



Wednesday, October 21
9:00 am–10:30 am

**209 The New Administration and Congress:
What it Means for the Economy, the
Financial Markets, the Regulatory
Environment and Your Company**

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**Financial Regulatory Reform
&
Congress:**

What does it mean to your company?

How do you manage those risks?

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Financial Regulatory Reform

- I. Consolidation and Reorganization of Regulators
- II. Oversight, Systemic Risk, and the Role of the Federal Reserve
- III. Consumer Protection Initiatives
- IV. Investor Protection Initiatives
- V. Hedge Funds and Other Unregulated Entities
- VI. Credit Rating Agencies
- VII. Derivatives
- VIII. The Insurance Industry
- IX. Executive Compensation Restrictions
- X. Fall 2009 Forecast: House, Senate, Industry

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I. Consolidation and Reorganization of Regulators

- Under the Administration's Proposal:
 - OCC and OTS would be eliminated.
 - National Bank Supervisor would be created.
 - SEC and CFTC would not merge, but would need to harmonize their statutory and regulatory frameworks.
 - Consumer Financial Protection Agency (CFPA) would be created.
 - Financial Oversight Council (Council) would be created to support Fed in monitoring of systemic risk.

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II. Oversight and Regulation of Systemic Risk and the Role of the Federal Reserve

- **Under Administration's Proposal:**
 - Fed would have authority to monitor systemic risk and have enhanced resolution authority.
 - In consultation with Treasury Fed would promulgate rules to guide identification of Tier 1 Financial Holding Companies (FHCs).
 - And in consultation with Council, Fed would set prudential standards for Tier 1 FHCs to maximize financial stability.
- **Opposition to Fed:** Some, including SEC and FDIC, prefer greater power be given to Council, because being made of up agency heads it would be better equipped to understand systemic risk, and Fed has previously failed in this position.

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III. Consumer Protection Initiatives

- **Under Administration's Proposal:**
 - CFPB would be created with goal of protecting consumers in financial products and services markets.
 - "Plain Vanilla" loans would need to be offered before other options could be considered, and consumers would need to be adequately warned of the risks of other products. [Note: Barney Frank appears to be dropping this requirement from the House bill]
 - CFPB rules would be a floor, not ceiling for states.
- **Congress:**
 - Despite strong criticism of creation of CFPB, Chairman of HFSC Frank (D-MA) plans on moving forward with such legislation.
 - On May 22, 2009 Congress passed CARD Act, to protect consumers from certain actions by credit card companies.

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IV. Investor Protection Initiatives

- **Under Administration's Proposal:**
 - All brokers and investment advisers giving advice to retail clients and customers would become subject to a single fiduciary standard of conduct.
 - SEC would be give new rule-making authority to establish harmonized disclosure standards and rules governing sales practices, conflicts of interest and compensation schemes
 - Other provisions would:
 - Give SEC the authority to ban mandatory arbitration clauses
 - Enhance whistleblower protection
 - Tougher standards on aiding and abetting and controlling person liability
- **SRO for Investment Advisers?**

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V. Regulation of Hedge Funds and Other Unregulated Entities

- **Under Administration's Proposal:**
 - All advisers to hedge funds and other private pools of capital with more than \$30 million of assets under management, would be required to register with SEC under Investment Advisers Act.
 - Investment adviser would need to make public reports, records, and other documents that SEC deems necessary to protect investors and public interest.
 - SEC would conduct regular examinations of funds and share the information with Fed and Council in order to determine if they should have Tier 1 FHC status.
- **IRS Action:** On June 12, 2009, the IRS announced that all hedge funds and private equity investors must disclose their off-shore investments.

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VI. Regulation of Credit Rating Agencies

- **SEC Action:** On April 10, 2009, new rule came into effect requiring nationally recognized statistical rating organizations (NRSROs) to provide enhanced disclosures on manner they measure performance, and procedures and methods used to determine ratings.
- **Under Administration's Proposal:** On July 21, 2009 legislation was sent to Congress, not only to provide for increased transparency and oversight of NRSROs, but reduce reliance on these organizations, reduce conflicts of interest at these organizations, and have them register with the SEC.

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VII. Regulation of Derivatives

- **Market Reforms:** On April 8, 2009 International Swaps and Derivatives Association agreed to abide by certain market reforms, with goal of facilitating centralized clearing of swaps.
- **Under Administration's Proposal:**
 - Regulators would be required to impose capital, reporting, and margin requirements on all derivative dealers and major market participants.
 - All standardized OTC derivatives would be cleared through a regulated central clearing house and traded on either an SEC or CFTC regulated exchange or a regulated transparent electronic trading system.
 - Tailored swap transactions would be regulated to ensure such transactions are not used solely as a means to avoid clearing requirements.

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VIII. Regulation of the Insurance Industry

- **Under Administration's Proposal:**
 - Office of National Insurance (ONI) would be created within Treasury.
 - ONI would monitor insurance industry for any financial troubles and recommend insurance companies that should be supervised as Tier 1 FHCs.
- **Congress:**
 - Administration's proposal is congruent with Rep. Bean's (D-IL) proposed bill, "National Insurance Consumer Protection Act" (H.R. 1880), introduced on April 2, 2009.
 - Rep. Kanjorski (D-PA) also introduced H.R. 2609, "Insurance Information Act", which mirrors Administration's proposal.

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IX. Executive Compensation Restrictions

- Executive compensation restrictions for those who received or will receive TARP funds under the Emergency Economic Stabilization Act (EESA) (as amended by the American Recovery and Reinvestment Act).
- Treasury Interim Final Rule places restrictions on compensation structures for Senior Executive Officers, created pursuant to the EESA.
- Compensation Czar oversees the compensation structures of the 7 largest companies who received TARP funds and advises others who received federal assistance.
- Both the Senate and the House have introduced measures to prohibit or limit various forms of bonuses.
- House bill (HR 3269) would require financial institutions, broadly defined, to report details of all incentive compensation arrangements, and would give agencies power to prohibit any incentive arrangements found to encourage inappropriate risks.

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InfoPAKSM

A Primer on Financial Regulatory Reform

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A Primer on Financial Regulatory Reform

September 2009

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This InfoPAKSM explores the Obama Administration's efforts to restore, restructure, and improve the regulating agencies, private organizations, and public organizations that contributed to the economic turmoil plaguing many Americans as a result of the credit crisis of 2007. This InfoPAK is a helpful primer that also tracks the regulatory reform trends proposed by the House and Senate in an effort to alleviate the market inefficiencies. In addition, this InfoPAK provides an outlook of potential regulatory or legislative developments for specific areas of interest.

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I. Introduction

"In recent months, we've seen turmoil on Wall Street like we haven't seen in decades, as major financial institutions have faltered or have been sold off. And we have seen the fallout on Main Street. . . . This financial crisis was not inevitable. It happened when Wall Street wrongly presumed markets would continuously rise, and traded in complex financial products without fully evaluating their risks. Here in Washington, our regulations lagged behind changes in our markets -- and too often, regulators failed to use the authority that they had to protect consumers, markets and the economy." – President of the United States, Barack Obama, February 25, 2009.

In response to the credit crisis of 2007 and the national housing bubble, the Federal government has worked feverishly to avert a full-scale financial services industry meltdown and prevent the next "Great Depression." The Federal Reserve cut interest rates to unprecedented lows, the Department of Treasury bought ownership stakes in the nation's largest financial institutions, and "too big to fail" entities were given financial life preservers to stay afloat. While these actions helped to prevent catastrophic economic collapse and stabilize the nation's financial system, the need for full-scale financial services regulatory reform became readily apparent. Although outcries for massive regulatory reform began in 2007, the United States Presidential election of 2008 delayed both comprehensive legislative and administrative response. In 2009, Democrats enjoy not only the Presidency of the United States, but sizable majorities in the U.S. Senate and the U.S. House of Representatives. Under this leadership, the United States is undertaking the world's largest financial services regulatory overhaul, with global implications.

This primer identifies and discusses major themes of the proposed regulatory reform in an effort to provide context to the debates that will surround the process as it unfolds throughout the latter half of 2009. For each issue, this report reviews current financial crisis recommendations and actions of the Obama Administration and the U.S. Congress, along with references to global organizations such as the G-20 and G-30, the Treasury, the President's Working Group, and the Emergency Economic Stabilization Act of 2008 ("EESA") Congressional Oversight Panel.

By way of background, the 111th Session of the United States Congress began on January 3, 2009. This Congress has passed, in piecemeal, various forms of regulatory reform and will undertake a full regulatory overhaul this fall. The Obama Administration released its proposal, *Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation*, to Congress on June 17, 2009.¹

II. Consolidation and Reorganization of Regulators

A. Administration Proposals

The Administration has not proposed to merge the bank regulation responsibilities into one super bank regulator. Instead, they proposed the following:

I. National Bank Supervisor

The Federal Reserve ("Fed") would act as a systemic risk regulator, and create a new federal agency, the National Bank Supervisor ("NBS"). The NBS would conduct prudential supervision and regulation of all federally chartered depository institutions, and all federal branches and agencies of foreign banks. This agency would take over the prudential responsibilities of the Office of Comptroller of the Currency ("OCC") and the Office of Thrift Supervision ("OTS"). The NBS would be an agency with separate status within Treasury and should be led by a single executive. The consumer protection powers of the OCC and OTS will fall under the proposed Consumer Financial Protection Agency.

The proposal also calls for the elimination of the federal thrift charter, but continuing to preserve its interstate branching rules and applying them to state and national banks.

2. Securities and Exchange Commission and Commodity Futures Trading Commission

The Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC") would remain separate, though Administration officials have raised concerns, in internal discussions, that the U.S. is one of few, if any, countries without a unified regulator for financial markets. The U.S. Department of the Treasury's Secretary, Timothy F. Geithner, opted against proposing the merger after concluding that the existing structure had not contributed to the financial crisis.² If the Administration had pressed ahead with a merger, it would have confronted daunting jurisdictional issues on Capitol Hill. The SEC is overseen by the House Financial Services Committee and Senate Banking Committee, and the House and Senate Agriculture committees oversee the CFTC.

The Administration, instead, proposed that the Federal Reserve and the Federal Deposit Insurance Corporation ("FDIC") would maintain their respective roles in the supervision and regulation of state chartered banks, and the National Credit Union Administration ("NCUA") would maintain its authorities with regard to credit unions. The SEC and CFTC would maintain current responsibility and authority as market regulators, though Administration proposes to harmonize the statutory and regulatory frameworks for futures and securities. Though the SEC's Supervised Investment Banking Holding Program would be eliminated, such regulation would be moved to the care of the Federal Reserve.

3. Consumer Financial Protection Agency

A new Consumer Financial Protection Agency will also be created to supervise financial products, such as credit cards, mortgage-related products, and insurance. This new entity would not include investment products, which currently falls under the SEC's or the CFTC's purview.

4. Industrial Loan Companies

Industrial Loan Companies ("ILCs") will be eliminated under the new Administration proposal. The Administration is trying to eliminate a loophole that allows commercial firms to own banks through special-purpose ILCs without restrictions. Under the proposal, holding companies of ILCs would become bank holding companies ("BHCs"), which are subject to the Bank Holding Act.

5. Financial Services Oversight Council

The Financial Services Oversight Council would support the Federal Reserve (the "Fed") in monitoring systemic risk across all financial products and institutions. This would limit some of the Fed's power, as many fear one agency having too much overreaching power.

6. Resolution Authority

The Obama Administration has proposed a procedure to control capital levels as well as a resolution authority for Tier 1 Financial Holding Companies ("FHCs").

A Tier 1 FHC would be deemed to be undercapitalized if it "fails to meet the required minimum level for any relevant capital measure," which is determined by the Federal Reserve Board of Governors ("Board"). All undercapitalized Tier 1 FHCs would be required to submit a restoration plan to the Board.³ If a Tier 1 FHC is considered "critically undercapitalized" the Board would, within 90 days of becoming critically undercapitalized, require the Tier 1 FHC to file a petition for bankruptcy, or would file a petition for bankruptcy against the Tier 1 FHC.⁴

The resolution authority would apply to any Tier 1 FHC or bank holding company. To invoke this special authority, Treasury would have to determine that:

- the firm is in default or in danger of defaulting;
- the failure of the firm and its resolution under otherwise applicable bankruptcy law would have serious adverse effects on the U. S. financial system or the U.S. economy; and
- use by the government of the special resolution regime would avoid or mitigate these adverse effects.⁵

This process could only be initiated by the Treasury or the Federal Reserve, or if the subsidiary of the failing firm is a broker-dealer or securities firm, by the FDIC or SEC.

The actual authority to formally put a failing financial firm into receivership or conservatorship would be vested solely with the Treasury. However, before acting the Treasury would need to consult with the U.S. President and have written approval from two-thirds of the members of the Federal Reserve board and two-thirds of the board of the applicable agency.⁶

The Comptroller General would review the recommendation report and report to Congress on the basis, purpose, and likely effect of the determination. The Treasury Secretary would also, within 30 days of making such resolution determination, provide written notice of the determination to the Senate Committee on Banking, Housing, and Urban Affairs and the House Financial Services Committee.

This resolution authority would not replace bankruptcy procedures. For instance, bankruptcy procedures under the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") would apply in the normal course. The new resolution authority would be limited to the situations described above.

B. Congressional Actions

In a letter dated June 11, 2009, Senator Charles E. Schumer (D-N.Y.), a leading voice on financial policy and Vice Chairman of the Joint Economic Committee, urged Treasury Secretary Geithner to propose a single banking regulator and dispense with the alphabet soup of agencies that now oversee banks. Some Republicans on the House Financial Services Committee also proposed that one agency be responsible for bank supervision. They called for stripping existing powers from the Federal Reserve and Federal Deposit Insurance Corporation and merging the Office of Thrift Supervision and Office of the Comptroller of the Currency. However, members of Congress have recently turned their focus to the concept of “too big to fail” and their concern over giving the Federal Reserve too much power, considering past failures.

