Are We Halfway There Yet? House Passes Major Financial Services Bill While Senate Expected to Defer to Early Next Year

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On December 11, 2009, the House approved the approximately 1500-page Wall Street Reform and Consumer Protection Act of 2009 ("H.R. 4173" or the "Act"), a complex and sweeping overhaul of all aspects of financial services regulation that, if signed into law, will dramatically change the regulatory landscape. The House debated the bill and voted to approve a number of additional amendments, including a lengthy Manager's Amendment submitted by House Financial Services Committee Chair Barney Frank and a substitute over-the-counter ("OTC") derivatives bill negotiated between Chairman Frank and House Agriculture Committee Chair Collin Peterson. The final bill passed by a vote of 223-202 with no affirmative Republican votes.

This ambitious piece of legislation, among other things, would incorporate regulation and resolution of systemically important financial institutions, significantly expand federal oversight of and place substantial activities restrictions on depository institutions, regulate for the first time the OTC derivatives markets, splitting regulatory oversight between the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC"), create a new Consumer Financial Protection Agency

("CFPA") to regulate consumer financial products and services, require registration of advisers to most types of private investment funds, substantially enhance the SEC's oversight and enforcement authorities, increase oversight over credit rating agencies, and create a federal framework to address predatory mortgage lending.

The Act generally incorporates the Administration's priorities as set forth in its June 17, 2009 White Paper on financial regulatory reform,[1] but it also reflects a hard-fought negotiation process, resulting in a highly complex and cumbersome piece of legislation that will take time to parse.

H.R. 4173 now goes to the Senate for its consideration. The Senate will craft its own bill, led by Senate Banking Committee Chair Christopher Dodd. Senator Dodd released a discussion draft bill a few weeks ago, which was criticized by both Democrats and Republicans on the Banking Committee, prompting the Senator to divide the Committee members into working groups to which specific reform topics have been assigned. It is expected that Senator Dodd will receive a report from each group soon, but further consideration has been delayed until next year.

Overview of H.R. 4173

Title I—Financial Stability Improvement Act. Title I of the Act would establish a Financial Services Oversight Council ("Council"), comprised of the heads of the major federal financial regulatory bodies and chaired by the Secretary of the Treasury. The Council also would include as nonvoting members a state insurance commissioner and a state banking supervisor. The Council, which would not be deemed an "agency" for purposes of state or federal law, would have responsibility for, among other things, monitoring the markets to identify potential systemic risks, developing plans to prepare for threats, imposing financial companies and financial activities to stricter prudential oversight, monitoring international regulatory developments to identify conflicts, and resolving jurisdictional disputes among Council members. The Council and the Board of Governors of the Federal Reserve System (the "Federal Reserve") would be authorized to obtain information necessary to fulfill these functions.

Under certain circumstances, financial holding companies or financial activities or practices would be subject to heightened prudential requirements or other limitations, such as restrictions on proprietary trading. Companies subject to stricter standards would be required to conduct quarterly stress tests. Additional requirements would apply to significantly undercapitalized financial holding companies that are subject to stricter standards. The Council would be required to conduct a study on the effects of placing limitations on financial companies to prevent them from being "too big to fail." If the Council determined that a "liquidity event exists that could destabilize the financial system," a program could be set up to mitigate adverse systemic effects through guarantees of obligations of solvent entities. Participants in the program would be required to fund its costs.

Generally, H.R. 4173 would eliminate the exception from the definition of "bank" in the Bank Holding Company Act that had excepted industrial loan companies ("ILCs"), savings and loan holding companies, trust companies, and similar "non-bank" banks from the requirement that their parent holding companies register with the Federal Reserve and thereby be subject to the restrictions on non-banking activities in the Bank Holding Company Act. Many of the parent companies of these kinds of "non-bank" banks have extensive commercial and industrial operations that are prohibited to registered bank holding companies.

The Act provides several "rollover" grandfather provisions that appear to continue the exception for unitary savings and loan holding companies previously grandfathered by Title IV of the Gramm-Leach-Bliley Act in 1999. The commercial or industrial parent companies of ILCs and trust companies and the other "non-bank" banks would be required to establish an intermediate holding company, a so-called Section 6 financial holding company, that would become subject to the Bank Holding Company Act as if it were a bank holding company that had elected to be a financial holding company. This would leave the industrial company as the ultimate holding company that would not be required to divest itself of its industrial and commercial operations. Ironically, a systemically important determination could nonetheless apply to a number of these industrial and commercial companies that have depository subsidiaries.

