treasury's role as chairman of the FSOC would result in decisions reflecting political considerations.

- identifying risks to the financial stability of the United States that could arise from financial distress or the failure of a large, interconnected financial institution,
- promoting market discipline to mitigate the "too big to fail" problem (by eliminating expectations on the part of market participants that they will be shielded from losses in the event of failure), and
- responding to emerging threats to the stability of the U.S. financial markets.

To these ends, the FSOC's specific duties would include:

- collecting information from member agencies and other regulatory agencies,
- facilitating information sharing among its member agencies and recommending to such agencies new or heightened standards and safeguards for financial activities that could create systemic risks,
- identifying gaps in regulation that could pose risks to U.S. financial system stability,
- resolving certain jurisdictional disputes among member agencies, and
- offering recommendations to U.S. financial regulatory agencies to apply new or heightened standards or practices to financial companies within the agencies' jurisdiction.

The Dodd Bill would establish an Office of Financial Research within the U.S. Treasury Department for the purpose of assisting the FSOC in carrying out its duties – particularly those relating to collecting and analyzing data regarding system-wide risk levels and patterns.[7]

Systemically Important Non-Bank Financial Institutions Placed Under Federal Reserve Supervision

The FSOC (by a two-thirds supermajority vote) is authorized to place any U.S. non-bank financial company determined to "pose a threat to the financial stability of the United States" under the comprehensive supervision and examination authority of the Federal Reserve.[8] In making determinations in this regard, the FSOC is instructed to focus on several different factors including the company's:

- degree of leverage,
- nature of financial assets,
- funding sources,
- linkages to other institutions, and
- importance as a source of credit and liquidity to the American financial system.

Similarly, the FSOC is also authorized to place any foreign (i.e., internationally-headquartered) non-bank financial company determined to pose a threat to U.S. financial stability under Federal Reserve supervision so long as the company has substantial assets or operations in the United States.[9] In determining whether a non-U.S. company meets the requisite criteria in terms of systemic importance, the FSOC is required to focus in particular on the company's U.S. activities and linkages (e.g., U.S. financial assets, U.S.-related off-balance sheet exposures, and the importance of the company as a source of credit and liquidity in the United States).

Unlike a similar regulatory reform proposal advanced by the Obama Administration last year, the Dodd Bill does not specifically restrict the types of non-financial activities that may be conducted by a non-bank financial institution placed under Federal Reserve supervision. As a result, it should generally be possible for any financial company, such as a private equity fund, deemed to be systemically-important (but not affiliated with a U.S. bank holding company or a non-U.S. bank subject to the

[7] This task would be assigned to the Federal Reserve under the House Bill.

[8] For purposes of the Dodd Bill, a "U.S. non-bank financial company" is one that is "substantially engaged" in activities of a financial nature (i.e., it should not cover manufacturers, retailers, or commercial companies). In addition, the term does not include a U.S. bank holding company or a bank holding company subsidiary (which, as described below, would automatically be subject to Federal Reserve supervision under the Dodd Bill if the holding company has at least $50 billion in consolidated assets).

By regulation, the Federal Reserve and the FSOC may exempt certain classes of non-bank financial companies from Federal Reserve supervision.

[9] For purposes of the Dodd Bill, the term "foreign non-bank financial company" does not include a non-U.S. bank that has U.S. banking operations (which, as described below, would, in general, automatically be subject to Federal Reserve supervision under the Dodd Bill).

activity restrictions of the U.S. Bank Holding Company Act) to manage and operate commercially-oriented portfolio companies. This aspect of the Bill appears to be responsive to concerns previously voiced by non-bank industry groups such as the non-bank asset management industry. Such groups, however, remain concerned over the possibility of a fund (or another non-bank entity) becoming subject to Federal Reserve supervision and the accompanying heightened regulatory scrutiny and restrictions.[10]

The "Hotel California" provision

Under the so-called "Hotel California" provision of the Dodd Bill, any non-bank financial company that (i) was a U.S. bank holding company having total consolidated assets equal to or greater than $50 billion as of January 1, 2010, and (ii) participated in the Capital Purchase Program established under the Troubled Asset Relief Program, would automatically be placed under Federal Reserve supervision. This provision appears intended to ensure that major institutions (e.g., Morgan Stanley and Goldman Sachs) that have recently become U.S. bank holding companies would (subject to a hearing and appeal process) remain subject to Federal Reserve supervision even if they were to choose to relinquish their current status as U.S. bank holding companies.

Systemically Important Bank and Non-Bank Financial Institutions Subject to Heightened Prudential Standards

The Dodd Bill directs the Federal Reserve to apply stricter prudential standards and reporting and disclosure requirements on the following categories of financial institutions:

- Non-bank financial companies placed under Federal Reserve supervision (in the manner described above),
- "Large, interconnected" U.S. bank holding companies with at least $50 billion in consolidated assets, and
- "Large, interconnected" non-U.S. banks that are subject to the Bank Holding Company Act (e.g., because they operate a U.S. branch, agency or commercial lending company) with at least $50 billion in consolidated assets.

For companies falling within one of these categories, heightened prudential standards (i.e., standards more stringent than those that would otherwise apply) would include:[11]

- (unspecified) risk-based capital requirements,
- (unspecified) leverage limits,
- (unspecified) liquidity requirements,
- resolution plan (or "funeral plan") requirements (i.e., periodic submission of a plan to efficiently wind-down the company's business operations in the event of material financial distress or failure),
- credit exposure report requirements (i.e., periodic submission of reports to the Federal Reserve, the FDIC and the FSOC regarding exposures to other significant non-bank and bank holding company counterparties), and
- concentration limits (i.e., a cap on aggregate credit exposures to any unaffiliated entity).[12]

In addition, the Federal Reserve may promulgate regulations or otherwise make decisions requiring such companies to:

- maintain an amount of contingent capital,[13]
- make enhanced public disclosures, and

[10] The heightened standards are discussed below (see "Systemically Important Bank and Non-Bank Financial Institutions Subject to Heightened Prudential Standards" and "The Volcker Rule Provisions: Additional capital requirements and quantitative limitations applied to systemically important non-bank financial institutions").

[11] The FSOC is authorized to offer recommendations to the Federal Reserve concerning the establishment and refinement of prudential standards and reporting and disclosure requirements.

[12] The default concentration limit to any unaffiliated company would be 25% of the capital stock and surplus of the systemically important institution.

[13] Contingent capital is long-term hybrid debt that is convertible to equity in times of financial stress.

The FSOC is required to conduct a study of the feasibility, benefits, and costs of such a requirement and report to Congress (the Federal Reserve may only promulgate regulations in this regard following the submission of this report).

- comply with new risk management requirements.

The Dodd Bill (unlike the House Bill) directs the Federal Reserve to increase the stringency of standards and requirements on the basis of certain systemic-risk characteristics of the company, including size and complexity. In so doing, the Dodd Bill attempts to strike a balance between a "bifurcated" and an "incremental" approach to systemic risk regulation of financial institutions. Only a relatively small number of the largest financial institutions would be subject to the heightened standards; i.e., the proposal creates a bifurcation between systemically important institutions subject to the standards and all other institutions which are not. At the same time, however, the intensity of the requirements would be incrementally ramped up or down to reflect the systemic importance of an institution subject to the heightened standards (i.e., an "incremental" approach). The objective of the incremental aspect of the approach would be to (i) ensure that requirements/standards are reflective of differing levels of systemic risks, and (ii) create additional disincentives for large, systemically-important companies to grow even larger and more complex.

Application of heightened prudential standards to non-U.S. financial companies

It appears that the Federal Reserve would have the authority to apply heightened prudential standards to non-U.S. companies on a global (i.e., not only U.S.) basis. In applying heightened standards to non-U.S. institutions, however, the Federal Reserve is directed to take into account the principle of national treatment (i.e., treating U.S. and non-U.S. institutions alike) and competitive equality.[14] Historically, the Federal Reserve's general approach in applying these principles has been to limit the extraterritorial reach of prudential standards such as those set out in the Dodd Bill.

Authority to Force Dispositions of Assets and Review Proposed Acquisitions by Systemically-Important Financial Institutions Subject to Heightened Prudential Standards

Under certain limited circumstances, a financial company subject to heightened prudential standards could be forced to terminate activities and/or dispose of certain assets. In particular:

- If the Federal Reserve and the FDIC jointly determine that the resolution plan of a company is not credible and the company fails to resubmit an acceptable plan within two years, the Federal Reserve and FDIC in consultation with the FSOC, may require divestiture of certain assets.[15]
- If the Federal Reserve determines that a company subject to heightened prudential standards poses a grave threat to the financial stability of the U.S., it may, with the approval of no less than two-thirds of the FSOC, require the company to (i) terminate or restrict activities or (ii) sell or otherwise dispose of assets or off balance sheet items to unaffiliated parties.[16]

In addition, certain acquisitions by a financial company subject to heightened prudential standards (e.g., acquisitions of a company having total consolidated assets of at least $10 billion and engaging in certain types of financial activities permitted under the Gramm-Leach-Bliley Act or acquisitions of 5% of a class of voting securities of a U.S. banking institution) would become subject to prior Federal Reserve review and/or approval.

The Federal Reserve's Emergency Lending Authority

Under Federal Reserve Act Section 13(3), the Federal Reserve is currently authorized to open the discount window to any individual, partnership or corporation

[14] Unlike under the House Bill, the Federal Reserve would not be required to consider the extent to which a non-U.S. institution is subject to similar requirements in its home country.