There has been general consensus among members of Congress that the policy of “too big to fail” is problematic, the concern being that it allows firms to take greater risks, because of the guarantee of the government, and promotes growth among smaller firms, in order to get this guarantee. The best way to deal with the issue has been open for debate. When questioned at a Senate Banking Committee hearing,⁷ Chairman Sheila Bair of the FDIC and Chairman Mary Schapiro of the SEC concurred that firms should be allowed to fail, and in place of a government guarantee there should be a resolution authority which allows these large institutions to be wound down, much like the FDIC currently does with smaller institutions. The underlying belief is that such authority limits industry risk taking, leading to better industry self-regulation. It has also been proposed that any form of designation as a Tier 1 firm should be eliminated, because such a designation only signals to investors that the government will not allow these firms to fail.

In addition, many Members fear giving a resolution authority to the Federal government, viewing it as simply giving the government too much power – power it cannot handle. Representative John Boehner (R-OH), House Minority Leader, called it “an unprecedented grab of power,” when Secretary Geithner first made the proposal in March 2009. Instead, some have argued that the bankruptcy code should be amended to accommodate these large interconnected firms, while others have called for an expansion of the FDIC’s current resolution abilities.

An even greater concern than granting a resolution authority is placing the systemic risk regulator with the Federal Reserve. FDIC Chairman Bair and SEC Chairman Schapiro both support the creation of a powerful council, as opposed to placing the power of systemic risk regulator with the Fed. The concern of both Chairmen, and some members of Congress, is that the Fed will be overwhelmed and will either fail as a regulator or let other responsibilities slip. In addition, there is a concern that the Fed does not have a diverse voice, whereas by contrast, a council made up of agency heads would bring a diverse voice and experience to the table, and such a council would be better equipped to understand systemic risk. This council would not be intended to become a new super agency, but rather a pair of eyes on the industry, able to set minimum standards for the proper oversight agencies. Under this scenario, the Fed would keep its current regulatory powers.

C. On the Horizon

Even in this climate of change, the proposals for regulatory consolidation/reorganization/creation continue to face congressional jurisdictional battles, industry opposition and Republican concerns about expanding the role of the government. For example, the concept of a single bank regulator is not likely to advance due to significant congressional reticence over investing too much power in

any one agency. Similarly, the recommendation that the Fed serve as the systemic risk regulator remains controversial with Senator Chris Dodd (D-CT), Chairman of the Senate Banking Committee, Senator Richard Shelby (R-AL), Ranking Member of the Senate Banking Committee, and Representative Frank (D-MA), who have expressed their doubts that the Fed can handle the new responsibilities.

Creation of a National Bank Supervisor is intended to streamline supervision from the OTS and OCC but it is not clear what impact such a consolidation would have on regulation of ILCs. Although the Administration's proposal eliminates ILCs, a majority of industrial loan companies are chartered in Nevada (Senator Harry Reid (D-NV), Senate Majority Leader) and Utah (Senator Bob Bennett (R-UT), Senate Banking Committee), which, due to the respective states' prominent Senators, presents a significant obstacle to the adoption of this provision. While their future status is not clear, ILCs most likely will be regulated by the National Bank Supervisor, as it assumes the responsibilities of the ILCs' former regulator, the OTS. The Consumer Financial Protection Agency proposal will face some Republican, and to a lesser extent, Democratic opposition as an expansion of government with too broad a mandate. But as one of the key components of the Administration's plan, it will likely be enacted in some form; the key being how narrowly or broadly the enacting legislation is written.

It appears that the legislative will likely result in additional resolution authority being granted to existing regulatory agencies. It is too early to determine which federal agency or agencies will definitely see an expansion of their ability to place a financial institution into receivership, conservatorship, bankruptcy, or even to be appointed as a trustee.

III. Oversight and Regulation of Systemic Risk and the Role of the Federal Reserve

Since the inception of the financial crisis, considerable attention has been paid to the notion of systemic risk. Traditionally, the concept of systemic risk has been described as having a "ripple effect" – meaning that the failure of a large company, with branches crossing many geographies and sectors such as banking and insurance, could cause the failure of other companies as losses ripple through the economy and the global financial system.

U.S. and global regulators have agreed on the overall need to establish a framework to mitigate against systemic risk. However, finding consensus on a single approach to achieve this goal has proven difficult, as Congress, the Administration, and global regulators have grappled with questions, such as: Who should be designated as the systemic regulator? How should systemically significant companies be defined? What is the definition of systemic risk and how should we pinpoint those institutions that might cause or enhance systemic risk? What, if any, moral hazard is created by designating certain institutions as systemically significant? Is it fair for the government to pick "winners and losers" in deciding which entities are systemically significant and should, therefore, be saved?

A. Past Recommendations

1. The Emergency Economic Stabilization Act Congressional Oversight Panel

On January 29, 2009, the Congressional Oversight Panel (“COP”) issued its special report on regulatory reform.⁸ The COP advised Congress and the President to: (1) mandate a new or existing agency (or an interagency task force) to regulate systemic risk within the financial system on an ongoing basis; (2) impose heightened regulatory requirements for systemically significant institutions to reduce the risk of financial crisis; and (3) establish a receivership and liquidation process for systemically significant nonbank institutions similar to the system for banks.

The COP contemplates housing the new single regulator within the Federal Reserve, suggesting that the advantage of this formulation would be keeping safety, soundness, and consumer protection responsibilities under one roof. The COP noted that, if the new regulator were to be incorporated in the Federal Reserve, the Fed would need to make consumer protection a primary responsibility - on par with bank supervision.

2. G-30 Report on Regulatory Reform

The G-30 issued a report entitled, *Financial Reform, A Framework for Financial Stability*, on January 15, 2009 (“G-30 Report”).⁹ The G-30 Report advised institutions to mitigate risk with the following three practices: (1) strengthening board of director oversight of compensation and risk mitigation; (2) using capital requirements that address the current tendency toward pro-cyclicality; and (3) incorporating in base-level liquidity standards a “sizable diversified mix” of long-term funding and highly liquid assets.

3. G-20 Summit

Systemic risk mitigation is high among the priorities of the G-20, which issued a statement on April 2, 2009, emphasizing the need for global coordination to discourage excessive risk taking. With the increasingly global structure of financial institutions, the G-20 outlined the need to establish a new Financial Stability Board (“FSB”) with a strengthened mandate as a successor to the Financial Stability Forum (“FSF”).¹⁰ The new FSB would broadly include all members of G-20 countries, FSF members, Spain, and the European Commission. This FSB would work with the International Monetary Fund (“IMF”) to address and provide early warning of macroeconomic and financial risks.

4. Treasury’s Framework for Regulatory Reform (“Outline”)

On March 26, 2009, Treasury announced its *Framework for Regulatory Reform* (“Outline”).¹¹ Treasury’s Outline recommended the establishment of a single independent regulator with responsibility over systemically important firms. Under the Outline, Treasury proposed working with Congress to enact legislation defining characteristics of covered firms, setting objectives for oversight, and assigning responsibility for regulating systemically significant firms. The factors to be taken into account in examining systemic risk included:

- the financial system’s interdependence with the firm;
- the firm’s combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and

- the firm's importance as a source of liquidity for the financial system and a source of credit for households, businesses, and governments.

B. Administration Proposals

The Administration's proposal grants the Federal Reserve the authority to monitor systemic risk, including the authority to supervise and regulate Tier 1 FHCs. Further, the Administration's proposal creates a Financial Services Oversight Council ("Council") with the authority to recommend firms subject to Tier 1 FHC supervision and regulation.

The Council, which would replace the President's Working Group on Financial Markets, would be comprised of: the Secretary of the Treasury, serving as Chairman; the Chairman of the Board of Governors of the Federal Reserve System; the Director of the National Bank Supervisor; the Director of the new Consumer Financial Protection Agency; the Chairman of the SEC; the Chairman of the CFTC; the Chairman of the FDIC; and the Director of the Federal Housing Finance Agency. In addition to advising the Federal Reserve on Tier 1 FHCs, the Council would play a role in facilitating information sharing among federal financial regulatory agencies and would identify emerging risks. The Administration's proposal outlines the factors the Federal Reserve should consider in identify Tier 1 FHCs, including:

- the impact the firm's failure would have on the financial system and the economy;
- the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and
- the firm's criticality, as a source of credit for households, businesses, state and local governments, and as a source of liquidity for the financial system.

The Federal Reserve, consulting with Treasury, should also establish rules to guide the identification of Tier 1 FHCs; Treasury would have no role in determining the application of these rules. Under the proposal, the Federal Reserve would have the authority to collect periodic and other reports from all U.S. financial firms that meet certain minimum size thresholds to determine whether such firms are Tier 1 FHCs .

In consultation with the Council, the Federal Reserve would set prudential standards for Tier 1 FHCs to maximize financial stability. These standards, at a minimum would be:

- greater capital requirements;
- the ability for prompt corrective action if a firm's regulatory capital levels decline;
- rigorous liquidity risk requirements;
- an overall risk management plan;
- enhanced public disclosures;
- compliance with the nonfinancial activity restrictions of the Bank Holding Company Act, regardless of whether a firm controls an insured depository institution; and
- a rapid resolution plan.

The Federal Reserve, in consultation with Treasury and external experts, should propose recommendations by October 1, 2009 to better align its structure and governance with its new authorities and responsibilities proposed by the Administration.

C. Congressional Actions

On July 22, 2009, Treasury announced the Administration's delivery of systemic risk legislation to the Hill. The proposed legislation draws directly from the Administration's June 2009 proposal with respect to the regulation of systemic risk.

D. On the Horizon

Multiple members of Congress are skeptical of granting the Federal Reserve the authority to monitor systemic risk. Some have cited the Federal Reserve's difficulties in handling its current responsibility as "umbrella" regulator over large, complex banking organizations in the period leading up to the economic crisis. The SEC and FDIC have publicly weighed in on the debate, suggesting that systemic risk regulation should rest with a stronger oversight council made up of financial regulatory agency heads with a diversity of opinion and expertise. Congressional leaders have appeared empathetic to this argument, but have not evidenced complete support for a reduced role for the Federal Reserve. Concern has been expressed that the creation of such an oversight council would blur accountability and produce bureaucratic road blocks.

IV. Consumer Protection Initiatives

A. Administration Proposals

The Administration proposed the creation of a new Consumer Financial Protection Agency ("CFPA"), which would protect consumers in the financial products and service markets. This new entity would not include investment products, which currently fall under the SEC's or CFTC's purview. The CFPA's mission would be to ensure that:

- consumers have the information they need to make responsible financial decisions;
- consumers are protected from abuse, unfairness, deception, or discrimination;
- consumer financial services markets operate fairly and efficiently with ample room for sustainable growth and innovation; and
- traditionally underserved consumers and communities have access to lending, investment, and financial services.

Harvard University Professor Elizabeth Warren is credited with proposing the creation of a CFPA. On June 24, 2008, she testified before the House Financial Services Committee during the hearing; *"Regulatory Restructuring: Enhancing Consumer Financial Products Regulation."* In addressing the Committee she said, "[C]onsumers cannot compare financial products because the financial products have become too complicated. In the early 1980s, the average credit card contract was

about a page long. Today, it is more than 30 pages.” For these and other reasons, Warren said a CFPA would accomplish the goals of: reducing systemic risk; reducing layers of redundant regulatory burdens from various agencies; fostering market innovation; and creating an agency where consumers are the first priority.

Prior to the announcement of the Obama plan, a number of agencies and institutions proposed recommendations for improving customer protections. The Emergency Economic Stabilization Act Congressional Oversight Panel suggested the creation of a single federal consumer protection regulator similar to what the Administration eventually proposed. The Policy Statement of the President’s Working Group on Financial Markets and the G-30 Report on Regulatory Reform did not propose the creation of a new agency but recommended increased transparency and stricter oversight and regulation.

The CFPA would serve as the "primary" protection for borrowers and other customers. The new agency would be able to write rules for banks and nonbank financial companies, supervise and examine banks for compliance, and enforce compliance through regulatory orders (including penalizing companies with fines). The agency would be independent and would work to ensure transparency, simplicity, fairness, accountability, and access to protect consumers in the areas of credit, savings, and payment markets. The CFPA would enforce all fair-lending laws, including the Community Reinvestment Act. The CFPA would have the authority to ban unfair terms, impose stronger duties of care on financial intermediaries, and protect consumers from conflicts of interest related to financial products.

The plan would give the new agency the power to mandate that consumers have a chance to “opt out” of standard financial products and services before being offered alternatives. The CFPA would require "plain-vanilla" loans to be offered with straightforward terms. The borrower would have to reject that offer before considering more complicated loans that are subject to more "stringent protections." Consumers would have to be "adequately" warned about the risks and benefits of a mortgage product: consumers would receive a single, simple federal mortgage disclosure. The CFPA’s rules would serve as a floor, not a ceiling. States would be able to adopt and enforce stricter laws, and the CFPA would ideally coordinate enforcement efforts with the states. On June 30, 2009, the Obama Administration delivered a Bill to Capitol Hill that would create the Consumer Financial Agency.

B. Congressional Actions

Prior to the announcement of the Obama Administration’s plan, multiple bills were introduced aimed at enhancing customer protections.

- On March 10, 2009, Senators Charles Schumer (D-NY) and Richard Durbin (D-IL) introduced the Financial Product Safety Commission Act of 2009 (S. 566) which creates a Financial Product Safety Commission (“FPSC”), a consumer protection entity modeled after the Consumer Products Safety Commission. The FPSC would add consumer protection to the factors lenders must consider in creating and offering financial products; the measure is intended to protect consumers from questionable mortgages, credit cards, and other risky financial products. The FPSC would be empowered to “ban dangerous financial instruments” from the marketplace and would coordinate enforcement with federal regulators, state regulators and the private sector to create a floor level of protection. The FPSC would report

to the public regarding safety of financial products.