H.R. 4173 would abolish the Office of Thrift Supervision, incorporating its functions into a division of the Office of the Comptroller of the Currency ("OCC"). Federally-chartered thrifts would be transferred to the OCC, while state-chartered thrifts would be transferred to the Federal Deposit Insurance Corporation ("FDIC").

Title I also provides that the Federal Reserve and the appropriate regulatory agency would recommend that the Secretary of the Treasury make a systemic risk determination with respect to a financial company. The Secretary (in consultation with the President) would make the determination that the financial company is in default or is in danger of default, that the failure of the financial company and its resolution under otherwise applicable federal or state law would have serious adverse effects on financial stability or economic conditions in the U.S., and that taking emergency action would avoid or mitigate the adverse effects. The appropriate regulatory agency would place the financial company into resolution, but the FDIC would have back-up authority to do so. The Secretary would take action, including appointing the FDIC (or other regulatory agency as appropriate) as receiver, but only if failure and resolution under the Bankruptcy Code would be systemically destabilizing. Before the Secretary or the FDIC could act, the Federal Reserve or the appropriate federal regulatory agency would be required to attempt to avoid or mitigate potential adverse effects on low-income, minority, or underserved communities affected by the failure of the financial company.

The costs of liquidating a financial company initially would be paid from the company's assets and borne by the company's shareholders and unsecured creditors and, in the event that the amount available for payment of claims is insufficient to satisfy the obligations to the federal government or to the resolution fund and the interests of the junior creditors and shareholders have been completely eliminated, by the secured creditors up to 10 percent of their claims. Excess costs would be paid through assessments on large financial companies into a new Systemic Dissolution Fund ("SDF"), established specifically for the resolution of failed financial companies that pose a systemic threat and funded through risk-based assessments on financial companies (including managers of hedge funds) above certain asset size thresholds. The SDF would be maintained and administered by the FDIC, separate and apart from the Deposit Insurance Fund. The Act also provides for additional borrowing authority from the Treasury.

After the FDIC has been appointed receiver, it would be authorized to take certain emergency stabilization actions, but only if six specified mandatory terms and conditions are met. The powers and authorities of the FDIC to resolve the financial company would be similar to those it now has to resolve insured banks, including the ability to liquidate, sell, merge, transfer assets or organize a bridge entity. In assessing financial companies, the FDIC, in consultation with the Council, would be required to establish a risk matrix taking into account general economic conditions so that higher assessments could be levied in good economic times and lower assessments in bad, basing it on numerous risk factors, and differentiating among financial companies considering such factors as complexity of operations or organization, interconnectedness, size, and direct or indirect activities.

Finally, the ability of the Federal Reserve to lend in unusual and exigent circumstances, pursuant to its authority under Section 13(c) of the Federal Reserve Act, would be sharply curtailed. The Act provides, among other things, that: such emergency lending could only occur upon the written determination of the Council (by a vote of at least two-thirds) that a liquidity event exists that could destabilize the financial system; written consent is given by the Secretary after certification by the President that an emergency exists; the instruments to be discounted by the Federal Reserve conform to certain standards; the collateral required by the Federal Reserve is of specified quality; and such lending is part of a broadly-available credit or other facility and not for a single and specific individual, partnership or corporation.

Title II—Corporate And Financial Institution Compensation Fairness Act. Title II of the Act generally tracks the Administration's proposed legislation, and would require an annual non-binding say-on-pay shareholder and independent compensation committees for all public companies. The Act also contains both substantive and disclosure provisions relating to "perverse incentives" in executive compensation at financial institutions. The Administration's proposal did not directly address perverse incentives.

Title III—Derivative Markets Transparency and Accountability Act. The Over-The-Counter Derivatives Markets Act that initially passed out of the Financial Services Committee was replaced in its entirety by an amendment negotiated by Reps. Frank and Peterson. Title III would divide jurisdiction over the OTC derivatives markets between the SEC, which would have jurisdiction over security-based swaps, and the CFTC, which would have jurisdiction over all other swaps. Swap dealers and "major swap participants" would be required to register and be subject to numerous requirements, including those relating to capital and margin. The Act defines "major swap participant" to exclude non-dealers whose positions are held primarily for hedging, reducing or otherwise mitigating commercial risk, as long as their outstanding swaps do not create substantial net counterparty exposure that could pose systemic risk.