[15] Should a company fail to submit an acceptable plan, the FDIC and the Federal Reserve may (prior to the end of the two-year period) impose tighter restrictions on growth, capital requirements, leverage requirements and limit activities.

[16] The Federal Reserve is authorized to promulgate regulations regarding the application of its authority in this regard to non-U.S. institutions.

(regardless of whether it is a bank or bank holding company) in "unusual and exigent circumstances". Section 13(3) lending was utilized in the Federal Reserve's rescue operations with AIG, Bear Stearns, and other non-bank operations with various lending facilities with broad based eligibility (e.g., the Commercial Paper Funding Facility and the Term Asset-Backed Securities Loan Facility).

The Dodd Bill would no longer allow the Federal Reserve to use its emergency powers to support any individual non-banking institution. In addition, based in part on FDIC chairman Sheila Bair's concern that the authorization could possibly allow "backdoor" bail outs, Senator Dodd's Manager's Amendment eliminated a provision that would have permitted the Federal Reserve to utilize its emergency authority as necessary to lend money to certain systemically important "financial market utilities" (e.g., a central clearinghouse).[17]

Instead, the Bill as approved by the Senate Banking Committee would only permit the Federal Reserve to use its emergency lending authority to support a program or facility with broad based eligibility for the purpose of providing liquidity to the financial system.[18] Moreover, the Federal Reserve would be required to obtain the approval of the Secretary of the Treasury before engaging in Section 13(3) lending and report to the U.S. Congress within seven days after any such lending is initiated.

Emergency Financial Stabilization Debt Guarantees

Under the Dodd Bill, the FDIC would be vested with the power to guarantee the debts of solvent FDIC-insured depository institutions and their holding companies (e.g., as was done as part of the FDIC's Temporary Liquidity Guarantee Program) during times of severe economic stress and under strict conditions. For the FDIC to exercise this authority, the Federal Reserve and the FDIC (in each case, by a two-thirds vote) must determine that there is a "liquidity event" that threatens financial stability. In addition, the terms and conditions of the guarantees must be approved by the Secretary of the Treasury.

Dissolution of Systemically Important Financial Institutions

Orderly Liquidation Process

The Dodd Bill provides for a special liquidation process – as an alternative to the normal bankruptcy process – to unwind certain systemically-important U.S. financial companies (potentially including financial holding companies, broker-dealers, insurance companies and hedge funds) that are in default or in danger of default.[19] The proposed legislation uses the term "orderly liquidation" in order to emphasize the point that the financial company is to be closed, rather than provided with assistance in order to remain open.

The process for triggering use of the authority includes:

- systemic risk recommendations made by each of the Federal Reserve and the FDIC to the Secretary of Treasury (to the effect that failure of the company would have adverse effects on the financial stability of the United States),
- a systemic risk determination by the Secretary of the Treasury and a decision by the Secretary to petition a panel of three U.S. bankruptcy judges to authorize the orderly liquidation process, and
- an order of the panel of judges (within 24 hours of receipt of the petition by the Treasury Secretary and upon a determination that the company is in default or in danger of default) authorizing the Secretary to

[17] The term '"financial market utility" is defined under the Dodd Bill to mean any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person.

[18] The Federal Reserve would be directed to issue policies and procedures (in consultation with the Treasury Department) designed to ensure that any emergency lending program is for the purpose of providing liquidity to the financial system, and not to aide a failing financial company.

[19] The vast majority of financial companies would continue to be subject to the normal bankruptcy process.

appoint the FDIC as receiver of the distressed company.[20]

In acting as receiver in connection with the orderly liquidation process, the FDIC is required to:

- determine that action is necessary for purposes of the financial stability of the United States (and not for purposes of preserving the company),
- ensure all claims are paid in full before shareholders of the institution receive any portion of the distribution,
- ensure that unsecured creditors maintain the same priority as in an ordinary bankruptcy proceeding,[21] and
- ensure that management responsible for the failed condition of the company is removed.

In many respects, the "orderly liquidation" regime is broadly modeled after the FDIC's powers to resolve an FDIC-insured institution. Differences include a 5-day stay that would be imposed on payments and delivery obligations due under a "qualified financial contract" (e.g., a swap agreement) following the appointment of the FDIC as receiver in connection with an "orderly liquidation". The House Bill would only provide a one-day stay – the same period of time currently provided for in the case of a receivership of an FDIC-insured depository institution.

Some commentators have questioned whether the FDIC – which currently handles the resolution of FDIC-insured banks – has sufficient expertise to unwind large, complex non-bank financial institutions. In this regard, others have argued that the requirement for such institutions to prepare their own resolution or "funeral plan" (as described above) could potentially facilitate the task of liquidating such an institution – although there is a counter-argument that any "funeral plan" that is prepared may be out of date by the time the FDIC needs to rely on it.

Orderly Liquidation Fund

The Dodd Bill would establish an "Orderly Liquidation Fund" to be available to help the FDIC carry out its responsibilities as receiver (including the payment of administrative expenses and costs to liquidate the company).[22] The Orderly Liquidation Fund – which is targeted at $50 billion – would be financed through risk-based assessments on bank holding companies with total consolidated assets equal to or greater than $50 billion and systemically important non-bank financial companies supervised by the Federal Reserve.[23] The risk-based assessment may vary among companies based on several different factors including the risks created by the financial company to the economy as a whole.

Partial Realignment of U.S. Bank Supervisory Authority Among the U.S. Federal Banking Agencies

The Dodd Bill would make changes to the regulatory and supervisory authority of the U.S. federal banking agencies. This part of the Dodd Bill has been described as one that would limit the authority of the Federal Reserve and enhance that of the other agencies. While, to a certain extent, this is true, as described below, the Federal Reserve does retain a great deal of authority.

As in the House Bill, the Dodd Bill consolidates the Office of Thrift Supervision ("OTS"), which regulates federal savings banks and other federally-chartered thrift institutions and their holding companies, with the Office of the Comptroller of the Currency ("OCC"), which

20 The House Bill would not require review by any bankruptcy judges (designed as a check on actions of the executive branch and the regulators) in order for the FDIC to act as receiver of a troubled financial company pursuant to the House Bill's dissolution authority provisions.

21 Unlike the House Bill, no provision in the Dodd Bill provides that secured lenders may have to take a discount or 'hair-cut' on their secured claims (i.e., along the lines of the so-called Miller-Moore amendment of the House Bill). While, as a general matter, the FDIC is required under the Dodd Bill to treat creditors similarly situated in a similar manner, the FDIC does have some flexibility to stray from this standard to maximize the returns of the estate.

22 The Chairwoman of the FDIC, Sheila Bair, who supports the creation of the Orderly Liquidation Fund, recently noted that "there is a temporary need for working capital as you break up and sell off" a systemically-important financial institution.

23 The contemplated funding period for the Orderly Liquidation Fund is five to ten years.

currently regulates national banks. Like the House Bill (but unlike legislation proposed by the Obama Administration in July 2009), the Dodd Bill would allow the OCC to retain its name.[24] In addition, the federal thrift charter is abolished over time and existing federal thrifts become national banks.

The OTS Chairman's seat on the FDIC board of directors would be taken by the Director of the new Bureau of Consumer Financial Protection (discussed below).

The Federal Reserve would also lose its regulatory and supervisory authority over FDIC-insured state banks that have chosen to become members of the Federal Reserve System. Those banks would become subject to the authority of the FDIC (i.e., in addition to the authority of the applicable state regulatory body). The OCC and FDIC accordingly would be the two remaining U.S. federal supervisory agencies for FDIC-insured depository institutions.

Finally, the Federal Reserve would lose its supervisory authority over those bank holding companies with total consolidated assets less than $50 billion. Those holding companies would become subject to OCC or FDIC supervision, depending on whether a holding company's national bank or state bank subsidiaries constituted the larger part of the company's consolidated assets. The agencies would develop a system for making this calculation and for establishing a system to transfer a company from one agency to the other in the event of becoming greater or less than the $50 billion cutoff, but such transfers may not be done more often than every two years.

As a consequence of the foregoing, the Federal Reserve would lose supervisory authority over a large majority of the institutions it currently supervises (the Federal Reserve currently supervises almost 5,000 holding companies whereas approximately only 55 holding companies have more than $50 billion in assets). Moreover, some of the regional Federal Reserve Banks (which currently carry out state-Federal Reserve System bank and bank holding company examinations) would not be left with jurisdiction over any institutions.[25]

However, the Federal Reserve retains a great deal of authority and receives new authority with respect to thrift holding companies:

- Supervisory authority over all U.S. bank holding companies and thrift holding companies with $50 billion or more consolidated assets and their nonbank subsidiaries.
- Rulemaking authority over all bank holding companies and thrift holding companies.
- Supervisory and regulatory authority over foreign banks with uninsured U.S. branches or agencies, uninsured state member banks (such as Depository Trust Company, ICE Trust U.S. LLC, and Warehouse Trust Company LLC), and Edge and Agreement corporations.
- Authority to issue regulations and interpret Sections 23A and 23B of the Federal Reserve Act ("Section 23A" and "Section 23B") and governing transactions between banks and their affiliates, including the Federal Reserve's Regulation W, and statutes applicable to extensions of credit to insiders, including the Federal Reserve's Regulation O (including the authority formerly held by the OTS to create exceptions).