- On April 30, the House passed the Credit Cardholders' Bill of Rights Act of 2009 (H.R. 627). On May 19, 2009 the Senate passed its version of credit card legislation, the Credit Card Accountability Responsibility and Disclosure Act of 2009 (S. 414). President Obama signed the Credit Card Accountability Responsibility and Disclosure ("CARD") Act of 2009 into law on May 22, 2009, as Public Law No. 111-24.

Among other things, the CARD Act:

- limits interest rate increases on existing balances;
- restricts the conditions under which late fees may be imposed;
- prescribes methods for the application of excess payments to higher interest rate balances;
- requires consumer permission for transactions over the account limit;
- restricts fees on sub-prime, low-limit credit cards;
- mandates clear disclosure of account terms;
- requires the public posting of credit card contracts;
- prescribes procedures for specified regulators to evaluate compliance;
- increases penalties against card issuers that violate the Act's restrictions; and
- includes restrictions for the protection of certain college students and young adults.

C. On the Horizon

The Administration's proposal to create the Consumer Financial Protection Agency has been met with sharp criticism from banking industry groups, while Congressional leaders, including Senate Banking Committee Chairman Dodd and House Financial Services Committee Chairman Frank, have voiced support for the independent agency. The scope of the proposed Agency remains unclear since the proposal does not describe the specific areas over which the Agency will have jurisdiction. For example, it is currently unclear if annuities and insurance will be regulated by the Agency.

Due to strong criticism from regulators and the banking industry, Chairman Frank postponed the debate on the CFPA until after Labor Day. During a June 24, 2008, hearing on "Regulatory Restructuring: Enhancing Consumer Financial Products Regulation", House Financial Services Committee Ranking Member Spencer Bachus (R-AL) called consumer protection a legitimate federal responsibility. He expressed concern that the Administration's proposal could make circumstances worse by restricting credit and restricting consumer choices. Other criticisms include concerns that separating consumer protection from safety and soundness regulation could lead to conflicts.

Chairman Dodd supports the creation of a consumer protection agency. Under Chairman Dodd's proposal, the independent consumer protection agency will:

- have broad regulatory and enforcement authority over credit and bank products;

- be responsible for protecting consumers from predatory practices of payday lenders, mortgage brokers, banks, and other financial institutions; and
- have a seat next to the safety and soundness regulators as part of a systemic risk council.

While it seems probable that the CFPA will pass in some form, the scope and significance of the agency is still unclear.

V. Regulation of Hedge Funds and Other Unregulated Entities

Current U.S. law requires that the majority of investors in a hedge fund be accredited.¹² To be accredited, the investor must earn a minimum amount of money annually¹³ or have a net worth of more than \$1 million, along with a significant amount of investment knowledge. A hedge fund need not register with the SEC and has far more flexibility in its investment strategies. By not having to register with the SEC, hedge funds need not disclose certain details, such as who manages the fund, the amount of money they manage, and what securities they buy. Private equity funds, like hedge funds, have 'sophisticated' investors, and under current law do not need to register their investments with the federal government; however, private equity funds do not have the same restrictions on investors as hedge funds do.

Until now, hedge funds have been successful in resisting regulation. Even the SEC attempted to regulate hedge funds, but failed. Instead, hedge funds were able to quickly overturn a rule-change requiring most fund advisers to register with the SEC as investment advisers under the Investment Advisers Act. It appeared that hedge fund regulation would not occur in the near future. But with the recent financial turmoil, the era of deregulation of hedge funds is likely coming to an end.

A. Administration Proposals

President Obama has not shied away from the topic of hedge fund and unregulated entity regulation. During the presidential campaign he was vocal in his calls for closing tax loopholes for hedge funds and for leveling the playing field in general. As President, he has not backed down from his campaign rhetoric and has stated that in order to prevent a future financial crisis, supervision must be extended "to all systematically important institutions, markets and products, (including hedge funds)."¹⁴

In President Obama's *Regulatory Reform Proposal*, all advisers to hedge funds (and other private pools of capital, including private equity and venture capital funds) that have more than \$30 million of assets under management, would be required to register with the SEC under the Investment Advisers Act.

The records and reports required to be filed with the SEC would include, but not be limited to, the amount of assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, trading practices, and such other information as the Commission, in consultation with the Board of Governors of the Federal

Reserve System, determines necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

In addition, an investment adviser registered under this proposal would be required to provide reports, records and other documents to investors, prospective investors, counterparties, and creditors. The investment adviser would provide documentation of any private fund advised, as prescribed by the SEC as necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

Finally, the proposed legislation would require the SEC to conduct regular examinations of such funds to monitor compliance with the terms of the proposed legislation and to assess potential risk. The SEC would share the disclosure reports received from funds with the Federal Reserve and the Financial Services Oversight Council, in order for them to determine if the fund should be considered a Tier 1 FHC.

B. IRS Actions

The IRS has recently announced that all hedge fund and private equity investors must disclose their off-shore investments. The IRS officially announced on June 12, during a conference call with industry lawyers and accountants, that investors in offshore funds indeed do need to file a Report of Foreign Bank and Financial Account ("FBAR"). In the past the policy was that hedge fund and equity advisors did not need to file the FBAR.

In 2009, the IRS extended the deadline for filing the FBAR until September 23, 2009, after complaints from investors that the original due date of June 30, 2009, did not provide enough time for investors to comply. FBARs for investors who have not previously reported must be filed for six years, dating back to 2003 for the 2009 reporting period.

C. Congressional Actions

"If the events of the last year have taught us anything, it's that we need to regulate firms that are big enough to destabilize our economy if they fail. It's time to subject financial heavyweights like hedge funds to federal regulation and oversight to protect our investors, markets, and financial system." – Senator Carl Levin (D-MI), January 29, 2009.¹⁵

Senator Levin's call for regulation did not fall on deaf ears. Many in Congress have repeatedly attempted to regulate the hedge fund industry, but to no avail. During the 110th Congress, at least five House and Senate bills were introduced with the purpose of regulating the hedge fund industry in some manner.¹⁶ None of these bills were successful. However, with the current financial crisis, a new Congress, and President Obama's *Regulatory Reform Proposal*, Congress is likely to pass some form of hedge fund regulation.

Below is a list of current legislation that has been introduced in the 111th Congress, portions of these bills could be cobbled together to overhaul the hedge fund industry. Chairman Barney Frank of the House Financial Services Committee has stated that the committee intends to give the SEC explicit authority to register hedge funds. Current legislation includes:

- **Hedge Fund Transparency Act, S. 344, 111th Cong. (2008).**
 - Sponsored by Senator Charles Grassley (R-IA), the act would require hedge funds to:
 - register with the SEC as “investment companies” under the Investment Company Act of 1940 and disclose their investors and ownership structure;
 - establish anti-money laundering compliance programs and report suspicious transactions under the Bank Secrecy Act; and
 - have “risk based” due diligence with respect to foreign investors.
- **Hedge Fund Adviser Registration Act of 2009, H.R. 711, 111th Cong. (2008).**
 - Introduced by Representatives Michael Capuano (D-MA) and Michael Castle (R-DE), this proposed bill would remove the private advisor exemption from Section 203 of the Investment Advisers Act of 1940 - in effect requiring hedge fund managers to register with the SEC.
- **Pension Security Act of 2009, H.R. 712, 111th Cong. (2009).**
 - Introduced by Representatives Michael Capuano (D-MA) and Michael Castle (R-DE), this proposed bill would require Employment Retirement Income Security Act of 1974 (“ERISA”) plans to disclose investments in hedge funds.
- **Hedge Fund Study Act, H.R. 713, 111th Cong. (2009).**
 - Introduced by Representatives Michael Capuano (D-MA) and Michael Castle (R-DE), this proposed bill would require the President’s Working Group on Financial Markets to conduct a study of the hedge fund industry.¹⁷
- **The Private Fund Transparency Act of 2009, S. 1276, 111th Cong. (2009).**
 - Sponsored by Senator Jack Reed (D-RI), this bill would amend the Investment Advisers Act of 1940 to require advisers to hedge funds, private equity funds, venture capital funds, and other private investment pools to register with the SEC.
- **Section 4 of the Corporate and Financial Institution Compensation Fairness Act of 2009 (HR 3269).**
 - Introduced on July 21, 2009, states that all “covered financial institutions” would be required to disclose the structures of incentive-based compensation arrangements to Federal regulators. Federal regulators would also be permitted to prohibit “certain compensation” structures if they could have a “serious adverse effect on financial stability.”
 - Under the proposed legislation, “covered financial institutions” would include “any other financial institution that the appropriate Federal regulators, jointly, by rule, determine should be treated as a covered financial institution for purposes of this section.”
 - It does not appear from the conversation surrounding this legislation that the intent is to capture hedge funds and other unregulated entities, but it is possible that certain vehicles could be determined to fall within this law’s jurisdiction, and thus be subject to these executive compensation restrictions.

D. On the Horizon

It seems likely that the final legislation will include oversight of the hedge fund industry. The lack of regulation is frequently cited as one of the primary causes of the economic decline.

However, the hedge fund industry is well organized and has a vested interest in retaining its independence. Many in the industry have lobbied for a “mix” of regulations, because each type of private firm differs in size, investments, and risk level, and should not all be regulated in “one-size-fits-all” legislation. Industry insiders argue that “one-size-fits-all” legislation will end up causing more burdens on companies and investors, and will have a negative rather than positive impact on the market place.

The tension between government regulation, free market principles and investor protection will play a vital role in determining how much oversight hedge funds must accept.

The SEC is likely to become the overseer of hedge funds, though depending on the fund characteristics, there might be some sharing of responsibilities with the CFTC. Currently, the two agencies are cooperating, but that could change if the proposal impacts either agency’s jurisdiction.

With strong support from the Obama Administration and Congress, it is safe to assume that hedge fund regulation will occur; however, the form and severity of regulation remains unclear.

VI. Regulation of Credit Rating Agencies

A credit rating agency (“CRA”) assigns credit ratings for issuers of debt obligations and debt instruments. The credit rating evaluates the issuer’s credit worthiness, which affects the interest rate applied to the security being issued. Investors rely on these ratings and the reliability of the agencies that issue them when making investments.

These CRAs have come under fire, because they were giving investment-grade ratings to securitization transactions (collateralized debt obligations and mortgaged backed securities) based on subprime mortgage loans. Higher ratings were justified by various credit enhancements, which included overcollateralization, credit default insurance, and equity investors willing to bear the first losses.

In addition, some critics claim that conflicts of interest were involved, because rating agencies are paid by the firms that organize and sell the debt to investors. The potential for conflict was discovered by congressional investigators: some rating agency employees suspected that lax standards for rating structured credit products would produce negative results.¹⁸

A. SEC Regulation

On February 2, 2009, the SEC adopted rule amendments meant to increase transparency and improve the reliability of nationally recognized statistical rating organizations (“NRSROs”). The three largest NRSROs - Fitch Ratings Ltd., Moody's Investor Services Inc., and Standard & Poor's Ratings Services - have identified deficiencies in the companies’ ratings and ratings processes for

complex financial instruments, which prompted the SEC's action. The amendments took effect on April 10, and require that NRSROs:

- provide enhanced disclosure of the way they measure performance, and the procedures and methods that are used to determine credit ratings for structured products and other debt securities;
- make and preserve additional records in accordance with Securities Exchange Act § 17g-2 (1934);
- disclose on their websites a random sample of the ratings histories of issuer-paid credit ratings no later than six months after the ratings actions are taken; and
- provide an annual report to the SEC.

The SEC has also issued a number of proposals that apply to NRSROs, such as:

- requiring public disclosure of credit rating histories for ratings issued on or after June 26, 2007, when the ratings are paid for by the product's issuer,
- preventing an NRSRO from issuing a rating for a structured finance product paid for by the issuer unless the NRSRO discloses the basis for the rating, and
- increasing disclosures relating to NRSROs and arrangers.

B. Administration Proposals

The Administration plans on reducing investors' and regulators' reliance on credit-rating agencies. The proposal would require a clear distinction between the ratings assigned to asset-backed securities and other forms of debt such as corporate bonds. The agencies also would be required to disclose more information about their methodology, and about conflicts of interest. Generally, the agencies are paid by the company that issues the security.

C. Administration Announcement

On July 21, 2009, the Administration sent proposed legislation concerning credit rating agencies to Congress. The legislation would amend the Securities Exchange Act of 1934 to provide increased transparency and oversight of NRSROs, and reduce reliance on these organizations. The legislation would also attempt to reduce conflicts of interest at credit rating agencies. To accomplish these goals, the proposed legislation includes provisions that would: prohibit NRSROs from consulting with companies that contract for ratings; impose restrictions or prohibitions on conflicts of interest, including with respect to former employees of NRSROs that are hired by issuers of debt, as well as requiring the fees paid by the issuer of debt to the NRSRO; require designation of a compliance officer that reports to the SEC on an annual basis; require issuers to disclose all preliminary ratings received from NRSROs; introduce new symbols to be used by NRSROs when rating structured finance products; require a more robust explanation for the reasons underlying an NRSRO's rating; strengthen the SEC's authority and supervision of NRSROs, including requiring all NRSROs to register with the SEC; and require investigation into ways to reduce reliance on ratings.