Swaps, if accepted for clearing, would be required to be cleared through a registered derivatives clearing organization and traded on a regulated exchange or swap execution facility. To prevent conflicts of interest, certain swap dealers and major swap participants would be restricted from directly or indirectly owning more than 20 percent of a clearing organization's voting securities. The SEC and the CFTC would be required to determine whether a swap or class of swaps should be cleared. Swaps not cleared would need to be reported to a central repository. A contract would not need to be cleared if one of the parties is neither a swap dealer nor a major swap participant, is using the swap to hedge against commercial risk, and notifies the appropriate regulator how it generally meets its financial obligations in connection with non-cleared swaps.

Title IV—Consumer Financial Protection Agency Act. Title IV of the Act would establish the CFPA, a new independent agency with significant authority over rule-writing, supervision and enforcement relating to consumer financial products and services other than securities-related products and services. An eleventh-hour compromise on preemption, negotiated among the Administration, Chairman Frank, and a group of conservative and moderate Democrats provides that state consumer financial laws would be preempted only to the extent they prevent, significantly interfere with, or materially impair a federally-chartered bank from engaging "in the business of banking." Either a court or the OCC would be authorized to make a preemption determination on a case by case basis. The Act would exclude lawyers from the CFPA's reach to the extent that their activities involve the practice of law.

Title V—Capital Markets. Title V contains several subtitles relating to regulation of the U.S. capital markets, including regulation relating to private investment fund advisers, credit rating agencies, and investor protection.

The Private Fund Investment Advisers Registration Act would require registration under the Investment Advisers Act of 1940 of most private fund advisers as well as new recordkeeping and disclosure requirements. Advisers to hedge funds, private equity firms, single-family offices, and other private pools of capital with assets under management of at least $150 million would be covered. However, advisers to venture capital funds (to be defined by the SEC) would be exempt from registration but would be subject to some disclosure and recordkeeping requirements.

Credit Rating Agencies. The Act would amend the Securities Exchange Act of 1934 to require additional disclosures by and internal controls for credit rating agencies.

The Investor Protection Act contains numerous provisions that would enhance the SEC's authority. It would establish an Investor Advisory Committee to address the SEC's regulatory priorities as well as issues relating to the regulation of securities products, trading strategies, fee structures, and effectiveness of disclosure. This subtitle also would provide, among other things, for a uniform standard of conduct for broker-dealers and investment advisers as to personalized investment advice to retail customers. The Manager's Amendment clarifies that broker-dealers would not owe a continuing "duty of care or loyalty" to the customer after providing securities advice. This subtitle also would permit the SEC to limit pre-dispute arbitration clauses imposed by broker-dealers and would make auditors of non-public broker-dealers subject to regulation by the Public Company Accounting Oversight Board. It would enhance the SEC's powers to enforce the securities laws in various respects, including empowering the SEC to make monetary awards to whistleblowers. Finally, this subtitle would permit the SEC to adopt rules regarding proxy access for all public companies and would exempt small reporting companies from the Sarbanes-Oxley Act's requirement for audits of their internal controls over financial reporting.

Title VI—Federal Insurance Office. H.R. 4173 would create a Federal Insurance Office ("FIO") to gather insurance information for the federal government. The FIO would be permitted to negotiate international agreements jointly with the Office of the U.S. Trade Representative. Also of interest to the insurance industry is a decision by the House to clarify that credit insurance activities would not be within the scope of the CFPA. In all other respects, the House legislation is most notable for not addressing an optional Federal charter for insurers, the status of equity index annuity contracts as a "security," and the absence of suitability duties in the sale of insurance policies and annuity contracts.

Title VII—Mortgage Reform and Anti-Predatory Lending Act. This title, approved by the House in May by a vote of 300-114, contains comprehensive mortgage reform and anti-predatory lending measures designed to prevent abusive lending practices.

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[1] WilmerHale Alert: "President Obama's Regulatory Reform Proposal—Major Overhaul or Missed Opportunity?", June 17, 2009, available here.

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