The retention of rulemaking authority by the Federal Reserve over all bank holding companies is logical. Otherwise, the same provisions of the Bank Holding Company Act could be subject to different and conflicting regulations among the agencies. However, the result is that the OCC and FDIC would simply implement rules mandated by the Federal Reserve. For example, while apparently applications to become a bank holding company or by a bank holding company to acquire another bank would be subject to OCC or FDIC approval, those agencies would apparently be constrained to apply the standards set forth by the Federal Reserve in its Regulation Y.

[24] The House Bill merges the OTS into a division of the OCC. The OCC would continue to be the primary regulator of national banks and would also regulate federally-chartered thrift institutions.

[25] There are twelve regional Federal Reserve Banks spread geographically across the country.

Also, the loss of supervisory authority over holding companies with less than $50 billion in consolidated assets means that the Federal Reserve will not have authority to examine those organizations or take enforcement actions against them for violations of law or for unsafe and unsound activities. However, arguably those holding companies are of less interest to the Federal Reserve from a systemic viewpoint. Rather, it would be able to focus on the largest organizations. In addition, the Federal Reserve would not be subject to criticism for failing to detect violations or control deficiencies at smaller organizations.

Retention of authority over foreign banks with uninsured U.S. branches and agencies similarly allows the Federal Reserve to continue to serve as the primary agency with relationships with foreign bank supervisory agencies. One ambiguity in the Dodd Bill is whether a foreign bank with both a U.S. branch and a U.S. bank subsidiary would be subject to Federal Reserve supervision if its consolidated assets are less than $50 billion; as a bank holding company (because it owns a U.S. bank), it might be subject to OCC or FDIC supervision. The Dodd proposal is silent on whether the $50 billion threshold is determined only on the basis of U.S. assets for a foreign bank or on global assets, as would be the case for a U.S. holding company.

The Dodd Bill requires that the Federal Reserve collect assessments, fees or other charges for the expense of carrying out its regulatory and supervisory authority from bank and savings and loan holding companies with consolidated assets of $50 billion or more and all nonbank financial institutions designated as systemically significant. Interestingly, the provision does not apply to foreign banks with only U.S. branches or agencies.

The draft legislation provides that this rearrangement would become effective one year after enactment of the draft, with a two year transition period for certain purposes beginning at that point, subject to the possibility of extending the beginning point. Personnel, facilities and the like would be allocated by agreement among the Federal Reserve/FDIC/OCC, including participation in each agency's retirement and long term care plans for employees either being transferred to or from an agency. Personnel and property of Federal Reserve Banks are treated as Federal Reserve property for this purpose. Many Reserve Banks would likely lose personnel and much property to the OCC or FDIC as a result of these provisions.

The Volcker Rule Provisions

The President's proposed restrictions on certain capital markets activities of, and concentration limits for, banking institutions and their affiliates – popularly referred to as the "Volcker Rule" – are reflected in the Dodd Bill.[26] Particularly given the late introduction of the Volcker Rule into the reform dialogue (the President initially called for the reforms more than a month following passage of the House Bill) as well as the controversial nature of the rule, there was much speculation surrounding the question of whether the Volcker Rule would be included in the Dodd Bill.

The Dodd Bill lays out the statutory framework for the U.S. federal banking agencies to implement the Volcker Rule in either a wide ranging or more limited manner following the enactment of the legislation into law. In particular, the Bill grants the U.S. federal banking agencies not only the authority to address specific interpretive issues that may arise, but also the broader authority to effectively modify the statutory restrictions themselves through the issuance of administrative regulations based on the recommendations of the FSOC (which must be produced within six months of enactment of the Bill into law). In this regard, the FSOC is authorized to recommend "modifications to the definitions, prohibitions, requirements and limitations" set out in the Dodd Bill (which are summarized below) to the extent such modifications would "more effectively implement" the purposes of the Volcker Rule (also

[26] The President dubbed the restriction on capital markets activities the "Volcker Rule" (although the nickname "Volcker Rule" or "Volcker Rules" has since been attached to both of the restrictions) after the former Federal Reserve chairman and strong advocate of the Rule, Paul Volcker.

summarized below).[27] The U.S. federal banking agencies would have up to nine months following the release of the FSOC's report to issue final regulations implementing the Volcker Rule restrictions.

Capital Markets Restrictions on Banking Institutions and Their Affiliates

The following institutions are subject to various capital markets-related restrictions under the Dodd Bill's adaptation of the Volcker Rule:

- FDIC-insured depository institutions,
- Any company that controls an FDIC-insured depository institution (e.g., a U.S. bank holding company),
- A non-U.S. bank subject to the Bank Holding Company Act (or the parent company of such a bank), and
- Any subsidiary of any of the foregoing (e.g., a broker dealer subsidiary of a bank holding company).

More specifically, subject to the recommendations of the newly formed FSOC and to joint rules of the U.S. federal banking agencies, and following a two year transition period, each covered entity would be prohibited from conducting the following types of activities:[28]

- "proprietary trading",
- "sponsoring and investing in" a hedge fund or a private equity fund, and
- engaging in "covered transactions" (for purposes of Section 23A) with an advised hedge fund or private equity fund.

As used in the Dodd Bill, "hedge funds" and "private equity funds" are funds exempt from registration as an investment company pursuant to section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") (or a "similar fund", as determined by the federal banking agencies).

The Dodd Bill suggests that the objectives of the capital markets prohibitions include:

- promotion/enhancement of the safety and soundness of banking institutions,
- protection of taxpayers,
- enhancement of financial stability,
- limitation of inappropriate transfer of federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the federal government to unregulated entities, and
- reduction of inappropriate conflicts of interest between institutions and their customers.

After taking these objectives into account, the FSOC is authorized under the Dodd Bill to recommend (among other changes) that the absolute prohibitions on "proprietary trading" and "sponsoring and investing in" a hedge fund or private equity fund be replaced with a maximum threshold or "cap" approach coupled with additional capital requirements.

Prohibitions on "proprietary trading" and "investing" in a hedge fund or private equity fund

The U.S. federal banking agencies are directed (subject to modification by the FSOC) to prohibit entities covered by the capital markets restrictions from "proprietary trading" which is defined as follows:

"*. . . purchasing or selling, or otherwise acquiring and disposing of, stocks, bonds, options, commodities, derivatives, or other financial instruments . . . for the trading book (or such other portfolio as the federal banking agencies may determine) of such institution or company, or subsidiary, and . . . not on behalf of a customer, as part of market making activities, or otherwise in connection with or in facilitation of customer relationships, including risk-mitigating hedging activities [related to the foregoing].*"

A limited carve-out to this prohibition is provided for "proprietary trading" in U.S. government obligations,

[27] Our client publication "Understanding the Significance of the Obama Administration's Proposed "Volcker Rules"" provides an in depth discussion of the purposes of the Volcker Rule (as well as arguments in favor of and against the Volcker Rule). The publication is available at http://www.shearman.com/understanding-the-significance-of-the-obama-administrations-proposed-volcker-rules-02-17-2010/.

[28] Each individual entity covered by the prohibitions would have the ability to apply for extensions of up to 3 additional years.

related "agency" securities (e.g., Ginnie Mae, Fannie Mae, Freddie Mac), and state and municipal obligations, where otherwise authorized under law.

Separate and apart from the prohibition on "proprietary trading", the Dodd Bill directs the U.S. federal banking agencies (subject to modification by the FSOC) to prohibit entities covered by the capital markets prohibitions from "investing" in hedge funds and/or private equity funds. There would be a limited carve out for investments in small business investment companies where otherwise authorized under law.

It is noteworthy that the Dodd Bill prohibits all "investing" in hedge funds and private equity funds (which suggests that any investment would be prohibited even if acquired as part of a "buy and hold" strategy) but only "proprietary trading" in any other asset class (which suggests that an investment should only be prohibited if acquired as part of a trading strategy). This statutory distinction begs the question of why, from a policy perspective, investments in a hedge fund or a private equity fund should be treated differently from investments in another asset class.

There are several important questions raised by these prohibitions – which, presumably, would need to be clarified, if not during the legislative process, then during the administrative rule-writing stage. These include:

- How (if at all) the prohibition on "proprietary trading" would apply to a non-customer-related investment (e.g., in precious metals, bonds or the stock of a commercial company) where the investment is not booked in a trading account?
- How (if at all) the investment/trading prohibitions would apply to a mutual fund sponsored or otherwise "controlled" by a banking institution?

Prohibition on sponsorship of hedge funds and private equity funds

The U.S. federal banking agencies are directed (subject to modification by the FSOC) to prohibit entities covered by the capital markets restrictions from "sponsoring" either a hedge fund or a private equity fund. "Sponsoring" a fund includes any of the following:

- serving as general partner, managing member, or trustee of a fund,
- in any manner selecting or controlling a majority of the directors, trustees or management of a fund, or
- sharing with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

Mr. Volcker's Congressional testimony (February 2, 2010) suggested that there may be a carve out from the general ban on fund "sponsorship" for bank sponsored "funds of funds" that invest exclusively in underlying independent hedge and/or private equity funds. The Dodd Bill, however, does not provide for such a carve-out (although the FSOC and U.S. federal banking agencies may have the legal authority to create such an exemption).