D. Congressional Actions

Congress has proposed various forms of legislation, and at the May 19, 2009, House Committee on Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises hearing entitled "Approaches to Improving Credit Rating Agency Regulation", the Members stressed the significant role credit rating agencies played in the current financial crisis. And Subcommittee Chairman Paul Kanjorski (D-PA) said that in light of the current situation, a subscriber pay model is worth reassessing. Several bills have been proposed to address credit rating agencies:

- **On February 5, 2009, Representatives Gary Ackerman (D-NY) and Michael Castle (R-DE) introduced H.R. 1181, 111th Cong. (2009).**
 - This bill would require the SEC to promulgate rules to determine what types of financial instruments would be eligible to receive ratings from NRSROs. The bill also defines criteria that NRSRO-rated products must adhere to. Rep. Ackerman emphasized in the press release announcing that "nothing in [the] bill restricts the ability of originators to continue securitizing less predictable or riskier products," and instead requires that any financial product not meeting the criteria set forth in the bill be deemed ineligible for a NRSRO rating.
 - Further, the press release accompanying release of the bill takes issue with some rating agencies' contention that their ratings are opinions that are protected by the First Amendment, which Rep. Ackerman contends are not opinions but "often inappropriately favorable ratings that the agencies assigned to products issued by their clients amount[s] to nothing more than paid advertisements and endorsements."
- **On March 11, 2009, Rep. Patrick McHenry (R-NC) introduced the Credit Rating Agency Transparency and Disclosure Act, H.R. 1445, 111th Cong. (2009).** This bill would amend the Securities Exchange Act of 1934 requiring nationally-recognized credit rating agencies to provide additional disclosures with respect to the rating of structured securities. The bill would:
 - ensure issuers and originators are providing CRAs with adequate information on assets underlying a structured security;
 - require CRAs to institute procedures for getting data from issuers and originators to attest to the data's veracity and the fraud detection capabilities; and
 - require CRAs to disclose in a central database the historical default rates of all classes of financial products they rated.
- **On May 19, 2009, Senator Jack Reed (D-RI) introduced The Rating Accountability and Transparency Enhancement ("RATE") Act, S. 1073, 111th Cong. (2009).**
 - In his remarks stated "not every rating is suspect and these firms provide crucial information for investors and the marketplace, but credit rating agencies like any other industry should be held accountable if they knowingly or recklessly mislead investors." The RATE Act strengthens the SEC's oversight of NRSROs through enhanced disclosure and improved oversight of conflicts of interest, and makes credit rating firms more accountable through greater legal liability.

E. On the Horizon

Among the various proposals, it is likely that the SEC will be given additional authority to oversee and regulate the credit rating agencies. In addition, credit rating agencies will be required to increase transparency with respect to their ratings methodologies.

It is important to note that, despite their role in the economic crisis, the Obama Administration is not making reform of the credit rating agency a key component of the overhaul proposal. This may in part be due to the enactment of the Credit Rating Agency Reform Act of 2006, which sought to improve ratings quality and foster accountability, transparency, and competition in the credit rating agency industry. However, many legislators continue to place significant responsibility for the financial crisis on the credit rating agencies. As a result, it is highly likely that any reform package will include some sort of rating agency reforms, and such reforms may be more stringent than the Obama Administration's current proposal.

VII. Regulation of Derivatives

A. Past Recommendations

There is broad consensus that there needs to be a well-regulated, efficiently operated derivatives market. Over time, both U.S. and European institutions have recognized how important it is for markets to function with transparency. The G-20, the European Commission and the Federal Reserve Bank of New York have all met to discuss the over-the-counter ("OTC") derivatives market, including infrastructure and risk management issues.

I. ISDA's Big Bang Protocol

On April 8, 2009, approximately 1,900 businesses that deal in credit default swaps ("CDS") agreed to a number of market reforms proposed by the International Swaps and Derivatives Association (the reforms are referred to as the "Big Bang Protocol"). The reforms are intended to standardize the terms of CDS contracts and make the contracts more similar to the bonds or loans they relate to. The reforms should streamline the trading and settling of these swaps where the underlying bonds or loans default, and thus hopefully facilitate centralized clearing of swaps. It is important to note that the reforms do not apply to CDS tied to mortgage-backed securities or complex debt instruments. One reform will require CDS that are tied to North American companies to trade with "fixed coupons" and will require buyers and sellers of these swaps to cash up front transactions when entering trades. Previously, buyers would not be required to make upfront payments but would make quarterly payments over the life of the swap contract.

2. The Emergency Economic Stabilization Act ("EESA") Congressional Oversight Panel¹⁹

The COP sets forth different proposals for regulating the derivatives industry including applying capital requirements to firms engaged in making credit or insurance commitments through derivatives and requiring transparency around derivatives contracts tied to publicly traded

securities.

The COP also suggested alternatives for increasing transparency in the OTC derivatives markets, including using regulated clearinghouses, requiring all standardized OTC derivatives contracts be traded on regulated derivatives markets, and requiring CDS market participants to adhere to public disclosure requirements.

3. Policy Statement of the President's Working Group ("PWG") on Financial Markets²⁰

The PWG recommends:

- enhanced standards for the accuracy and timeliness of trade data submission and the timeliness of resolutions of trade matching errors for OTC derivatives,
- that the industry amend standard credit derivative trade documentation to provide for cash settlement or obligations stemming from credit event in accordance with the terms of cash settlement protocol; and
- that the industry should develop a longer-term plan for an integrated operational infrastructure supporting OTC Derivatives.

4. G-30 Report on Regulatory Reform

The Report recommends that the derivatives markets be held to "regulatory, disclosure, and transparency standards at least comparable to those that have historically been applied to the public securities."²¹ The Report also suggests that legislation should be established that creates a formal system of regulation and oversight of CDS and other OTC derivatives markets.

The Report also calls for transparency standards in structured product and derivative markets, reform in credit rating agencies, a formal system of regulation and oversight for CDS and OTC markets, a legal regime to provide regulators with authority to provide early warning and orderly closing of regulated banking institutions, and improved transparency for asset-backed and other structured fixed-income financial products.

5. Treasury's Framework for Regulatory Reform ("Outline")²²

The Treasury's Outline supports a comprehensive framework of oversight, protection, and disclosure of OTC derivatives market, including:

- regulating CDS and OTC derivatives for the first time;
- instituting a strong regulatory and supervisory regime;
- clearing all contracts through designated central counterparties;
- requiring non-standardized derivatives to be subject to robust standards;
- making aggregate data on trading volumes and positions available from central counterparties and trade repositories; and
- applying robust eligibility requirements to all market participants and, where appropriate, standards of care, as well as recordkeeping and reporting requirements.

B. Administration Proposals

The Administration's plan was initially laid out in a letter from Secretary Geithner to Sen. Harry Reid (D-NV), and focuses on the following proposals:

- **Mandatory Clearing of Standardized OTC Derivatives via a central counterparty ("CCP") & Mandatory Trading on an Exchange or a Regulated Electronic Trading System:** The Administration's proposal would require clearance and settlement of all standardized OTC derivatives through a CCP and traded on either an SEC or CFTC regulated exchange or regulated transparent electronic trading system.
- **Regulation of, and Mandatory Reporting By, Derivative Dealers:** Regulators would be required to impose capital, reporting and margin requirements on all derivatives dealers. Derivatives dealers would thus be subject to recordkeeping and reporting requirements for all of their OTC derivatives positions and transactions. These requirements would include retaining a complete audit trail.
- **Mandatory Reporting of Non-Standardized Bilaterally Negotiated Transactions to a Central Trade Data Repository:** In addition to imposing recordkeeping and reporting requirements on all derivative dealers, the CFTC and the SEC would require the reporting of the terms of all non-CCP settled trades to a regulated trade repository. Additionally, the CFTC and SEC would be given authority to police fraud, market manipulation and other abuses.
- **CFTC Proposal:** CFTC Chairman Gary Gensler recently unveiled a more comprehensive plan for the regulation of derivatives that involves two complementary regulatory regimes: one focused on the dealers that make the markets in derivatives and one focused on the markets themselves - including regulated exchanges, electronic trading systems and clearing houses. These two regimes would apply no matter the sort of firm, method of trading or type of derivative or swap involved in the trade.

On August 11, 2009, the Obama Administration sent its proposed legislation to Capitol Hill, focusing on the regulatory reform of OTC derivatives. The proposal, entitled the Over-the-Counter Derivatives Market Act of 2009, implements the Administration's comprehensive financial regulatory reform package. The Administration's proposal is significant in both its scope and its likely repercussions if it is ultimately enacted into law. For instance, the proposal would, in essence, subject the entire OTC market to the general oversight authority of the Commodity Futures Trading Commission ("CFTC") and require significant participants in such markets (including "swap dealers," swap trading platforms, swaps clearinghouses, swap repositories) to perform a broad panoply of capital and margin maintenance requirements as well as certain reporting and recordkeeping obligations.

With the narrow exception of foreign exchange related swaps and forward contracts, the Administration's Proposal would subject swaps that were previously exempted from the CFTC's jurisdiction by the Commodity Futures Modernization Act to CFTC oversight. Thus, both standardized and non-standardized swaps - from "plain vanilla" LIBOR interest rate swaps to total return swaps, credit default swaps and energy swaps - would be subject to general oversight by the CFTC. It would also subject related option and "swap dealers" and major market

participants to general oversight by the CFTC, with oversight of certain securities-related swaps markets done by the SEC. The proposal will be taken up by Congress in the fall as they begin to draft their own version of OTC derivatives markets legislation.

- **Regulation of the Markets – Standard Derivatives:** As with the earlier proposal, all standardized OTC derivatives would be required to be cleared through a regulated central clearinghouse and traded on either an SEC or CFTC regulated exchange or regulated transparent electronic trading system. Clearinghouses would be required to establish and maintain robust margin standards and other necessary risk controls and measures. The CCP would also be required to have fair and open access criteria that allow any firm that meets objective, prudent standards to participate regardless of whether it is a dealer or an investor/end user. A system for the timely reporting of trades and prompt dissemination of prices and other trade information to the public would be required. Both regulated exchanges and regulated transparent trading systems would have to allow market participants to see all bids and offers.
- **Tailored Derivatives:** Tailored swap transactions would also be regulated. Regulations would seek to ensure that customized derivative transactions are not used solely as a means to avoid the clearing requirement. This will be accomplished in two ways. First, regulators would be given authority to prevent fraud and market manipulation and to impose recordkeeping and transparency requirements with respect to the trading of all swaps. Second, dealers and traders would not be able to change just a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and electronic trading systems.

C. Congressional Actions

On May 13, 2009, House Agriculture Committee Chairman Collin Peterson (D-MN) and House Financial Services Committee Chairman Barney Frank (D-MA) made a joint statement after receiving word of the Administration's proposed regulatory framework on regulating OTC derivatives: "We applaud the letter by Treasury Secretary Timothy Geithner, and we agree there must be strong, comprehensive, and consistent regulation of OTC derivatives. As Chairmen of the Congressional Committees who share jurisdiction on this issue, we will work closely together to achieve that goal. Increased oversight, accountability, and transparency of the financial markets are essential to restore consumer confidence in the marketplace, protect investors, and preserve the overall integrity of the financial system."

On June 9, 2009, the House Financial Services Committee: Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing on, "*The Effective Regulation of the Over-the-Counter Derivatives Markets*." At this hearing, Subcommittee Chairman Paul E. Kanjorski (D-PA) recognized that all customized contracts cannot easily fit within a mandatory clearing or exchange trading regime, and he argued for "a delicate balance." According to the Chairman, "subjecting all contracts to mandatory exchange trading may cast too wide a net. Yet the clearing of most products – not all – through a central clearing entity seems appropriate and should not impose an undue burden on the affected parties." However, the Chairman warned that carving out too many exemptions as we tackle regulatory reform could create widespread economic harm in the long term. Further, even where clearing of contracts proves unfeasible, the Chairman believes transparency can still exist. Chairman Kanjorski argues that by mandating the collection

of relevant data in a repository, “we can help to ensure that regulators maintain access to useful trading information and perhaps detect warning signs of systemically risky transactions.”

Republicans stressed the need to guard against unnecessary and overly burdensome regulations that might cause markets to move overseas. Another risk is that the new regulation would hinder or prohibit firms from providing the superior risk management techniques that are so widely employed, and that could be enhanced by future innovations. In addition the following three bills have been introduced:

1. Derivatives Markets Transparency and Accountability Act of 2009, H.R. 977, 111th Cong. (2009).

On February 12, 2009, the House Agriculture Committee marked up and reported the Derivatives Markets Transparency and Accountability Act of 2009. This bill was introduced by Chairman Collin Peterson (D-MN) and pushes to strengthen the regulation of OTC derivatives. The principal features of the bill are:

- Commodity Futures Trading Commission (“CFTC”) authority to suspend trading in credit default swaps;
- Requirement for clearing house processing for over-the-counter derivatives;
- Position limits to prevent excessive speculation;
- Transparency measure: detailed reporting and disaggregation of market data;
- Exemption for carbon offset credits and emission allowances;
- CFTC authority to prosecute criminal violations of the Commodity Exchange Act; and
- Diversity requirement for boards of trade.

The bill also includes a variety of other provisions relating to the regulation of OTC derivatives including transparency of offshore trading, transparency and recordkeeping authorities, changes in CFTC administration, and a requirement for the CFTC and the Government Accountability Office (“GAO”) to issue reports on regulatory regimes for futures and derivatives trading.

2. Derivatives Trading Integrity Act of 2009, S. 272, 111th Cong. (2009).

On January 12, 2009, Sen. Thomas Harkin (D-IA) introduced the Derivatives Trading Integrity Act of 2009. The bill amends the Commodity Exchange Act to eliminate the distinction between “excluded” and “exempt” commodities and regulated, exchange-traded commodities, so that futures contracts for all commodities would be treated identically. In addition, the bill eliminates the statutory exclusion of swap transactions from the Commodity Exchange Act, and ends the CFTC’s authority to exempt swap transactions from the requirement that a contract for the purchase or sale of a commodity for future delivery can only trade on a regulated board of trade.

3. Prevent Excessive Speculation Act, S. 477, 111th Cong. (2009).

On Feb. 13, 2009, Sen. Carl Levin (D-MI) introduced Prevent Excessive Speculation Act, a bill that authorizes the CFTC to require or permit a contract market, derivatives transaction execution facility, or electronic trading facility, with respect to a significant price discovery contract, to establish and enforce position accountability.