Special limited exemption from application of the prohibitions on "proprietary trading" and "sponsoring and investing in" hedge funds and private equity funds for non-U.S. banks with U.S. banking operations

The prohibition on each of "proprietary trading" and sponsorship and investment in hedge funds and private equity funds would not apply to the activities of non-U.S. institutions (that are not controlled by a U.S. company) that are conducted solely outside of the United States.

Restrictions on relationships with "advised" or "managed" private equity and hedge funds

Entities covered by the capital markets restrictions would not be permitted to both (i) act as an investment adviser or investment manager of a private equity or hedge fund, and (ii) enter into any Section 23A "covered transaction" with the advised or managed fund. For these purposes, prohibited "covered transactions" with an advised/managed fund would include:

- Providing credit to the advised/managed fund,
- Buying assets from the advised/managed fund, and
- Issuing a guarantee on behalf of the advised/managed fund.

In addition, any permissible transaction between a covered entity and an advised fund would be subject to Section 23B "arms-length" transaction standards.

These restrictions would be applied on a group-wide basis; i.e., if any entity within a financial group serves as investment adviser/manager, each entity within the group would be subject to the restrictions.

Perhaps somewhat surprisingly in view of existing law in the area, the Dodd Bill does not include a statutory carve out for the non-U.S. activities of non-U.S. institutions. Thus, in other words, as currently drafted, the restrictions could potentially apply to transactions/relationships between the head office of a non-U.S. bank (with U.S. banking operations) and a non-U.S. fund.

Additional capital requirements and quantitative limitations applied to systemically important non-bank financial institutions

The Federal Reserve is directed (subject to modification by the FSOC and certain limited carve outs) to subject non-bank financial institutions under Federal Reserve supervision (i.e., those non-bank institutions designated as systemically-important but not otherwise subject to the capital markets-related restrictions) to heightened capital requirements and quantitative limits on any proprietary trading and hedge fund and private equity fund-related activities they may conduct.

Concentration Limits on Financial Institutions

The Volcker Rule concentration limit is intended to supplement the existing 10% cap on the accumulation of nationwide deposits. Subject to any modifications that the FSOC may make to the concentration limit and certain limited exceptions for *de minimis* or failed bank acquisitions, the Dodd Bill's adaptation of the limit restricts mergers, acquisitions and consolidations where the acquiring financial company's total consolidated liabilities upon consummation of the transaction would exceed 10% of the aggregate consolidated "liabilities" of all "financial companies" at the end of the prior calendar year. For purposes of calculating the cap:

- A "financial company" includes (i) an insured depository institution, (ii) any U.S. bank holding company, (iii) any non-U.S. bank or company subject to the Bank Holding Company Act, and (iv) systemically-important non-bank financial companies supervised by the Federal Reserve (i.e., that do not "control" a depository institution), and
- "Liabilities" that would count towards to the threshold are generally determined by reference to risk-based capital rules applicable to the financial institution.
  - In the case of a U.S. institution, "liabilities" are the total adjusted risk-weighted assets of the institution less its total regulatory capital.
  - In the case of a non-U.S. institution, "liabilities" are the total adjusted risk-weighted assets of its U.S. operations less the total regulatory capital of its U.S. operations.
  - In the case of non-bank financial institutions subject to Federal Reserve supervision, the Federal Reserve is required to issue guidance on the term to ensure consistent and equitable treatment.

The Dodd Bill suggests that the objectives of the concentration limits include the following:

- Ensure financial stability,
- Minimize "moral hazard" in the financial system, and
- Promote efficiency and competitiveness of U.S. financial firms and markets.

After taking these objectives into account, the FSOC is authorized under the Dodd Bill to recommend changes to the statutory concentration limit.

Enhancements to the Regulation of Bank Holding Companies and Depository Institutions

Like the House Bill, the Dodd Bill adds a number of new requirements on bank holding companies and depository institutions. For example, financial holding companies would be required to be "well capitalized" and "well managed" in order to engage in expanded financial activities permitted under Section 4(k) of the Bank Holding Company Act. In addition, in order for a bank holding company to engage in interstate bank acquisitions, the bank holding company must be "well capitalized" and "well managed," rather than the existing standard of being "adequately capitalized" and "adequately managed".

In addition, other important changes to the regulation of bank holding companies and/or U.S. depository institutions include:

- The removal of certain constraints under existing law for the appropriate federal supervisor of a U.S. bank holding company to examine, and obtain reports for, regulated subsidiaries of the holding company,
- The requirement that a financial holding company receive prior approval in order to commence a new financial activity if it involves the acquisition of assets that exceed $25 billion,
- The prohibition on a national bank converting into a state bank, and a state bank converting into a national bank, at a time when such bank is subject to a cease and desist order, memorandum of understanding, or other enforcement action, and
- The elimination of the remaining restrictions on interstate branching by national and state banks.

Unlike the House Bill, the Dodd Bill does not include a requirement that the U.S. federal bank agencies impose "counter-cyclical" capital requirements on banking institutions.

Enhanced Restrictions on Transactions with Affiliates

Section 23A places limitations on transactions between a bank and its affiliates and is designed to protect a depository institution from suffering losses in its transactions with affiliates.

The Dodd Bill enhances restrictions on derivatives transactions between a bank and its affiliates by subjecting them to Section 23A. In particular, derivatives transactions would be subject to Section 23A "to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate". The credit exposure resulting from a derivatives transaction between a bank and its affiliates would need to be fully collateralized for the life of the transaction.[29] Similarly, the Bill would require credit exposures arising out of securities lending/borrowing transactions between a bank and its affiliates to be fully secured. Derivatives and securities lending/borrowing transactions would count towards the Section 23A quantitative limits unless fully secured by obligations of the U.S., obligations fully guaranteed by the U.S., or a segregated, earmarked deposit account.

As under the House Bill, Section 23A would be amended to define an investment fund for which the member bank, or an affiliate thereof, serves as an investment adviser as an affiliate of the member bank – which would represent a modest expansion of the application of Section 23A.[30]

The Dodd Bill would also make the following "technical" changes to Section 23A: (i) it treats repo transactions (where the bank "repos in" securities from an affiliate) as extensions of credit for purposes of the Section 23A rather than asset purchases, and (ii) it eliminates the special treatment for covered transactions with "financial subsidiaries" of a bank.

Lending limits currently applicable to national banks would be applied to all FDIC-insured institutions.[31] These limits would explicitly include credit exposures due to derivative transactions, repurchase and reverse repurchase agreements, and securities borrowing and lending transactions.

[29] Unlike the House Bill, the Dodd Bill does not require that "potential future credit exposures" arising out of a derivatives transaction be secured for the life of the transaction.

[30] Under current law, an advised fund may, under certain circumstances, be an "affiliate" of a member bank. In particular, (i) an investment fund both "sponsored and advised" by a bank would be an affiliate of the bank for these purposes, and (ii) a registered investment company for which a bank serves as an investment adviser for purposes of the Investment Company Act, would be an affiliate of the bank.

[31] While the original House committee draft had a provision (like the Dodd Bill) that would have imposed the national bank lending limits on all FDIC-insured state banks, the provision was deleted from the House Bill.

Study on Exemption from Bank Holding Company Act Coverage for Credit Card Banks, Industrial Loan Companies, and Trust Banks

Unlike the House Bill, the Dodd Bill does not eliminate the exception from the definition of "bank" in the Bank Holding Company Act for industrial banks, industrial loan companies, and insured savings associations. Instead, the Dodd Bill calls for a Government Accountability Office study on whether it is necessary to eliminate the exceptions (due within 18 months of the enactment of the Dodd Bill into law) in order to strengthen the safety and soundness of the institutions or the stability of the financial system. The Dodd Bill also effectively calls for a temporary moratorium (three years) on acquisitions or "de novo" establishments by commercial companies of FDIC-insured industrial loan companies, credit card banks or trust banks.

Bureau of Consumer Financial Protection

Overview

The Dodd Bill would establish the Bureau of Consumer Financial Protection ("BCFP") as a new arm of the Federal Reserve with the responsibility of protecting the interests of retail consumers of financial products. Senator Dodd's initial reform plan (released in November 2009) proposed to create an independent, stand-alone agency – broadly comparable to the Consumer Financial Protection Agency that would be created under the House Bill – to serve in this role.[32] However, Republicans on the Senate Banking Committee voiced passionate dissent against that idea principally on the grounds that, in their view, rules created by an independent agency could potentially be inconsistent with, and even undermine, efforts by the "prudential" financial supervisors to ensure the "safety and soundness" of financial institutions.

[32] In November 2009, Senator Dodd introduced, and then withdrew, a proposed financial regulatory reform package. While several reforms included in the November proposal appear in the Dodd Bill many others were substantially modified or dropped.

The placement of the BCFP within the Federal Reserve reflects an effort on the part of Chairman Dodd to reach out across the aisle to Republicans and work with them on the issue. Chairman Dodd ultimately arrived at the view that regardless of where the BCFP is housed, the critical issues are whether the BCFP would have adequate authority to independently draft and enforce regulations to effectively protect consumers. Nonetheless, it still came as a surprise to many observers when Chairman Dodd proposed to place the BCFP within the Federal Reserve, an agency which he has harshly criticized for inaction with respect to consumer protection during the financial crisis.

Independence of the BCFP

The Dodd Bill includes the following safeguards to ensure that the BCFP has some degree of "independence" from the U.S. Congress and the Federal Reserve:

- The BCFP would be led by an independent director (the "BCFP Director") who would be appointed by the President and confirmed by the Senate (the Director would serve a five-year term),
- The BCFP would receive a dedicated budget paid by the Federal Reserve, rather than Congress,
- The Federal Reserve is not permitted to:
  - intervene in any matter or proceeding before the BCFP Director, including examinations or enforcement actions, unless otherwise specifically provided by law,
  - appoint, direct, or remove any officer or employee of the BCFP, or
  - merge or consolidate the BCFP, or any function or responsibility of the BCFP, with any division or office of the Federal Reserve.
- The BCFP is authorized to write rules without interference from the Federal Reserve.

Authority of the BCFP

The BCFP would have broad authority over the offering and provision of "consumer financial products or services" (i.e., in general, financial products or services used by individuals primarily for "personal, family, or household" purposes but not including insurance). In this regard, the BCFP would consolidate and strengthen consumer protection responsibilities currently handled by the OCC, OTS, FDIC, Federal Reserve, National Credit Union Administration, and the Federal Trade Commission (the "FTC").

The key functions of the BCFP include:

- conducting financial education programs,
- collecting, investigating and responding to consumer complaints,
- identifying risks to consumers,
- supervising certain "covered persons" for compliance with federal consumer financial law and taking appropriate enforcement action, and
- issuing rules, orders, and guidance implementing federal consumer financial laws (e.g., including, among many others, the Truth in Lending Act, and the financial privacy provisions of the Gramm-Leach-Bliley Act).[33]

Rule-making authority

The BCFP's rule-making authority may be summarized as follows:

- The BCFP has the power to prescribe rules and issue orders and guidance, as may be necessary or appropriate to carry out various U.S. federal consumer financial laws.
- The types of entities covered by the rule-making authority of the BCFP may differ depending upon the statutory authority for the rules at issue.
- There are certain restrictions on the BCFP's rule-making authority in the case of:
  - merchants, retailers, or sellers of any non-financial good or services,
  - real estate brokers,
  - accountants/tax preparers, and
  - employee benefit and compensation plans.

While SEC and CFTC supervision of products and services within their historic purview are theoretically outside the BCFP's jurisdiction, a consultation right in favor of the BCFP offers it a "foot in the door." In particular, the SEC and CFTC would be required to consult and coordinate with the BCFP with respect to any rule regarding an investment product or service that is the same type of product as, or that competes directly with, a consumer financial product or service.

Limited supervisory authority to require reports from small depository institutions

The BCFP may require reports from FDIC-insured depository institutions and credit unions with $10 billion or less in assets. However, the BCFP would be required to rely upon existing reports provided to another federal or state agency to the fullest extent possible.

Full supervisory and examination authority over certain institutions

The BCFP would have full supervisory authority over the following types of entities (in certain cases, examination authority is shared with the entity's assigned federal or state "prudential" regulator or other agency) for purposes of assessing compliance with federal consumer financial law and related purposes:

- Non-bank residential mortgage originators, brokers and servicers as well as companies that provide loan modification and foreclosure relief services in connection with residential mortgages,
- Certain non-bank entities deemed by regulation to be "larger participants" in a consumer financial product market (e.g., the credit card, check cashing, debt collector, consumer reporting agency, and payday lender markets, etc.),[34] and
- FDIC-insured depository institutions and credit unions with more than $10 billion in assets and any

[33] Under the Dodd Bill, the Community Reinvestment Act does not fall within the BCFP's jurisdiction. Moreover, the principal mission of the BCFP would not include expansion of home ownership or provision of financial products to low income consumers.

[34] BCFP and the FTC are directed to issue rules defining those entities that fall within this category.

affiliate of such depository institutions/credit unions.

Enforcement authority

The BCFP's enforcement authority may be summarized as follows:

- Subject to certain restrictions, the BCFP may take appropriate enforcement action with respect to (i) any entity offering or providing a consumer financial product or service to prohibit unfair, deceptive, or abusive acts, and (ii) as otherwise provided under a U.S. federal consumer financial law.
- The BCFP has primary enforcement authority with respect to those institutions over which it has full supervisory and examination authority.
- The BCFP may not enforce compliance by an FDIC-insured depository institution or a credit union with $10 billion or less in assets.
- The BCFP may not enforce any consumer financial protection provisions of the Dodd Bill, or rules promulgated by BCFP thereunder, with respect to various entities including:
  - insurance companies/agents (but enforcement authority exists where the entity is engaged in the offering or provision of consumer financial products (i.e., non-insurance products)),
  - an entity regulated by a state securities commission (but only to the extent that the entity acts in a regulated capacity),
  - an entity (e.g., a broker-dealer) regulated by the SEC, and
  - an entity (e.g., a futures commission merchant) regulated by the CFTC.

Challenge of a BCFP Rule by a Prudential Regulator and the FSOC's Authority to Set Aside a Regulation Issued by the BCFP

The Dodd Bill provides for a process by which the FSOC could set aside a final regulation promulgated by the BCFP.[35] In particular, a BCFP regulation would be set aside if a federal financial or "prudential" regulatory authority raises an objection to the regulation, and the FSOC by a two-thirds vote determines that the regulation would jeopardize the safety and soundness of the U.S. banking system or the stability of the U.S. financial sector.

State Law Preemption Standards for National Banks

As a general principle, state consumer financial laws that provide greater protections than the rules of the BCFP (and are not otherwise inconsistent with the consumer financial protection provisions of the Dodd Bill) would not be preempted from applying to national banks. Exceptions to this general principle would apply where:[36]

- The application of a state consumer financial law would have a discriminatory effect on national banks, in comparison with the effect of the law on a bank chartered in that State,
- A determination regarding preemption of a state consumer financial law is made in accordance with the legal standard of the U.S. Supreme Court's Barnett Bank v. Nelson decision (i.e., the state consumer financial law "prevents or significantly interferes with" the operations of a national bank),[37] or
- The state consumer financial law is otherwise preempted by federal law (other than the consumer financial protection provisions of the Dodd Bill).

Preemption determinations under the Barnett standard would be made by a court or by regulation or order of the OCC on a case-by-case basis, and not by a national bank

[35] Prudential agencies would also have an opportunity to provide comments on a proposed BCFP rulemaking prior to adoption of the rule.

[36] The same basic standards would apply with respect to federal savings associations.

[37] 517 U.S. 25 (1996).

itself. In order for the OCC to determine that its regulations preempt state law, it must consult with the BCFP. A court reviewing an OCC determination would be directed to assess its reasoning, thoroughness, and consistency, as well as any other factors the court considers relevant.

Subsidiaries or affiliates of a national bank would not benefit from any special preemption provisions (i.e., even if the state law at issue is deemed not to apply to the national bank itself). In addition, a state attorney general would have the power to bring civil actions against a national bank to enforce violations of non-preempted state and federal consumer financial protection laws.

Very generally speaking, the Dodd Bill framework (as well as similar preemption standards established under the House Bill) would revert preemption standards back to their pre-2004 state, i.e., before the OCC issued broad preemption rules that effectively allow a national bank to determine whether a state law is preempted under the parameters established by the OCC and pending court or OCC review.

Derivatives Reform

The provisions of the Dodd Bill relating to the derivatives markets are broadly similar to those of the House Bill and to the prior version of financial reform legislation introduced by Senator Dodd in November 2009. At the time the Dodd Bill was introduced, Senator Dodd stated that he expected that the OTC derivatives title would be substantially replaced by provisions under negotiation between Senators Gregg and Reed. The status of any such alternative is uncertain.

The portion of the Dodd Bill that deals with OTC derivatives aims to enhance oversight and transparency of the swap market generally. It contains provisions that aim to mitigate counterparty risk while enhancing the reliability, accuracy, and accessibility of transaction information. The Dodd Bill seeks to achieve these goals primarily through regulations that require central clearing, reporting and recordkeeping, minimum capital and margin requirements, and position limits on certain types of swaps.

Allocation of Responsibility Between the SEC and CFTC

As with the House Bill, the Dodd Bill assigns regulatory authority over derivatives and market participants based on the underlying asset. The SEC would have authority over swaps on individual securities or narrow-based indices of securities (so-called "security-based swaps"), and dealers and major market participants in those swaps ("security-based swap dealers" and "major security-based swap participants"). The CFTC would have authority over swaps on other underlying assets (so-called "swaps"), and dealers and major market participants in those swaps ("swap dealers" and "major swap participants"). Notably, swaps on broad-based indices of securities would fall within the CFTC's, rather than the SEC's, jurisdiction.

Regulation of Major Swap Participants and Securities-Based Swap Participants

The Dodd Bill, like the House Bill, would require registration and regulation by the SEC and/or CFTC of dealers and major swap participants in OTC derivatives transactions. A key question as the legislation has evolved has been the scope of the major swap participant definition, which is also relevant in determining whether a firm is subject to the clearing requirement described below. A major swap participant could potentially be defined broad enough to capture various types of investment funds and derivatives-trading arms of financial groups.

The Dodd Bill defines major swap participant as any non-dealer "who maintains a substantial net position in outstanding swaps, excluding positions held primarily for hedging, reducing or otherwise mitigating commercial risk; or whose failure to perform under the terms of its swaps would cause significant credit losses to its swap counterparties". The definition of major swap participant in the Dodd Bill is similar to the House Bill's, although arguably broader because the second prong of the definition looks at individual counterparty risk as opposed to market risk generally.[38] The SEC and the CFTC would be required to jointly define "substantial net position" at a threshold that each determines is "prudent for the effective monitoring, management, and oversight of the financial system."