D. On the Horizon

Enactment by the 111th Congress of legislation revisiting the legal status of OTC derivatives and derivatives dealers under U.S. Commodity and Securities Laws seems likely. Much of the focus remains on modifications to the Council of Economic Advisor's swaps exclusion. This is due to the role of CDS trading in AIG's demise and the fact that its extensive OTC derivatives activities and the absence of a clearinghouse and central counterparty for CDS helped make AIG "too big to fail." A solid consensus has quickly emerged that any new legislation should, at a minimum, require certain standardized OTC swaps to be submitted, novated, and settled on a net basis through a CCP or clearinghouse. However, it is unexpected that any OTC derivatives reform package will go as far as some of the bills introduced earlier in 2009 in the Senate. Any new regulatory framework for OTC derivatives adopted in 2009 will be driven by Congress and the White House's desire to:

- lower systemic risk;
- preserve market efficiency; and
- promote market integrity (through the prevention of fraud, manipulation, and other market abuses), and enhance market confidence.

There is also some possibility that Congress will go as far as imposing position limits or rules designed to protect the retail markets from being indirectly impacted by behaviors in the institutional OTC markets, including marketing practices with respect to OTC derivatives and smaller municipalities.

Therefore, we expect significant Congressional debate will ensue in the coming months over what sort of customized OTC swaps should continue to be bilaterally negotiated and settled and what other protections and obligations should also be put in place over both the OTC marketplace and OTC market participants. In this regard, we expect intensive Congressional debate over imposing reporting and investor protection requirements on OTC derivative dealers and other obligations on all OTC market participants.

Policymakers also appear keen to reduce opacity in the OTC markets. In this regard, it is significant that International Swaps and Derivatives Associations ("ISDA") has already expressed its support for the notion that OTC trades that are not centrally cleared should be reported to a central trade data repository. Such a repository would help streamline the cost to the industry of meeting new reporting obligations and enhance the overall transparency within the market.

Policymakers and legislators thus appear focused on market integrity issues but also on enhancing investor protection rules for institutional investors and the confidence of institutional investors and eligible contract participants in the OTC market's overall integrity and robustness. The issues raised at the Congressional hearings have already become fairly wide-ranging, including a discussion of possibly imposing suitability standards, an OTC contract approval process, possible market conduct and customer protection rules and rules requiring the segregation of customer margin deposits in the context of all OTC transactions.

Secretary Geithner's letter to Congressional leadership called for a dual regulatory framework where securities related OTC derivatives would be regulated by the SEC and all other OTC

derivatives (i.e. interest rates, foreign exchanges, commodities, etc) will be regulated by the CFTC. According to the SEC, trading markets and clearing organizations for securities-related OTC derivatives would be subject to SEC registration requirements as exchanges and clearing agencies. For OTC contracts that would be ineligible for central clearing because of customized terms, Chairman Schapiro has nevertheless called for imposing margin and capital requirements.

The Administration is also being careful not to leave open any loopholes for future abuse. For instance, Gensler went out of his way in his recent Senate testimony to stress the need for clear standards for determining what constitutes a non-standardized OTC product. He also took the position that customized products should still be subject to fairly strict capital and margin requirements, especially since they will be bilaterally settled. He explained that these requirements would prevent the need to overlook each contract on a case by case basis.

VIII. Regulation of Insurance Industry

Reform of insurance industry regulation is among the agenda items of the 111th Congress, with the existing state-by-state regulatory framework facing scrutiny, in particular following the demise of insurance giant AIG. In coming months, it is anticipated that Congress may approve legislation for an optional federal charter. There is also speculation that the federal charter may be mandatory for certain insurance companies that reach a threshold of systemic significance. Further, given the increasingly global existence of multinational insurance companies, there is likely to be further coordination and harmonization of the regulation of systemically significant insurance companies in the upcoming year.

A. Administration Proposals

The Administration proposes to establish the Office of National Insurance (“ONI”) within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector.

The ONI would be responsible for monitoring all aspects of the insurance industry. It would gather information and be responsible for identifying the emergence of any problems or gaps in regulation that could contribute to a future crisis. The ONI would also recommend to the Federal Reserve any insurance companies that it believes should be supervised as Tier 1 FHCs. The ONI would also carry out the government’s existing responsibilities under the Terrorism Risk Insurance Act. Six principles for insurance regulation are supported by the proposal:

- effective systemic risk regulation with respect to insurance;
- strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies;
- meaningful and consistent consumer protection for insurance products and practices;
- increased national uniformity through either a federal charter or effective action by the states;
- improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business; and
- international coordination.

It should also be noted that this proposal can be congruent with Rep. Bean's (D-IL) proposed bill, the National Insurance Consumer Protection Act, H.R. 1880, discussed below.

B. Congressional Actions

Numerous bills were proposed in the 111th Congress before the announcement of the Obama Plan. Signifying an activist approach, Representative Paul Kanjorski (D-PA) stated that, "The events of the last year have demonstrated that insurance is an important part of our financial markets. The Federal government therefore should have a role in regulating the industry. As such, we now must ask how the Federal government should oversee insurance going forward."

■ **National Insurance Consumer Protection Act, H.R. 1880, 111th Cong. (2009).**

- On April 2, 2009, Rep. Melissa Bean (D-IL) and Rep. Ed Royce (R-CA) introduced the National Insurance Consumer Protection Act, a measure that would establish an optional federal charter regime applicable to life insurers, property and casualty insurers, and reinsurance insurers. The bill would establish a parallel, national system of regulation and supervision for insurers, insurance agencies, and insurance producers (agents and brokers), similar to the dual banking system. Insurers, agencies, and producers could elect national or state regulation, charters and licenses. States would maintain responsibility of regulating state licensed insurers, agencies and producers.
- Among other things, the bill would establish an Office of National Insurance ("ONI") that would share information about carriers with the new systemic-risk regulatory entity (yet to be established by Congress). This Systemic Risk Regulator would then ultimately determine whether a given insurance carrier is systemically important, and therefore eligible for national chartership.
- The bill also contains a provision to require all nationally regulated insurers to pay into a federal guaranty fund. Other co-sponsors of the bill include Representatives Jim Cooper (D-TN), Henry Cuellar (D-TX), Deborah Halvorson (D-IL), Jim Himes (D-CT), Walter Minnick (D-ID), and Jim Moran (D-VA).

■ **National Association of Registered Agents and Brokers Reform Act of 2009, H.R. 2554, 111th Cong. (2009).**

- On May 21, 2009, Rep. David Scott (D-GA) and Rep. Randy Neugebauer (R-TX) introduced the National Association of Registered Agents and Brokers Reform Act of 2009 ("NARAB II"). The bill would streamline licensing for insurance agents and brokers operating in multiple states.
- The bill creates a central clearing house responsible for establishing one set of licensing and other insurance producer qualification and continuing education standards applicable in all states where the producers conduct business.
- Despite the current trend toward increased Federal government control, under NARAB II the licensing entity is not an agent of the Government but a nonprofit corporation.

■ **The Insurance Information Act of 2009, H.R. 2609, 111th Cong. (2009).**

- On May 21, 2009, Rep. Paul Kanjorski (D-PA) introduced The Insurance Information Act of 2009. The bill would establish an Office of Insurance Information within the Department of Treasury. The Office would collect and study insurance data from state and other sources. Using this information the Office would serve as a liaison between federal government and states regarding insurance matters and establish a federal policy on international insurance matters. The Office of Insurance Information will also advise Treasury on insurance policy issues.
- According to the bill, if state insurance measures treat non-U.S. insurers more or less favorably than domestic insurers and are inconsistent with federal policy, the state measure will be preempted.

C. On the Horizon

Despite the release of the Administration's Plan, many questions regarding insurance reform remain unanswered. The Plan does not mandate Federal regulation of insurance, but adds federal components to the current system, and leaves the door open for even broader federal oversight of the insurance industry. The Plan does not reject a federal charter but rather states that the Administration will support "proposals to modernize and improve" insurance. If Congress were to allow a federal charter it likely initially would only be in the life insurance area. Adding to the ambiguity, the Plan says the Administration will support "increased national uniformity through either a federal charter or effective action by states." The Plan adds certain federal components – for instance, the Office of National Insurance can recommend that insurers that pose systemic risk should be regulated by the Federal Reserve Board in addition to their state regulators.

The Plan does not expressly mention that the new Consumer Financial Protection Agency will have jurisdiction over the insurance industry, but there has been a great deal of debate on the Hill about this issue. House Financial Services Committee Chairman Barney Frank (D-MA) has previously said that certain annuities would be under the jurisdiction of the Agency. He has recently scaled back these comments and has not directly addressed the issue of insurance regulation. It is entirely possible that the House keeps the language used in legislation, pertaining to the Agency, deliberately so vague so the Senate can include insurance as they see fit. On June 30, 2009, the Obama Administration released proposed text (Titles X and XI) for the Consumer Financial Protection Agency Act that will serve as the starting point for consideration of the bill in Congress. The definitions section of the bill provisions clarify that insurance is not considered a "financial activity" for the purposes of the bill with the exception of credit insurance, mortgage insurance, and title insurance.

Some Republicans on the Senate Banking Committee have criticized the Plan for not going far enough in the insurance area. In a July 28, 2009 hearing entitled "Regulatory Modernization: Perspectives on Insurance," Senate Banking Committee Ranking Member Richard Shelby (R-AL) accused the Obama Administration of taking a "pass" on insurance reform. He said that comprehensive insurance reform must be part of the Administration's reform efforts.

IX. Accounting and Audit Standards (Including Global Convergence of Standards)

On December 19, 2008, the International Accounting Standards Board (“IASB”) and the Financial Accounting Standards Board (“FASB”) issued a discussion paper describing their vision for an improved global standard for recognition of revenue, with a target of 2011 for a final standard. The comment period for this discussion paper closed on June 19, 2009. FASB and IASB are driving toward a “contract-based revenue recognition principle” that will help to establish a more reliable set of accounting standards. The discussion paper states:

[W]hen an entity becomes a party to a contract with a customer, the combination of the rights and obligations in that contract gives rise to a net contract position. Whether that net contract position is a contract asset, a contract liability, or a net nil position depends on the measurement of the remaining rights and obligations in the contract. [...] In the proposed model, revenue is recognized when a contract asset increases or a contract liability decreases (or some combination of the two). [...] That occurs when an entity performs by satisfying an obligation in the contract.

FASB and IASB have stated that accounting practices would not change for many transactions under the proposed model, especially for “commonplace retail transactions.” The model would, however, likely change accounting practices in the use of the contract-based revenue recognition principle, identification of performance obligations, use of estimates, and capitalization of assets.

Recently, the FASB and IASB heard from representatives of the construction, telecommunications, and insurance industries, questioning the usefulness and the practicability of their planned revenue recognition model. These representatives questioned the possibility that a single model could be applied in all situations. IASB Director Peter Clark stated, “Part of the team's thinking here was a worry about the tightness of the timetable and a worry about the possibility of a failed exposure draft.” In seeking to meet the 2011 deadline, FASB plans to solicit “key decisions” from the boards in September or October, and then seek comments through an outreach drive.

A. Administration Proposals

The Administration’s *Regulatory Reform Proposal* calls for the Financial Accounting Standards Board (“FASB”), the International Accounting Standards Board (“IASB”), and the SEC to review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information.

Fair value accounting rules also should be reviewed with the goal of identifying changes that could provide users of financial reports with both fair value information and greater transparency regarding the cash flows management expects to receive by holding investments. Finally, the

Proposal calls for Generally Accepted Accounting Principles ("GAAP") to be changed, eliminating "gain on sale" accounting so that asset values would be more accurately reflected over time.

B. Congressional Actions

- **Federal Accounting Oversight Board Act of 2009, H.R. 1349, 111th Cong. (2009).** On March 5, 2009, Rep. Ed Perlmutter (D-CO) and Rep. Frank Lucas (R-OK) introduced the Federal Accounting Oversight Board Act of 2009. This bill would create a new Federal Accounting Oversight Board (FAOB) to assure correct application of U.S. generally accepted accounting principles. The FAOB would include five regulators:
 - the chairman of the Federal Reserve,
 - the secretary of the Treasury,
 - the chairman of the SEC,
 - the chairman of the FDIC, and
 - the chairman of the Public Company Accounting Oversight Board ("PCAOB").

C. On the Horizon

While the likelihood of significant changes to accounting rules remains unclear, FASB has been working closely with the IASB in setting standards and issuing guidance on accounting rules. The two bodies have formed a Financial Crisis Advisory Group to address the international financial crisis. This group plans to issue recommendations to FASB and the IASB during the summer.

Legislators have been subject to intense lobbying efforts from business groups regarding changes to the mark-to-market accounting rules and fair-value accounting standards. Statements from the American Bankers Association ("ABA") express support for Federal Accounting Oversight Board Act of 2009, primarily because the bill would require additional study and "proper cost benefit analysis" before making any changes to accounting standards. The ABA also called the current system "inadequate" and in need of revision to prevent the reporting of market losses, rather than economic losses.

A March 9 letter from the U.S. Chamber of Commerce, ABA, American Council of Life Insurers, Financial Services Roundtable, real estate and home builders groups, the Council of Federal Home Loan Banks, and other organizations expressed a need to correct "the unintended consequences of mark-to-market accounting." These groups urge immediate action to address mark-to-market accounting.

The ABA wrote separately to the SEC to urge changes to fair-value accounting standards. Other groups, such as the Center for Audit Quality (affiliated with the American Institute of Certified Public Accountants), have stated it is disingenuous to imply that the financial crisis was somehow caused by fair-value accounting, and critics urged policy makers not to be influenced by political pressure.

The reviews of accounting standards as required by the Administration's proposal will occur; however, implementation of any change to these standards will need to most likely undergo

significant review and debate prior to the promulgation of a final rule addressing the alteration.

X. Regulation of Mortgage Products

A. Past Recommendations

1. The Emergency Economic Stabilization Act Congressional Oversight Panel

The COP recommends:

- the elimination of federal pre-emption of the application of state consumer protection laws to national banks, allowing state consumer protection laws to apply to national banks; and
- the creation a single federal regulator for consumer credit products, including mortgages.