Clearing and Exchange Trading Requirement

Clearing would be required for swaps that both (i) a clearing organization will accept for clearing and (ii) the CFTC and/or the SEC requires to be cleared. The SEC or the CFTC would require certain swaps to be cleared based on factors such as the degree to which the swap is referenced in other transactions or disseminated in the market, transaction volume, similarity to other centrally cleared transactions, and ability and willingness of a clearing organization to clear the swap.

All cleared swaps would also have to be traded on a regulated exchange or on a registered "alternative swap execution facility," which is defined as an electronic trading system with pre-trade and post-trade transparency where multiple participants have the ability to execute or trade swaps by submitting bids and offers.

The Dodd Bill would permit the CFTC/SEC, in consultation with the FSOC, to exempt from the clearing and trading requirement transactions by a non-dealer, non-major swap participant who does not meet the eligibility requirements of a derivatives clearing organization. However, unlike the House Bill, this exemption would require action by the agency and would not be automatically available.[39]

Capital and Margin Requirements for Swap Dealers and Major Swap Participants

Minimum capital requirements and minimum initial and variation margin requirements would apply to swap dealers and major swap participants. Non-cleared swaps would be required to have stricter capital requirements than cleared swaps in order to "offset the greater risk to the dealer, participant and/or financial system."

The Dodd Bill would authorize the CFTC and the SEC, in consultation with the FSOC, to exempt transactions with non-swap dealers and non-major swap participants from the margin requirements. However, this exemption is narrower than the corresponding exemption in the House Bill, due to the fact that the Dodd Bill requires that the transaction be part of an "effective hedge under generally accepted accounting principles", as opposed to being for hedging purposes more generally.[40]

Segregation of Assets Held as Collateral

Under current law, swap dealers are generally not required to segregate initial margin received from customers, and unless otherwise agreed with their customers they may typically use or rehypothecate that margin. Under the proposed legislation, a swap dealer or clearing organization would be required to segregate initial margin for cleared contracts. For non-cleared swaps, at the request of the swap counterparty providing initial margin to a swap dealer, that dealer must segregate that initial margin in an account that is carried by an independent third-party custodian and designated as a segregated account for the counterparty. Furthermore, the Bill would prohibit the swap dealer from pledging, rehypothecating, or encumbering such property.

Position Limits

Under the Dodd Bill, the CFTC would have the power to establish limits (including related hedge exemption provisions) on the aggregate number or amount of positions for a particular commodity held by any person or group for each month in (i) U.S. futures contracts, (ii) contracts traded on certain foreign boards of trade, and (iii) swaps that perform or affect a significant price discovery function with respect to regulated markets.

38 In the House Bill, the second prong of the definition of major swap participant reads any non-dealer whose "outstanding swaps create substantial net counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets."

39 In contrast, the clearing exemption in the House Bill applies if one of the counterparties to the swap was a non-dealer, non-major swap participant using swaps to hedge commercial risk and had notified the CFTC/SEC of how it planned to meet it obligations generally under the swap.

40 In addition, the non-swap dealer or non-major swap participant must be predominantly engaged in activities that are not financial in nature, as defined in the Bank Holding Company Act.

Reporting

The reporting, recordkeeping, and business conduct requirements of the Dodd Bill would be generally similar to those contained in the House Bill.

The Dodd Bill would amend the Commodity Exchange Act to add a mandatory reporting requirement for large swap traders, who must keep books and records of any cash or spot transactions in, inventories of, and purchase and sale commitments of, any related commodity traded on or subject to the rules of any board of trade. The books and records must show complete details concerning all transactions and positions and be open at all times for inspection and examination.

Ongoing Bipartisan Negotiations

Senators Jack Reed (a Democrat) and Judd Gregg (a Republican) have previously announced that they are working on significant amendments to the Dodd Bill's derivatives provisions, although the details are still uncertain.[41] It is also expected that Senator Blanche Lincoln, Chairman of the Senate Committee on Agriculture, Nutrition and Forestry (the Senate Committee that has had primary responsibility for the futures markets and the CFTC), will submit a draft bill addressing derivatives regulation in the near future. The prospect of a new bill proposed by Senator Lincoln, coupled with the announced negotiation of a revised Dodd Bill by Senate Banking Committee Democrats and Republicans, make it possible that significant changes will be made to the Dodd Bill.

Private Adviser Exemption Eliminated

Many fund managers who are not currently registered with the SEC would no longer be able to rely on the "private adviser" exemption from registration under the Investment Advisers Act of 1940 (the "Advisers Act"). The Dodd Bill would require unregistered hedge fund advisers, managing over $100 million in assets, to register with the SEC as investment advisers and "disclose all financial data needed to monitor systemic risk and protect investors."[42] Under the proposed legislation, money managers with less than $100 million in assets under management would shift from the SEC's purview to individual state regulation; the current threshold for SEC oversight is $25 million. The stated objective is that providing the SEC access into a hedge fund's operations – through registration of the fund's investment adviser – will facilitate a further understanding of how these investment vehicles operate and might identify perceived stress points which such funds create in the broader market. The proposed legislation, however, would also have an impact on how those operations may be conducted. As described below, the Dodd Bill would also have significant implications for advisers of private equity and venture capital funds, even though those advisers are proposed to be exempt from registration.

The proposed legislation authorizes the SEC to require registered investment advisers to maintain and provide the SEC with records and reports regarding each private fund advised by the investment adviser, including at least the following information:

- the amount of assets under management,
- use of leverage,
- counterparty credit risk exposure,
- trading and investment positions,
- valuation policies and practices of the fund,
- types of assets held,
- side letters and similar arrangements, and
- trading practices.

The Dodd Bill would expressly provide for confidential treatment of proprietary information.[43]

The practical effects of requiring registration under the Advisers Act span not only administrative burdens, but

[41] It has been reported that Senators Reed and Gregg believe that the Dodd Bill does not adequately address the diversity of derivatives available to users.

[42] The House Bill includes a similar proposal except that the corresponding threshold is $150 million.

[43] Proprietary Information is defined as: (i) sensitive, non-public information regarding the investment or trading strategies of the investment adviser; (ii) analytical or research methodologies; (iii) trading data; (iv) computer hardware or software containing intellectual property; and (v) any additional information that the SEC determines to be proprietary.

core business considerations as well. Registration will cause covered investment advisers to reexamine their:

- advisory contracts,
- categories of investors subject to performance-based fees,
- standards of care owed to clients,
- disclosure to clients and regulators,
- custody of client assets,
- recordkeeping,
- advertising,
- trading and investment practices,
- supervision, compliance, and personal trading practices, policies, and procedures,
- employees' political contributions (if a rule on that subject is adopted by the SEC as expected),
- use of solicitors and placement agents, and
- SEC examinations and possible remedial measures, discipline, and disqualification.

The Dodd Bill would provide partial relief from such burdens for certain investment advisers. Venture capital and private equity fund managers would not be required to register – although they would be subject to certain reporting and recordkeeping requirements. The functional scope of the exemptions for these two categories of investment advisers remains to be determined after the SEC publishes its corresponding rules. Family offices, also to be defined by the SEC, would fall outside of the definition of investment adviser altogether. The SEC would be required to adopt final rules within six months defining "venture capital fund" and "private equity fund", but the timing and form (whether by rule, regulation or order) of the SEC's adoption of a definition of "family office" is not specified.

The Dodd Bill provides for a limited exemption (much narrower than under current law) for non-U.S. investment advisers that fall within the definition of an exempt "Foreign Private Adviser". To qualify, the investment adviser must:

- have no place of business in the United States,
- have fewer than 15 clients who are domiciled in or residents of the United States,
- have assets under management attributable to clients who are domiciled in or residents of the United States of less than $25 million, or such higher amount as the SEC may, by rule, deem appropriate,
- not hold itself out generally to the public in the United States as an investment adviser or act as an investment adviser, and
- not advise any investment company registered under the Investment Company Act or that has elected regulation as a business development company.

As described below, the Dodd Bill also raises the possibility of a special self-regulatory organization to assist with oversight of the private funds industry. Also as described below, the Dodd Bill proposes limits on which investors in private funds can be deemed an adviser's "client" for purposes of antifraud rules under the Advisers Act.

Developments in Investor Protection

The Dodd Bill calls for a raft of miscellaneous initiatives that would have the collective effect of overhauling key protections for investors in the securities markets.

Whistleblower Bounties

The Dodd Bill incentivizes whistleblowing by setting a "bounty" on those who have committed securities law violations. Those whistleblowers whose efforts lead to over $1 million in monetary sanctions will be paid between 10% and 30% of recovered funds; the prior cap was 10% and limited to instances of insider trading. These monies will be paid out of the newly established Investor Protection Fund which is funded by the monetary sanctions collected by the SEC. The bill also provides whistleblowers with a private right of action against employers who retaliate against them.

Self-Funding of the SEC

The Dodd Bill would amend the Securities Exchange Act of 1934 (the "Exchange Act") to provide for self-funding of the SEC. Under the new mechanism, the SEC would deliver a budget to Congress that is automatically funded on the first day of the year. The SEC is required to pay back to the Treasury the amount that was funded before the end of the year from fees and assessments (subject to an exception in the event that the SEC has insufficient funds). This system could have the effect of increasing the SEC's budget and would provide it greater control over the budget, including for longer-term initiatives that may be impracticable under the current annual Congressional appropriations process.[44]

Securitizations and the "Skin in the Game" Proposal

Many experts have pointed to the securitization-related activities of a number of financial institutions as a contributing factor to the onset of the recent financial crisis. In particular, many observers have pointed to incentives that originators and securitizers may have had to employ weak underwriting standards where they planned to securitize – and then pass off the risks associated with – the assets being underwritten. [45]

In an effort to reduce these incentives, the Dodd Bill requires the U.S. federal bank agencies and the SEC to prescribe rules that mandate the securitizer and originator to collectively retain not less than 5% of the credit risk of the securitized assets sold through the issuance of an asset-backed security unless the assets meet certain standards of low credit risk.[46] Separate rulemaking will address distinct asset classes (e.g., commercial mortgages, commercial loans, and auto loans) and may provide for exemptions/adjustments to the risk retention requirements. The hope is that institutions would devote greater efforts to prudent underwriting and selling practices as a result of the new requirements.

Although the House Bill also includes a 5% risk retention requirement, the basic framework differs from the Dodd Bill in certain respects. For example, under the Dodd Bill (but not under the House Bill), the SEC is required to adopt rules compelling issuers of publicly-issued asset-backed securities to perform strict due diligence reviews of underlying assets and to disclose "the nature of the analysis." In addition, the Dodd Bill does not apply to whole loan transfers by creditors in the secondary market.

The 5% risk-retention requirement has been a source of particular concern for many financial institutions and important industry groups. John Dugan, the Comptroller of the Currency, as well as many others, have suggested more stringent underwriting standards as a better course of action than a risk retention rule which, according to this view, could have adverse effects on the availability of credit, and thus, the broader economy.

Step-Back from the Broker Dealer Fiduciary Standard, Plus a New SRO Study

Drawing a distinction from the House Bill, the Dodd Bill would not impose a fiduciary duty on broker-dealers in providing investment advice about securities to retail customers. The Dodd Bill instead would require an SEC study of the effectiveness of existing standards of care for broker-dealers and investment advisers for providing investment advice and recommendations about securities to retail customers. In addition, the SEC would be required to consider the potential impact of designating one or more self-regulatory organizations to support the SEC's efforts to oversee the financial services industry, with the potential for new coverage of the investment adviser and investment funds communities by such an organization.[47] The SEC would be required to seek and consider public commentary and data. After the study is complete, if the SEC determines there are shortfalls

[44] In contrast to the Senate Bill, the House Bill would increase the SEC's Congressional appropriations but would not provide for self-funding.

[45] Generally speaking, an "originator" makes the loans that become part of a securitization pool while a "securitizer" buys the loans from the originator and packages them in to asset backed securities that are sold to investors.

[46] In allocating the 5% risk retention amount between the securitizer and the originator, the U.S. federal banking agencies and the SEC must reduce the securitizer's risk retention obligation by the risk retention obligation of an originator.

[47] The Dodd Bill would also require the Comptroller General to conduct a study of the feasibility of forming a self-regulatory organization to oversee private equity funds, and venture capital funds. The report would be due one year after enactment.

within the current fiduciary framework, then the SEC would be required to promulgate rules under its existing statutory authority within two years of enactment.

"Client" for Purposes of Advisers Act 206(1) and 206(2)

The Manager's Amendment to the Dodd Bill would prohibit the SEC from defining "client" to include investors in a private fund for purposes of the anti-fraud provisions found in Sections 206(1) and 206(2) of the Advisers Act. The Amendment would clarify that for the purposes of Sections 206(1) and 206(2), the term "client" refers to the private fund itself rather than its investors.

Accredited Investor Standard

The SEC has not updated its accredited investor standards in nearly thirty years. In light of this, the Dodd Bill would require the SEC to increase the assets and income thresholds for a natural person accredited investor to account for inflation since the figures were determined, and to adjust them at least once every five years to account for inflation. The effects of this change would include reducing the pool of individuals who can qualify as accredited investors and require periodic updating of subscription documents to reflect the higher standards. It seems likely that an accredited investor in a product would not be precluded from making follow-on investments (i.e., would be "grandfathered" as to that investor) but the definitive answer will have to wait for the SEC rulemaking for which the proposed legislation calls. In addition, the Comptroller General of the United States is to conduct a study to determine the appropriate criteria for determining accredited investor standards.

Private Placement Offerings

The Dodd Bill would alter the regulatory framework applicable to securities offered in private placements that are exempt from registration under the Securities Act of 1933 (the "Securities Act") in reliance upon Rule 506 of the SEC's Regulation D. Under current federal law, such securities are classified as "covered securities", with the result that state regulations, other than notice filing requirements, are generally preempted with respect to the securities.

The Dodd Bill would give the SEC authority to carve out from the definition of covered security, and therefore make subject to state regulation, classes of exempt securities, taking into account the size of the offering, the number of states in which the security is being offered and the nature of the persons to whom the security is being offered. The SEC would be required to conduct a rulemaking within one year of the Dodd Bill becoming law to determine whether to designate a class of securities as not covered.

The Dodd Bill would also require the SEC to review any filings made relating to covered securities within 120 days of the filing. If the SEC fails to review a filing for a covered security, the security would no longer be a covered security unless the SEC determines that (i) the issuer made a good faith and reasonable attempt to comply with the requirements of the filing, or (ii) the SEC determines that any failure to comply with the requirements of the filing are insignificant to the offering as a whole.

Mandatory Arbitration Provisions

The Dodd Bill would expressly authorize the SEC to issue rules under the Exchange Act and the Advisers Act that restrict the ability of broker-dealers and investment advisers to include mandatory arbitration provisions in agreements with customers or clients. This gives the SEC more flexibility than other proposals that would have directed the SEC to prohibit such provisions.

Codification of the Investment Advisory Committee; New Office of the Investor Advocate

In June 2009 the SEC announced the creation of an Investor Advisory Committee to advise the SEC on matters of concern to investors in the securities markets, provide the SEC with information pertaining to investors' perspectives on current regulatory issues, and provide recommendations to the SEC regarding its regulatory programs. The Dodd Bill would codify this committee and requires it to advise and consult with the SEC on:

- the regulatory priorities of the SEC,
- issues related to the regulation of securities products, trading strategies, fee structures and disclosure,
- investor protection initiatives, and
- initiatives to protect investor confidence and the integrity of the securities marketplace.

The Committee would include, as a member, the newly established Investor Advocate. The Investor Advocate would be appointed by and report to the SEC Chairman, focus on the interests of investors (and particularly retail investors) and make an annual report to Congressional committees without prior review of the report by the SEC.

New Disclosures to Mutual Fund and Other Investors

The Dodd Bill would require the Comptroller General to conduct a study on mutual fund advertising to identify existing advertising practices and provide recommendations to improve investor protections. In addition, the Dodd Bill would provide the SEC express rulemaking authority under the Exchange Act with respect to information to be provided to retail investors before the purchase or sale of a security.

Securities Lending

The Dodd Bill would amend the Exchange Act to require the SEC to promulgate rules designed to increase the transparency of information available to brokers, dealers and investors relating to securities lending.

Lack of Aiding and Abetting Liability Provisions

The Dodd Bill does not include provisions relevant to aiding and abetting liability that had appeared in Senator Dodd's proposed legislation issued (and then later withdrawn) in November. Altering the U.S. Supreme Court's decision in Stoneridge Investment Partners v. Scientific-Atlanta, 552 U.S. 148 (2008), Senator Dodd's initial reform proposal would have allowed private rights of action with respect to aiders and abettors of certain violations of the Exchange Act. The November bill also contained provisions that would have clarified SEC authority to bring actions against persons who aid and abet certain violations of the Securities Act, the Investment Company Act and the Investment Advisers Act.

Employee Compensation and Corporate Governance

The onslaught of regulation relating to executive compensation continues with the introduction of the Dodd Bill. The inclusion of compensation-related provisions in the Dodd Bill is not surprising, as many of them - including mandatory "say on pay", clawbacks and disclosure of hedging by employees and directors - were proposed in Senator Dodd's original draft bill that was published in November 2009. Though the two drafts are similar, the most notable revision is the elimination of the "say on pay" requirement for "golden parachute" arrangements that are triggered by corporate transactions.

The Dodd Bill addresses some of the same executive compensation related issues raised in the House Bill. Like the House Bill, the Dodd Bill would provide that the SEC will require annual proxy statements to include a separate resolution providing shareholders with the right to a nonbinding vote approving executive compensation, commonly referred to as "say on pay".[48] Both bills also require that the SEC adopt rules requiring that all members of an issuer's compensation committee be independent.

The most intriguing of the executive compensation provisions in the Dodd Bill is the requirement that companies implement a clawback policy. The Dodd Bill would require listing exchanges to mandate that issuers implement a policy enabling the recovery of incentive based compensation (including stock options) paid to a current or former executive during the three-year period preceding an accounting restatement due to material noncompliance of the issuer.

[48] The Manager's Amendment to the Dodd Bill provides that only votes cast by beneficial owners of a security or by members given specific voting instructions by the beneficial owner to vote the proxy will be included in the vote tally for "say-on-pay".