Notably, on March 6, 2009, the COP released a report entitled, *March Oversight Report, The Foreclosure Crisis: Working Toward a Solution*. The report examined the causes of the foreclosure crisis and the impediments to its resolution, and provided a checklist for foreclosure mitigation program success. Additionally, the report criticized certain elements of the Administration's Homeowner Affordability and Stability Plan, announced on February 18, 2009.

2. G-30 Report on Regulatory Reform

The G-30 Report calls for a clear separation of the functions of "private sector mortgage finance risk intermediation from government sector guarantees or insurance of mortgage credit risk."²³ These recommendations appear to be targeted at Fannie Mae and Freddie Mac and suggest that the degree of government support for such institutions must be clearly defined. Notably, the Report suggested that hybrids of private ownership, with government sponsorship, should be avoided.

B. Administration Proposals

The Administration's regulatory reform calls for imposing robust reporting requirements on the issuers of asset-backed securities. The plan includes several measures aimed at increasing transparency in the asset-backed securities market, including mandated disclosure of loan-level data, disclosure of broker, originator and sponsor compensation and risk retention, promotion of standardized legal documentation, and implementation of clear and uniform rules for servicer loan modification. Further, the plan would require lenders to retain at least five percent of the credit risk of securitized exposures.

Earlier this year, the Administration had announced its Making Home Affordable Program ("MHA"), which provides homeowners the opportunity to refinance or modify existing mortgages. On March 4, 2009, Treasury issued a detailed program description, outlining both the Home Affordable Refinance program and the Home Affordable Modification program. Under the Home Affordable Refinance Program, homeowners with strong payment history on an existing mortgage owned by Fannie Mae or Freddie Mac may be eligible to refinance their loans, even if their loan-to-value ratio might not otherwise permit refinancing. The Home Affordable Modification program allows modification of qualifying loans to reduce monthly payments and prevent foreclosure. Thus far, none of the programs have achieved the desired mass success that

was anticipated. Treasury, the Department of Housing and Urban Development, and Congress continue to work together to tailor the programs to reach more at-risk borrowers and prevent additional foreclosures.

C. Congressional Actions

- **Mortgage Reform and Anti-Predatory Lending Act of 2009, H.R. 1728, 111th Cong. (2009).**
On May 7, 2009, the House passed the Mortgage Reform and Anti-Predatory Lending Act of 2009, which is aimed at curbing predatory lending and includes an assignee liability provision for securitizers. The bill would:
 - strengthen restrictions on compensation paid to mortgage loan originators and brokers, based on a loan's interest rate and terms, often called yield-spread premiums;
 - strengthen language on "assignee liability" to make mortgage securitizers, who package home loans into securities, more liable for fraudulent loans;
 - impose underwriting standards to prohibit lenders from underwriting loans when consumers do not have a reasonable ability to repay and prohibit practices that increase the risk of foreclosure for consumers;
 - include provisions to encourage the market to move toward making 30-year fixed-rate, fully documented loans;
 - include anti-steering measures to protect consumers from being steered into loans that are not in the borrower's best interest; and
 - include enhanced disclosure provisions to provide for greater transparency by ensuring lenders make full disclosure of the terms of the loan at the time of origination.

- **Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. (2009).**
 - On March 5, 2009, the House passed the Helping Families Save Their Homes Act of 2009, a housing package that includes a measure to allow Chapter 13 bankruptcy judges to modify the terms of primary residential mortgages of at-risk homeowners. However, on May 6, 2009, the Senate passed its version of the housing bill (S. 896) with no the cram-down provision included. S. 896 passed the House on May 19, 2009. Senator Richard Durbin (D-IL) hinted in August 2009 that he may reintroduce the cram down option before the end of the year.

 - On May 20, 2009, Obama signed the Helping Families Save Their Homes Act of 2009 into law. The Act improves borrowers' ability to utilize the HOPE for Homeowners program established in the prior Administration. Further, the measure increases the flow of credit by expanding the borrowing authority of the Federal Deposit Insurance Corporation ("FDIC") and the National Credit Union Administration ("NCUA"). Additional provisions in the Act establish protections for renters living in foreclosed homes and mandate borrower notification when the borrower's loan is sold or transferred.

D. On the Horizon

The mortgage industry has criticized the effectiveness of the Administration's proposal to mandate lender risk retention in asset-backed securities, while others argue that the proposal's five percent provision does not go far enough.

Also, mortgage originators, loan servicers, mortgage servicers, and securities issuers will object to additional reporting burdens and the related additional costs. This may minimize some of the requirements sought to be enforced, but the resulting legislation will likely include a higher level of disclosure than that currently in place.

For more information about the sale of mortgages into secondary markets and related mortgage-backed securities regulation, please see the section on Securitization below.

XI. Securitization

A. Administration Actions

Introduced in November 2008 and a vital part of the Administration's Financial Stability Plan, the Term Asset-Backed Securities Loan Facility ("TALF") has been relied upon to revive the dormant asset-backed and commercial mortgage-backed securities ("CMBS") markets. The TALF's mechanism originally consisted of the Federal Reserve providing non-recourse three or five year loans to borrowers in exchange for newly-issued eligible asset-backed securities ("ABS") backed by various type of underlying collateral, including credit cards, auto loans, student loans and loans guaranteed by the Small Business Administration. This was later revised to include newly or recently issued AAA-rated ABS backed by four additional types of consumer and business loans – mortgage servicing advances, loans or leases relating to business equipment, leases of vehicle fleets, and floor plan loans.

There was recently an expansion of the eligible asset classes to include newly issued eligible CMBS and eligible "Legacy CMBS" – those issued prior to January 1, 2009 – to restore access to credit markets for owners of and lenders for commercial real estate.

The Federal Reserve Bank of New York is considering an expansion of TALF to include residential mortgage-backed securities. Some of the issues facing such an expansion include the lack of trust in the ratings the pre-2009 securities received, the fact that some of the securities are no longer rated "AAA," and the general administrative burdens raised by such an endeavor. In addition, the TALF is set to expire on December 31, 2009, and the Board of Governors has not yet voted to extend the program into 2010.

B. Administration Proposal

The Administration's regulatory proposal also took up the issue of securitization. As part of its regulatory reform, the Administration will attempt to change the way investments are made in mortgage loans, which are ultimately placed into securitization trusts as part of ABS offerings.

Within the proposal, federal banking regulators would have the authority to require lenders of

residential mortgage loans to retain at least five percent of the risk of losses on each pool of mortgage loans. Certain details, such as whether it should be a first loss position or a pro rata vertical slice, will be left to the regulators to decide. As an interest holder, the lender would gradually recoup her purchase price through remittances, which would cause lenders and servicers to have "skin in the game" and improve its collections process and have a greater incentive to prevent homes from going into foreclosure. Requiring part of the loss to be potentially born by the lender will encourage responsible lending, create safer investments and renew the flow of funding for mortgages and other loans. The proposal also expands the SEC's authority to require loan-level disclosure for asset-backed securities in a standard format to enhance the ability of investors to perform their own due diligence.

In connection with the regulation of securitization markets, the financial regulatory reform includes adopting performance-based, medium- to long-term approaches to fees and commissions. The Treasury Department cites the Financial Accounting Standards Board ("FASB") and Generally Accepted Accounting Principles ("GAAP") proposals to eliminate immediate recognition of gain on sale by originators at the inception of a securitization as another example of changing the perspective of these transactions to one that is much longer-term in focus.

One additional tenet of the proposal is to give the SEC explicit authority to increase the transparency and standardization of ABS. According to recent media reports, the Administration determined that securitization encouraged irresponsible lending standards. The companies that originated and then quickly sold the loans to investors for a securitization had little incentive to service the loans once they were off their books. Critics of such a proposal point out that many lenders retained pieces of their own securitization offerings over the last few years, which resulted in massive losses and damage to firms' bottom lines.

In addition, the proposal also requires that nationally recognized statistical rating organizations (such as S&P, Moody's and Fitch) make clear to investors that asset-backed securities are riskier than traditional investments such as corporate bonds. Regulators will be encouraged to reduce their use of credit ratings in regulations and supervisory practices where possible. Rating agencies would also be required to disclose more information about their rating methodology and follow higher transparency standards generally. The SEC's authority would be expanded beyond the sale of securities to require increased disclosures about the contents of ABS offerings and to include ABS in its database of corporate bond issues.

With respect to federal legislation regarding futures and securities regulation, the Obama Administration advocates giving the CFTC and the SEC the chance to harmonize regulations and statutes regulating futures and securities.

C. On the Horizon

As noted in this primer's Regulation of Mortgage Products section, the proposal requiring an issuer to retain five percent of an ABS is being criticized as too much government intervention into the market place and, on the other hand, as not being significant enough of a holding to correct banks' origination requirements.

Rating agencies will object to many of the proposals, and the extent of increased regulation and SEC oversight will depend on the perceived necessity for rating agencies in the industry versus

how much blame they should shoulder for the economic decline.

The Federal Reserve Bank of New York, which is operating the TALF, has pointed to several signs that the facility is unfreezing the ABS and CMBS markets. First, the issuance of consumer ABS securities has been gradually reviving. Second, the securitization market is showing signs of operating without TALF financing. Finally, market observers have noted that the spreads on consumer ABS have decreased from last year's levels. It is too soon to say that securitization is back on track to where it was several years ago, but the TALF's existence has slowly improved market conditions.

XII. Executive Compensation Restrictions

There has been much concern over the current level of executive compensation; many argue that the promise of high salaries has promoted excessive risk taking by firms, with little drawback for the executives. As a result of this concern, numerous policy actions have been taken to regulate executive compensation.

A. Administration Proposals

The Administration on June 10, 2009, announced the appointment of a well-known Washington lawyer, Kenneth R. Feinberg, to oversee the compensation of employees at the seven largest companies to receive TARP funds -- the American International Group, Citigroup, Bank of America, General Motors, Chrysler, and the financing arms of the two automakers. He will have broad discretion to set the salaries and bonuses for their five most senior executives and the companies' 20 most highly paid employees.

While there is no salary cap at the seven companies, the plan offers an incentive for companies to adopt a voluntary cap. If they limit executive pay to no more than \$500,000, Mr. Feinberg's approval will be automatic. This is a compromise from Obama's Feb. 4, 2009 announcement of a \$500k cap on executive salaries. It is a compromise between public outrage on excessive compensation and the effects of such a cap "spooking" Wall Street. Mr. Feinberg will also have the right to review the compensation for the 100 most highly paid employees and any other executives. Mr. Feinberg will determine whether it would be in the public interest to force executives at companies receiving assistance who might have been overpaid -- for example, if their pay was based on revenue and profit that turned out to be illusory -- to return the money. For the smaller institutions that remain in the TARP, executives face some restrictions, but there are loopholes. Many of the new rules, for instance, will not apply to companies that received the relief funds before February -- the vast majority of companies in the program.

For other financial institutions that have received federal assistance, Mr. Feinberg will play an advisory role in establishing the overall compensation structure, but without setting the exact level of pay. The goal is to reduce excessive risk-taking by executives whose compensation is tied to company performance.

The Administration has also stated that it is not interested in "capping pay" or "setting forth precise prescriptions for how companies should set compensation." Instead, the aim of the Administration is to rein in pay practices that motivated executives to take excessive risks in pursuit of profit.

B. Treasury Department Actions

In a Treasury Press Release U.S. Department of the Treasury Secretary, Tim Geithner outlined certain principles that Treasury has identified as central to its efforts in addressing compensation arrangements:

- Compensation plans should properly measure and reward performance;
- Compensation should be structured to account for the time horizon of risks;
- Compensation practices should be aligned with sound risk management;
- The Treasury should reexamine whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders; and

The Treasury should promote transparency and accountability in the process of setting compensation.

Furthermore, IRS Notice 2009-49, effective as of June 4, 2009, addresses the question of whether § 409(A) of the Internal Revenue Code will prevent distribution of deferred compensation amounts in the context of the Treasury's acquisition of a company's stock. By way of background, § 409(A) provides that amounts deferred under a nonqualified deferred compensation plan cannot be distributed unless one of six "trigger" events occurs, one of which is a change in ownership or effective control of the corporation or the assets of the corporation. IRS Notice 2009-49 states that an acquisition of a company's equity by Treasury is not a change in ownership or control for purposes of § 409A. However, a nonqualified deferred compensation plan will not be in violation of § 409A merely because the plan does not include a provision stating that acquisition of a company's equity does not qualify as a change of ownership or control.

Finally, on June 15, 2009, the Treasury released the Interim Financial Rule ("Interim Rule") pursuant to EESA, as amended, to provide guidance on executive compensation limitations that apply to entities that receive funds under TARP. The Interim Rule imposes several significant restrictions on compensation structures for "Senior Executive Officers" ("SEOs").²⁴

C. Congressional Actions

- **Emergency Economic Stabilization Act:** Those firms that participate in the Treasury's programs under the EESA must abide by the Act's executive compensation rules. In early 2009, the EESA established limitations on compensation paid to executives, or SEOs. Under EESA, an SEO is a CEO, CFO, or one of the next three most highly compensated employees in a fiscal year. The determination of who qualifies as an SEO takes into account all employees at companies in a parent-subsidary relationship where the parent owns 80% or more of the subsidiary. In sum, the executive compensation limitations imposed under EESA are:
 - Restrictions on "Golden Parachute" payments to SEOs that equal or exceed three times the SEO's base amount, under a wide variety of events that cause an SEO's departure from the institution;
 - Limits on deductibility of SEO compensation such that participating employers must limit their annual deduction for compensation paid to any SEO to \$500,000, for as long as the Treasury holds a debt or equity position in the company. The \$500,000 deduction

cap that is applicable to compensation earned during a year covered by the TARP rules also applies to any future tax year in which that compensation is actually paid;

- Requirements under TARP rules for institutions participating through direct purchase programs are to eliminate compensation incentives that encourage excessive risk-taking, and to file an annual certification that they have complied with the above requirements; and
- "Clawback provisions," which require the clawback of any bonus or incentive-based compensation paid to a CEO if the payments were based on financial statements or any other performance metrics later determined to be "materially inaccurate."

■ **American Recovery and Reinvestment Act:** The American Recovery and Reinvestment Act ("Stimulus Bill") applies to institutions that have received or will receive TARP funds. The amount of TARP funds received by an employer determines which CEOs and/or employees are subject to certain restrictions. Thus, if an institution receives:

- \$25 million or less, then the restrictions apply to the most highly compensated employee.
- \$25 million to \$250 million, then the restrictions apply to the 5 most highly compensated employees.
- \$250 million to \$500 million, then the restrictions apply to the 5 CEOs and the 10 next most highly compensated employees.
- More than \$500 million, then the restrictions apply to the 5 CEOs and at least the 20 next most highly compensated employees.

First, "Golden Parachute" payments have been defined more expansively as ANY payment upon separation from service for ANY reason, except for payments for services already performed or benefits already accrued.

Second, there is a prohibition on paying bonuses, retention awards, or other incentive compensation during the period that any obligation arising from the receipt of financial assistance under TARP is outstanding, with a limited exception for payment of long term restricted stock.

Importantly, the prohibition on bonuses, retention awards, and other incentive pay does not prohibit any bonus payment required to be paid pursuant to a written employment contract executed on or before February 11, 2009. It is important to note that Treasury is authorized to determine the validity of such written employment agreements.

Any compensation plan or arrangement that could encourage the manipulation of reported earnings in order to enhance an employee's compensation is prohibited. And there is a limitation on so-called "luxury expenditures," which have not yet been defined by Treasury.

In addition, the Treasury has also retained the authority to review all prior payments to CEOs and require reimbursement to the U.S. government where appropriate.

Several bills have been introduced in Congress to address executive compensation among TARP recipients. Most of the early efforts were sparked by outrage over bonuses paid to AIG executives, and accordingly these bills attempt to recapture bonuses through taxes, enforcement actions, or

intervention by the government in the bonus arrangements themselves:

- **H.R. 1586, 111th Cong. (2009):** This bill imposes a 90% tax on either a bonus or the amount of an employee's gross income that exceeds \$250,000 (whichever is less) when paid by a TARP participant that receives and retains \$5 billion of TARP funds. If the participating institution's retained TARP fund amount falls below \$5 billion, the provisions of the bill will no longer apply. In addition, employers will be subject to these provisions if they are affiliates of TARP recipients with \$5 million in TARP funds, and if they are partnerships where more than 50% of the partnership interests are owned by any such entity or its affiliates. No tax would be imposed on normal compensation payments, commissions, welfare or fringe benefits, or reimbursements for expenses. This bill was passed before the House on March 19, 2009.
- **S. 651, 111th Cong. (2009):** This bill would subject all retention bonuses along with any other bonus in an amount over \$50,000 to two separate taxes: a 35% tax on the employer paying the bonus, and a separate 35% tax on the recipient of the bonus. The tax would apply on bonuses paid on or after January 1, 2009. Further, the bill would set limits on deferred compensation arrangements, where a taxpayer would not be able to defer more than \$1 million in compensation in a 12 month period. The limitation would not include interest on these amounts so long as the interest was based on a statutorily defined market rate of return. These provisions would apply to Fannie Mae and Freddie Mac, any institution receiving and retaining \$100 million or more of TARP funds or an institution in which the government has an equity interest, or affiliates of such entities. This bill was introduced in the Senate on March 19, 2009.
- **H.R. 1664, 111th Cong. (2009):** This bill amends EESA to prohibit, under either a new or existing compensation arrangement, any compensation that is "unreasonable or excessive," or any bonus or supplemental payments that is not directly based on standards for performance. Treasury regulations will define "unreasonable and excessive" and performance standards under this section; regulations will be drafted in consultation with the Chair of the Congressional Oversight Panel and approved by agencies that are members of the Federal Financial Institutions Examination Council ("FFIEC").
 - As for standards of performance, the standards would include performance of the bonus recipient; ability of the institution to repay government funds; and adherence by executives and employees to appropriate risk management requirements. These limits would apply to any financial institution that receives a capital infusion under TARP, as well as to Fannie Mae, Freddie Mac, and any Federal home loan bank that receives a capital investment under the Housing and Economic Recovery Act of 2008.
 - An institution remains subject to these rules as long as it retains the capital investment. This bill was passed out of the House Financial Services Committee on March 26, 2009. On April 1, 2009, the bill passed the House by a vote of 247-171.
- **H.R. 3269:** H.R. 3269 passed the House on July 31, 2009, by a vote of 237-185. The Corporate and Financial Institution Compensation Fairness Act of 2009 (H.R. 3269) amends the Securities and Exchange Act of 1934 to require a nonbinding shareholder vote on executive compensation at all companies, not just TARP recipients (the so-called "say on pay" requirement). It provides protections that attempt to ensure the independence of the

compensation committee of a public company, and requires all financial institutions with more than one billion in assets to disclose compensation structures that include any incentive-based elements. This specifically includes banks, bank holding companies, broker-dealers, credit unions, investment advisors, Fannie Mae & Freddie Mac, and any financial institution identified as appropriate during joint rulemaking by the relevant Federal financial regulators.

D. On the Horizon

There have been numerous unsuccessful attempts by Congress to legislate in this area over the recent years. The public outcry on the AIG bonus matter this spring was the impetus for many of the executive compensation bills released in early 2009. While recent outrage over the AIG matter has subsided somewhat, there appears to be a continued desire to reign in executive compensation not only at companies that have received TARP funds, but with all U.S. corporations.

Generally, executive compensation proposals have been generally embraced by investors, but not by business. Business groups decry the proposals as being harmful to industry. Some analysts believe that limitations on executive compensation will drive talent from American financial firms to foreign firms. Others express concern at applying Treasury's executive compensation rules to all publicly traded companies, rather than financial institutions only.

Institutional investors have expressed support for executive compensation limits. Say-on-pay has become more acceptable, and makes boards more careful about rewarding underperforming CEOs. Others indicated that say-on-pay is already in effect at approximately 25 companies and that other businesses will not oppose the measure.

For these reasons, executive compensation will continue to be an important part of Congress' regulatory agenda going forward.

XIII. Other Regulatory Reform Initiatives

A. Government Sponsored Entities ("GSEs")

The 2008 Housing and Economic Recovery Act ("HERA") created the Federal Housing Finance Agency ("FHFA"), a new independent regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. HERA provided the FHFA with temporary emergency authority allowing the Treasury to inject capital into Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, through December 31, 2009. Both Fannie and Freddie have been in conservatorship since September 7, 2008, and under control of the FHFA.

President Obama's regulatory reform proposal states that the Treasury and the Department of Housing and Urban Development, together with other government agencies, will explore options regarding the future of the GSEs, and report to the Congress and the American public at the time of the President's 2011 budget. And Secretary Geithner in the June 18, 2009 Senate Banking Committee hearing on *The Administration's Proposal to Modernize the Financial Regulatory System*, noted that they had not yet designed a process for dealing with GSEs, and he believed it reasonable to take and make recommendations in the first half of 2010.

The budget report for 2011 is slated to come out in late February or early March of 2010, however, the Administration could lay out their plan for GSEs as early as the 2010 State of the Union address. It is possible that members of Congress will continue to examine the interim state of the GSE's in due process of overall consideration of the Obama plan.

B. Short Selling

On March 16, 2009, Sen. Ted Kaufman (D-DE) introduced S.605, 111th Cong. (2009), which directs the SEC to take specified actions to regulate short sales of securities, including:

- reinstating regulations in effect on July 5, 2007, prohibiting short sales of securities unless the previous price movement on such securities had been upward (the uptick rule);
- rescinding the prohibition against applying certain price tests to short sales;
- requiring trades by short sellers to yield priority and preference to transactions effected by long sellers of securities;
- prohibiting short sales of securities of financial institutions unless such trades are effected at a price (in minimum lots, as specified by the SEC) that is at least five cents higher than the immediately preceding transaction in such securities; and
- issuing regulations that prohibit short sales unless the seller can demonstrate a legally enforceable right to deliver the securities at the required delivery date and that require all short sales to settle on the same time frame employed for long sales of the same securities.

In addition, in March of 2009, several members of Congress called for the return of the uptick rule, followed by the SEC approving the release of five proposals for reinstating the uptick rule on April 9, 2009. Each proposal has a public comment period that runs through June 19, 2009. An SEC decision is expected in October of 2009.

If Congress is not satisfied with the SEC's ongoing re-examination of Rule 204(T) and Regulation SHO expected to conclude in the fall, it is possible that the Senate will look at its possible inclusion in the regulatory reform legislation.

C. Municipal Bonds

Rep. Gerry Connolly (D-VA) introduced the Federal Municipal Bond Marketing Support and Securitization Act of 2009, which was designed to jumpstart the issuance of municipal bonds by giving the Treasury Department, the Federal Reserve, and the Federal Financial Bank new authority to guarantee and purchase municipal securities.

And in May 2009, the House Financial Services Committee held hearings to discuss four independent pieces of legislation aimed to improve the efficiency and oversight of municipal finance. The legislation included:

- the Municipal Bond Fairness Act which seeks to ensure a consistent rating system is applied to municipal and corporate bonds;

- the Municipal Bond Insurance Enhancement Act which creates an Office of Public Finance in the Treasury Department to provide reinsurance coverage for insured losses of qualified municipal bond insurers;
- the Municipal Bond Liquidity Enhancement Act which provides the Federal Reserve with the necessary authority to create a lending facility for the purchase of certain variable rate demand obligations and short-term bonds issued by a municipal issuer; and
- the Municipal Advisers Regulation Act which would permit the SEC to regulate municipal financial advisors.

D. Money Market Funds

Money market funds are considered one of the most stable and least risky investment vehicles available on the market. Nonetheless, the credit crisis, particularly the bankruptcy of Lehman Brothers, demonstrated that money market funds were not immune from the consequences of the failure of systemically important institutions. Treasury's Framework for Regulatory Reform indicates that the SEC should strengthen the regulatory framework, supporting money market funds in order to reduce the credit and liquidity risk profile of individual money market funds and to make the money market fund industry as a whole less susceptible to runs.

The Investment Company Institute ("ICI") formed a Money Market Working Group to develop recommendations to "improve the functioning of the money market and, in particular, the operation and regulation of money market funds."²⁵ According to the ICI their recommendations are designed to better position money market funds to sustain prolonged and extreme redemption pressures. Furthermore, the recommendations aim at immediately stopping runs that may strike money market funds and treating shareholders fairly if such an event occurs.

Specifically, the ICI recommends that the SEC:

- Impose daily and weekly minimum liquidity requirements on money market funds. The ICI also recommends regular stress testing of a money market fund's portfolio.
- Tighten the portfolio maturity limit applicable to money market funds and add a new portfolio maturity limit.
- Raise the credit quality standards under which money market funds operate by requiring a "new products" or similar committee; encouraging advisers to follow best practices for determining minimal credit risks; requiring advisers to designate the credit rating agencies their funds will follow to encourage competition among the rating agencies to achieve this designation; and prohibiting investments in "Second Tier Securities."
- Require money market fund advisers to adopt "know your client" procedures and require them to disclose client concentrations by type of client and the potential risks, if any, posed by a fund with a client base that is strongly concentrated.
- Enhance risk disclosure for investors and the market and require monthly website disclosure of a money market fund's portfolio holdings.
- Assure that when a money market fund proves unable to maintain a stable \$1.00 NAV, all of its shareholders are treated fairly. A money market fund's board of directors, or a committee of the board, would be authorized to suspend redemptions and purchases of fund shares

temporarily under certain situations, and permanently for funds preparing to liquidate, in order to ensure that all shareholders are treated fairly.

- Enhance government oversight of the money market by developing a nonpublic reporting regime for all institutional investors in the money market, including money market funds, and encourage the SEC staff to monitor higher-than-peer performance of money market funds.
- Address market confusion about money market institutional investors that appear to be – but are not – money market funds.²⁶

E. Money Service Businesses (“MSBs”)

On June 3, 2009, the House Subcommittee on Financial Institutions and Consumer Credit held a hearing on regulation and disclosure requirements for Money Service Businesses (“MSBs”) engaged in the business of money transmission and, in particular, in international remittances. The focus of the hearing was on the perceived need for uniform remittance disclosures; the wide support for federal regulation of MSBs and international money transmitters; the current patchwork of state regulations and the associated increased compliance costs for MSBs; and the concern that many depository institutions are refusing to provide services to MSBs as a result of regulatory burdens associated with banking such entities.

On May 12, 2009, the Financial Crimes Enforcement Network (“FinCEN”) issued a notice of proposed rulemaking regarding regulations promulgated under the Bank Secrecy Act; the comment period runs until September 9, 2009. The main purpose of the proposed rulemaking is to address new areas of development, international transactions, and Internet based businesses.

XIV. About Patton Boggs

A. About the Firm

The current economic environment has created unprecedented challenges for the financial services industry. What began as a subprime mortgage crisis has evolved into a mortgage “meltdown,” potentially affecting the performance of many types of mortgages, as well as residential, construction and commercial real estate loans. The resulting decline in credit quality has adversely impacted many financial institutions’ liquidity and capital levels, leading to a variety of regulatory enforcement actions and a wide range of litigation.

Patton Boggs is uniquely positioned to assist financial institutions as they face a myriad of challenges. Nationally recognized as a premier provider of legal representation to financial sector businesses throughout the United States, we have provided strategic counsel to commercial banks, savings institutions, bank and thrift holding companies, mortgage companies, real estate investment trusts (“REITs”) and specialty finance companies for decades.