While the requirement for a limited clawback was included in the Sarbanes-Oxley Act of 2002, companies have voluntarily adopted more stringent clawback policies in recent years. In addition, shareholder activists and corporate governance experts continue to demand that companies adopt clawback policies that go beyond statutory requirements. According to Shearman & Sterling LLP's survey of the corporate governance practices of the largest 100 companies in the United States, 56 companies disclosed that they had clawback policies based on certain events relating to the company's financial statements in 2009, up from 35 in 2007.[49] Many institutional investors and corporate governance experts see a mandatory clawback as the next logical step.

The Dodd Bill would also direct the SEC to require additional disclosure in the issuer's annual proxy statement showing the relationship between compensation actually paid and the financial performance of the issuer. The SEC would also require issuers to disclose (i) whether any directors or employees may engage in hedging transactions to offset decreases in the value of equity securities granted as part of compensation and (ii) the median of the annual total compensation of all of its employees (other than the chief executive officer), the annual total compensation of the chief executive officer and the ratio of the amount of the median total compensation of all employees to the amount of total compensation of the chief executive officer.

Finally, the Dodd Bill would address "excessive compensation" of executives of holding companies of depository institutions. This provision requires the Federal Reserve to prohibit as an unsafe and unsound practice any compensation plan that provides an executive officer, employee or director with excessive compensation, or a compensation plan that could lead to material financial loss to the bank holding company. The Dodd Bill does not define what compensation would be considered "excessive".

49 2009 Trends in the Corporate Governance of the Largest US Public Companies: Director & Executive Compensation, Shearman & Sterling LLP Publication, available at www.shearman.com/corporategovernance/.

Corporate Governance

The Dodd Bill, like the House Bill, gives the SEC authority to issue regulations that would require inclusion of shareholder nominees for the board in a public company's proxy statement.

The Dodd Bill also includes requirements that public companies make certain disclosures regarding their leadership (Chairman and CEO) structures and requirement that public companies employ majority voting standards in uncontested elections for board membership.

Credit Rating Agencies

The Dodd Bill would subject nationally recognized statistical rating organizations ("NRSROs") (such as Moody's, Standard & Poor's and Fitch Ratings) to increased regulation by the SEC in an effort to enhance the accountability of NRSROs and the transparency of credit ratings.

Internal Controls Over Processes for Determining Credit Ratings

Under the proposed legislation, NRSROs would be required to develop, maintain, enforce and document an internal control structure that puts into place polices, procedures and methodologies for determining credit ratings. NRSROs would be required to file an annual internal controls report with the SEC that contains a description of the responsibility of management of the NRSRO in establishing and maintaining an internal control structure, together with an assessment of its effectiveness and an attestation of the chief executive officer of the NRSRO.

Conflicts of Interest

In an effort to curb conflicts of interest, the Dodd Bill directs the SEC to issue rules designed to prevent the sales and marketing considerations of an NRSRO from influencing its ratings. An NRSRO compliance officer would not be permitted to perform credit ratings, participate in the development of ratings methodologies, perform sales or marketing functions, or participate in setting compensation levels for NRSRO employees. Each NRSRO would be required to file with the SEC annually a report on its compliance with the securities laws and the policies and procedures of the NRSRO that includes a description of any material changes to the code of ethics and conflict of interest policies of the NRSRO.

Board of Directors of an NRSRO

Each NRSRO would be required to have a board of directors of which at least half of the members, but not fewer than two members, must be independent of the NRSRO. A portion of the independent directors are required to be users of credit ratings from an NRSRO. The board would oversee the establishment, maintenance and enforcement of policies and procedures for determining credit ratings and for addressing, managing and disclosing any conflicts of interest. The board would also oversee the effectiveness of the internal control system and the compensation and promotion policies and practices of the NRSRO.

Credit Rating Methodologies

The Dodd Bill directs the SEC to prescribe rules with respect to the procedures and methodologies, including qualitative and quantitative data and models, used by the NRSRO to ensure that credit ratings are determined using procedures and methodologies that are approved by the board of the NRSRO and to provide information when those procedures and methodologies are changed.

Transparency of Ratings Performance

The SEC would be directed to establish rules that require NRSROs to publicly disclose information on the initial credit ratings determined by the NRSRO for each type of obligor, security and money market instrument it rates, and any subsequent changes to such credit ratings. The stated purpose of this proposal is to allow all users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different NRSROs.

Transparency of Credit Rating Methodologies and Information Reviewed

The Dodd Bill would direct the SEC to require NRSROs to develop a form to accompany the publication of each credit rating that contains qualitative and quantitative information about the credit rating. The form must include information relating to the main assumptions underlying the credit rating procedures and methodologies, the data relied upon to determine the credit rating, how the NRSRO used servicer or remittance reports to conduct surveillance of the credit rating, and other information that an investor can use to better understand the credit rating issued by the NRSRO.

In determining the appropriate credit rating, an NRSRO must consider information from a source other than the issuer if it considers such information credible and potentially significant to the credit rating.

Due Diligence Services for Asset-Backed Securities

An issuer or underwriter of any asset-backed security would be required to make publicly available the findings and conclusions of any third-party due diligence report that it obtains and the person providing the due diligence services would be required to provide a written certification to any NRSRO that produces a rating to which such services relate.

Universal Rating Symbols

The Dodd Bill would require each NRSRO to have written policies and procedures that assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security. NRSROs would also be required to clearly define and disclose the meaning of any symbol that it uses and apply any such symbol in a consistent manner for all types of securities and money market instruments for which it is used.

Qualification Standards for Credit Rating Analysts

The Dodd Bill would direct the SEC to issue rules designed to ensure that NRSRO employees meet standards of training, experience and competence necessary to produce accurate credit ratings and be tested for their knowledge of the credit rating process.

Liability of NRSROs

The Dodd Bill would broaden the SEC's enforcement power to impose fines on NRSROs under the Exchange Act and to temporarily suspend or permanently revoke the registration of an NRSRO with respect to a particular class or subclass of securities. Such a suspension or revocation requires a determination that the NRSRO does not have adequate financial and managerial resources to consistently produce accurate credit ratings. In making this determination, the SEC must consider whether the NRSRO has failed over a sustained period of time to produce ratings with integrity for the relevant class or subclass of securities.

The Dodd Bill would also seek to increase the accountability of credit rating agencies by applying the enforcement and penalty provisions of the Exchange Act to statements made by a credit rating agency to the same extent that such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws. In addition, in establishing the requisite state of mind in a private action for damages brought against a credit rating agency or a controlling person under the Exchange Act, the Dodd Bill provides that it is sufficient to state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation or obtain reasonable verification of the factual elements it relied on in rating a security. These provisions would apply to all credit rating agencies, not just NRSROs.

Establishment of Office of Credit Ratings

The Dodd Bill calls for the SEC to establish an Office of Credit Rating staffed by persons with expertise in corporate, municipal and structured debt finance to administer the new rules. The Office of Credit Rating would be required to conduct a review of each NRSRO at least annually and produce a report available to the public summarizing its findings.

Future Studies

The Dodd Bill instructs (i) the Comptroller General to conduct a study of the scope of provisions of federal and state laws and regulations with respect to the regulation of securities markets, banking, insurance, and other areas that require the use of ratings issued by NRSROs, (ii) various federal agencies to review their regulations that require or reference credit ratings, and to review various alternative standards of creditworthiness, (iii) the SEC to study the independence of NRSROs, and (iv) the Comptroller General to study alternative means for compensating NRSROs in order to create incentives for NRSROs to provide more accurate credit ratings and to study the feasibility and merits of creating an independent professional organization for rating analysts employed by NRSROs.

Other Proposed Reforms

Office of National Insurance

The Dodd Bill would create the Office of National Insurance within the Treasury Department tasked to monitor the insurance industry, coordinate insurance issues with state regulators and report to Congress recommendations on ways to modernize insurance regulation. This Office would serve as a consultative and advisory office, not a regulatory agency.

Federal Reserve Supervision of Systemically Important Payment, Clearing and Settlement Facilities and Activities

The Dodd Bill would give the FSOC the authority to designate a particular financial market utility (which is, generally speaking, a legal entity engaged in a payment, clearing or settlement activity) or payment, clearing or settlement activity as being, or being likely to become, systemically important. The Federal Reserve would have the authority to issue risk management standards governing the operations of designated financial market utilities and the conduct of designated activities with a view to promote robust risk management, promote safety and soundness, reduce systemic risks, and support the stability of the broader financial system. In doing so, the Federal Reserve would be obligated to consult with appropriate financial supervisors of entities so designated and with the FSOC.

Improving Access to Mainstream Financial Institutions

The Manager's Amendment added a new title to the Dodd Bill designed to increase the accessibility of financial products and services for low to moderate income individuals. One of the main objectives of this title is to create programs that would help these individuals to open a bank account with a U.S. FDIC-insured depository institution.

Conclusion

The Dodd Bill calls for significant structural changes to the financial regulatory framework which would affect the business operations of many participants in the financial industry. It appears increasingly likely that many of the elements of the Dodd Bill - particularly those that closely coincide with provisions included in the House Bill - will survive the legislative process. (Senator Bob Corker, a Republican from Tennessee, recently put the odds at 90% that reform legislation would be passed.) At the same time, several proposals will no doubt be reshaped, paired back or discarded once the Dodd Bill hits the Senate floor and the next round of vigorous debate begins. We will continue to monitor and report on important developments as the legislative process continues.

As a final note, we emphasize that the legislation is a complex and composite assortment of amendments to multiple parts of federal financial laws. This publication is not meant to be, and cannot be, a complete discussion of the proposal or its consequences.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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