Based in Washington, D.C., Patton Boggs is a leader in public policy, litigation, and business law, and is well known for its deep bipartisan roots in the U.S. political arena. The firm’s core practice areas are Public Policy and Regulatory, Litigation, Business, and Intellectual Property. With offices in New York, New Jersey, Dallas, Denver, Anchorage, and Northern Virginia and internationally in Doha, Qatar and Abu Dhabi, United Arab Emirates, more than 600 lawyers and professionals provide comprehensive, practical, and cost-effective legal counsel to clients around the globe. For more information, visit us at www.pattonboggs.com.

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XV. Appendix A: Acronyms

- ABA - American Bankers Association
- ABCP - Asset Backed Commercial Paper
- ABS - Asset-Backed Securities
- CARD - Credit Card Accountability Responsibility and Disclosure Act of 2009
- CCP - Central Counterparty
- CDS - Credit Default Swaps
- CEO - Chief Executive Officer
- CFO - Chief Financial Officer
- CFPA - Consumer Financial Protection Agency
- CFTC - Commodity Futures Trading Commission
- CMBS - Commercial Mortgage-Backed Securities
- COP - Congressional Oversight Panel
- CRA - Credit Rating Agency
- CSBS - Conference of State Bank Supervisors
- EESA - Emergency Economic Stabilization Act of 2008
- EFA - Exceptional Financial Assistance
- FAOB - Federal Accounting Oversight Board
- FASB - Financial Accounting Standards Board
- FBAR - Foreign Bank and Financial Account
- FDIC - Federal Deposit Insurance Corporation
- FDICIA - Federal Deposit Insurance Corporation Improvement Act
- FHFA - Federal Housing Finance Agency
- FHCs - Financial Holding Companies
- FinCEN - Financial Crimes Enforcement Network
- FPSC - Financial Product Safety Commission
- FSB - Financial Stability Board
- FSF - Financial Stability Forum
- GAAP - Generally Accepted Accounting Principles
- GAO - Government Accountability Office
- GSEs - Government Sponsored Entities
- HOEPA - Home Ownership and Equity Protection Act
- ICI - Investment Company Institute

- ILCs - Industrial Loan Companies
- IMF - International Monetary Fund
- ISBA - International Accounting Standards Board
- ISDA - International Swaps and Derivatives Association, Inc.
- MHA - Making Home Affordable Program
- MSBs - Money Service Businesses
- NAIC - National Association of Insurance Commissioners
- NCUA - National Credit Union Association
- NICPA - National Agencies and National Insurance Providers
- NBS - National Bank Supervisor
- NRSROs - Nationally Recognized Statistical Rating Organizations
- OCC - Office of Comptroller of the Currency
- ONI - Office of National Insurance
- OTC - Over-the-Counter (derivatives market)
- OTS - Office of Thrift Supervision
- PCAOB - Public Company Accounting Oversight Board
- PWG - President's Working Group
- SEC - Securities and Exchange Commission
- SEOs - Senior Executive Officers
- TALF - Term Asset-Backed Securities Loan Facility
- TARP - Troubled Asset Relief Program

XVI. Endnotes

¹ Due to publication deadlines, this report covers regulatory and legislative actions that occurred up through July 31, 2009, with the exception of Chapter VII on Derivatives, which includes the Administration's August 11, 2009 regulatory proposal.

² David Cho ET AL., "Anticipating Resistance On Tight Management Of The Financial Sector, Obama Changes Track On Reform Plans", Washington Post, June 10, 2009, *available at* <http://www.cbsnews.com/stories/2009/06/09/politics/washingtonpost/main5074870.shtml>.

³ The restoration plan would need to specify: (1) the steps the Tier 1 FHC will take to become well capitalized; (2) the levels of capital to be attained by the Tier 1 FHC during each year in which the plan will be in effect; (3) how the Tier 1 FHC will comply with the restrictions or requirements then in effect for Tier 1 FHCs; (4) the types and levels of activities in which the Tier 1 FHC will engage; and (5) any other information that the Board requires. If the Tier 1 FHC fails to submit and implement their restoration plan the Board may: (1) require the Tier 1 FHC to sell enough shares or obligations of the Tier 1 FHC so that the Tier 1 FHC will be well capitalized after the sale; (2) further require that instruments sold under clause (1) be voting shares; (3) require the Tier 1 FHC to be acquired by or combine with another company; (4) require the Tier 1 FHC to comply with section 23A of the Federal Reserve Act (12 U.S.C. § 371c), as if it were a member bank, thus restricting its transactions with affiliates; (5) restrict the Tier 1 FHC's asset growth; (6) require the Tier 1 FHC or any of its subsidiaries to alter, reduce, or terminate any activity that the Board determines poses excessive risk to the Tier 1 FHC; (7) improve management by dismissing and replacing directors and senior executive officers; (8) require the Tier 1 FHC to divest itself of or liquidate any subsidiary if the Board determines that the subsidiary is in danger of becoming insolvent, poses a significant risk to the Tier 1 FHC, or is likely to cause a significant dissipation of the Tier 1 FHC's assets or earnings; and (9) require the Tier 1 FHC to take any other action that the Board determines will better carry out the purpose of the restoration plan.

⁴ A Tier 1 FHC is considered critically undercapitalized if it does not meet the ratio of tangible assets (or any other standard) the Board has specified.

⁵ A Tier 1 FHC and bank holding company are determined to be in default or danger of default if any of the following conditions exist: (1) a case has been, or likely will promptly be, commenced with respect to the

Tier 1 FHC or bank holding company under title 11, United States Code; (2) the Tier 1 FHC or bank holding company is critically undercapitalized, as such term has been or may be defined by the Federal Reserve Board; (3) the Tier 1 FHC or bank holding company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion without assistance under section 1204; (4) the Tier 1 FHC or bank holding company's assets are, or are likely to be, less than its obligations to creditors and others; or (5) the Tier 1 FHC or bank holding company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.

⁶ If the failing institution is a bank or thrift then a two-thirds vote of the FDIC Board is required. If the largest subsidiary of the firm is a broker-dealer, then approval by two-thirds of the Commissioners of the SEC is required. And if the failing firm is an insurance company, then the new Office of National Insurance must be consulted. Once the Treasury Secretary determines the Tier 1 FHC or bank holding company will be resolved, he may appoint the SEC or the FDIC - whichever agency is appropriate for the firm at hand - to be the conservator and/or receiver. As conservator the agency may take any action as may be necessary to put the Tier 1 FHC or bank holding company in a sound and solvent condition, and may do whatever is appropriate to carry on the business of the Tier 1 FHC or bank holding company and preserve and conserve its assets and property. As receiver the agency may place the Tier 1 or bank holding company in liquidation and proceed in such manner as the agency deems appropriate, including through the sale of assets, the transfer of assets to a bridge bank holding company, or the exercise of any other rights or privileges granted to the receiver. As conservator or receiver the agency may also merge the Tier 1 FHC or bank holding company with another company, or transfer any asset or liability of the Tier 1 FHC or bank holding company (including assets and liabilities associated with any trust or custody business) without obtaining any approval, assignment, or consent with respect to such transfer.

⁷ Senate Banking Committee Hearing on "Establishing a Framework for Systemic Risk Regulation," July 23, 2009.

⁸ Congressional Oversight Panel, *Special Report on Regulatory Reform* (Jan. 29, 2009), *available at* <http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf>.

⁹ The G-30, *Financial Reform, A Framework for Financial Stability* (Jan. 15, 2009) (G-30 Report), available at www.group30.org/pubs/reformreport.pdf.

¹⁰ The G-20, *Leader's Statement* (Apr. 2, 2009), available at <http://www.g20.org/Documents/final-communique.pdf>.

¹¹ Press Release, U.S. Department of the Treasury, Treasury Outlines Framework For Regulatory Reform (Mar. 26, 2009), available at <http://www.ustreas.gov/press/releases/tg72.htm>.

¹² Securities Act of 1933, Rule 501. <http://www.sec.gov/answers/accred.htm>.

¹³ The minimum amount for one person is an income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year.

¹⁴ White House Blog, *A Turning Point*, April 2, 2009 (quoting President Obama at the G-20 Summit), available at <http://www.whitehouse.gov/blog/09/04/02/A-Turning-Point/>.

¹⁵ Press Release, Senator Carl Levin (D-MI), Grassley and Levin Introduce Hedge Fund Transparency Bill, available at <http://levin.senate.gov/newsroom/release.cfm?id=307481>.

¹⁶ These proposed bills were: (1) S. 681 ("The Stop Tax Haven Abuse Act"), which was a bill to restrict the use of offshore tax havens and abuse of tax shelters to inappropriately avoid Federal taxation; (2) H.R. 3417 ("The Commission on the Tax Treatment of Hedge Funds and Private Equity Act of 2007") which would establish a Commission to investigate imposing regulations; (3) S. 1402 ("The Hedge Fund Registration Act of 2007"), which was a bill to amend the Investment Advisors Act of 1940, with respect to the exemption to registration requirements for hedge funds; (4) S. 1624, which was a bill to amend the Internal Revenue Code of 1986 to provide that the exception from the treatment of publicly traded partnerships as corporations for partnerships with passive-type income shall not apply to partnerships directly or indirectly deriving income from providing investment adviser and related asset management services; and (5) S. 3268 ("The Stop Excessive Energy Speculation Act of 2008"), which was a bill to amend the Commodity Exchange Act to prevent excessive price speculation with respect to energy commodities. The bill would give the federal regulator of futures markets the resources to detect, prevent, and punish price manipulation and excessive speculation.

¹⁷ The Hedge Fund Study Act (H.R. 713) would require the President's Working Group ("PWG") to conduct a study of the hedge fund industry, including an analysis of: (1) the changing nature of hedge funds and what characteristics define a hedge fund; (2) the growth of hedge funds within financial markets; (3) the growth of pension funds investing in hedge funds; (4) whether hedge fund investors are able to protect themselves adequately from the risk associated with their investments; (5) whether hedge fund leverage is effectively constrained; (6) the potential risks hedge funds pose to financial markets or to investors; (7) various international approaches to the regulation of hedge funds; and (8) the benefits of the hedge fund industry to the economy and the markets. Within 180 days of enactment, the bill would require the PWG's report to be issued including recommendations on: (1) any proposed legislation relating to appropriate disclosure requirements for hedge funds; (2) the type of information hedge funds should disclose to regulators and to the public; (3) any efforts the hedge fund industry or regulators of financial institutions should undertake to improve practices or provide examples of successful industry initiatives; and (4) any oversight responsibilities that members of the PWG should have over the hedge fund industry, and the degree and scope of such oversight.

¹⁸ House Committee on Oversight and Government Reform Hearing on "*Credit Rating Agencies and the Financial Crisis*," October 22, 2008, available at <http://oversight.house.gov/story.asp?ID-2250>.

¹⁹ The Emergency Economic Stabilization Act ("EESA") Congressional Oversight Panel.

²⁰ Policy Statement of the President's Working Group ("PWG") on Financial Markets.

²¹ G-30 Report.

²² Treasury Outlines Framework for Regulatory Reform.

²³ G-30 Report.

²⁴ The restrictions are:
 - CLAWBACK: Any bonus, retention award, or incentive compensation paid to an SEO or one of the next 20 most highly compensated employees must be subject to clawback if the payments were based on materially inaccurate information.
 - PROHIBITIONS: No bonuses, retention awards or incentive compensation can be paid to certain employees (the amount of TARP funds received by the employer will determine the employees to whom this prohibition applies – the greater the amount of funds, the greater the number of employees that are subject to the prohibition).

Bonuses, retention awards or incentive compensation cannot be delayed until after there are no obligations outstanding in order to avoid this rule. Commissions and arrangements where employees receive employer stock are not subject to the prohibition, provided the commission or stock arrangements meet certain standards. Golden parachute payments cannot be made to an CEO or the next 5 most highly compensated employees. Golden parachute payments cannot defer payments until after there are no obligations outstanding. No tax gross-ups or reimbursements for taxes paid are allowed for CEOs and the next 20 most highly compensated employees.

- COMPENSATION COMMITTEE: A compensation committee of independent board members must be formed to undertake periodic review of CEO and employee compensation plans, either (i) within 90 days of the closing date of the agreement between Treasury and the employer or (ii) 9/14/09 (whichever occurs sooner). For TARP recipients receiving less than \$25 million in funds the employer must either establish this committee or delegate review to the board of directors.

- DISCLOSURE: TARP recipients must disclose to Treasury and its federal regulator (i) any “perks” with total value over \$25,000 for the year afforded to an employee subject to the restrictions for bonus payments, and (ii) any engagement with a compensation consultant.

- EXCESSIVE/LUXURY EXPENDITURES POLICY: An excessive or luxury expenditures policy must be adopted, either (i) within 90 days of the closing date of the agreement between Treasury and the employer or (ii) 9/14/09 (whichever occurs sooner).

- SHAREHOLDER VOTE: A separate shareholder vote to approve executive compensation must be allowed.

- SPECIAL MASTER: The interim rule provides for establishment of the Office of Special Master for TARP Executive Compensation. For TARP recipients that receive “exceptional financial assistance” (“EFA”) (i.e., assistance under Systemically Significant Failing Institutions, Targeted Investment Program, Automotive Industry Financing Program, or any new program that qualifies as EFA) all compensation payments and structures for the CEO, all other executive officers, and 100 most highly compensated employees must be submitted to the Office of the Special Master for approval, unless the employer agrees to limit compensation for CEOs or the most highly compensated employees to \$500,000.

²⁵ Investment Company Institute, Report of the Money Market Working Group (March 17, 2009) at 3.

²⁶ *Id.* at 4.

ACC Extras

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Financial Regulatory Reform -- Full Steam Ahead for Regulators Despite
Expansive Legislative Proposals.

Webcast. September 2009

<http://www.acc.com/education/webcasts/financialregulatoryreform.cfm>

Winds of Change: Weathering Regulatory Financial Reform.

Webcast. May 2009

<http://www.acc.com/education/webcasts/windsofchange.cfm>

Financial Services General Counsel Roundtable.

Program Material. October 2008

<http://www.acc.com/legalresources/resource.cfm?show=154663>

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