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FINANCIAL REGULATORY REFORM POLICY UPDATE (PRELIMINARY)

From: Patton Boggs Financial Services Policy Group
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Subject: Senate Banking Committee Chairman Christopher Dodd Releases Discussion Draft of "Restoring American Financial Stability Act of 2009"

On November 10, 2009, the U.S. Senate Banking Chairman Christopher Dodd (D-CT) released a discussion draft of the "Restoring American Financial Stability Act of 2009" (RAFSA), a measure that would provide for a historic overhaul of the financial services regulatory system. The following is a preliminary summary of highlights of the proposal based on an initial review, with further analysis to be included in a follow-up report.

I. Executive Summary

The RAFSA is a comprehensive regulatory reform package that encompasses key elements of the Obama Administration's previously announced initiatives for a historic overhaul of the U.S. financial regulatory framework. Key components of the RAFSA include the creation of a systemic risk regulator, creation of a resolution authority, consolidation of prudential oversight into one agency, establishment of a consumer protection agency for financial products, enhanced executive compensation and corporate governance standards, regulation of derivatives, insurance companies, credit rating agencies, among myriad other provisions.

Timing. Notably, the discussion draft is a starting point of negotiations with further comments from members of the Senate Banking Committee anticipated to be received in the weeks ahead before it is formally introduced and marked up. The proposal as presently drafted does not have bipartisan support in the Senate. Meanwhile, the House Financial Services Committee is working on its counterpart measures for regulatory reform through individual legislative vehicles rather than a comprehensive package. Chairman Barney Frank (D-MA) has indicated a goal to move his individual pieces of regulatory reform legislation to the House floor as early as the first week of December. Negotiations to reconcile Senate and House versions are anticipated to continue through early 2010.

II. Discussion of Key Elements of the Proposal

The following is a summary of selected key provisions of the bill, including (1) consolidation of regulators into the Financial Institutions Regulatory Administration as a single super-regulator; (2) creation of the Agency for Financial Stability as a systemic risk regulator (3) resolution authority; (4) creation of a Consumer Financial Protection Agency; (5) role of the Federal Reserve; (6) regulation of the insurance industry; (7) regulation of derivatives; (8) regulation of hedge funds; (9) executive

compensation provisions; (10) SEC self-funding; (11) corporate governance provisions; and (12) regulation of credit rating agencies.

1. Consolidation Into Single Prudential Regulator

FIRA. The proposal would create the Financial Institutions Regulatory Administration (FIRA) as single prudential regulator by consolidating the oversight duties of the Office of Thrift Supervision (OTS), the Office of the Comptroller of Currency (OCC), the state bank supervisory functions of the Federal Reserve and the Federal Deposit Insurance Corp (FDIC), and the bank holding company authority supervision of the Federal Reserve.

Membership. The FIRA would be comprised of (1) an independent chairman appointed by the President and confirmed by the Senate; (2) a Vice Chairman experienced in state banking regulation; and (3) a board including the chairmen of the FDIC and the Federal Reserve and two other independent members. The FIRA would be funded by assessments on the industry.

Dual Banking System Preserved. Notably, the proposal would preserve the dual banking system to leave in place the state banking system that governs community banks. In addition, the measure would establish a separate division within the FIRA for regulation of community banks.

Fee Structure. Section 335 of the proposal grants the FIRA the authority to collect assessments, fees, and other charges from financial institutions. In establishing the amount of such a fee, the proposal permits the FIRA to take into account the total assets of the covered institution (including affiliate of a covered institution), the financial and managerial condition of the covered institution, and the examination rating of a covered institution that is supervised or regulated by FIRA, among other factors.

2. Systemic Risk Regulator

Chairman Dodd's proposal would establish an independent "Agency for Financial Stability" (AFS) which would act as a council of existing regulators to police firms and practices that present a systemic risk to the health of the entire financial system. The AFS would be comprised of: (1) an independent chairman, appointed by the President and confirmed by the Senate; and (2) a board comprised of nine members including the federal financial regulators and two independent members.

Purpose. The stated purpose of the AFS would be: (1) to identify risks to United States financial system stability and economic growth that could arise from the material financial distress or failure of large or complex financial companies; (2) to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and (3) to respond to emerging risks in financial activities and products that could destabilize United States financial markets.

Authority. Among other things, the bill would grant the AFS broad authority, including: (1) to have enhanced supervision and prudential standards including to write increasingly strict rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and

complexity to prevent companies from getting "too big to fail" in the first place; (2) to collect and analyze data to identify and monitor emerging risks to the economy and make reports to Congress to increase transparency; (3) give regulators the authority to break up large, complex companies that pose a systemic risk to the financial stability of the United States; (4) to identify unregulated financial companies that pose systemic risk and assign them to regulation under a federal regulator; and (5) identify systemically important clearing, payment and settlement systems to be regulated by the Federal Reserve.

Capitalization Restoration Plans. Notably, the measure requires that any specified financial company that is undercapitalized shall submit an acceptable capital restoration plan. The contents of the plan are to include: (1) the steps that the specified financial company will take to become capitalized; (2) the levels of capital to be attained by the specified financial company during the year in which the plan is in effect; (3) how the specified financial company will comply with the restrictions or requirements; and (4) the types and levels of activities in which the specified financial company will engage; and (5) other information as required.

3. Resolution Authority

The proposal would establish an enhanced resolution authority with the responsibility to make systemic risk determinations and wind down covered financial companies when necessary. Systemic risk determinations would originate in a written recommendation of the FIRA Board and the FDIC. The recommendation will contain an evaluation as to whether the specified financial company is in default or in danger of default; a description of the effect the default would have on economic conditions or financial stability in the United States; and a proposal regarding the actions that must be taken regarding the specified financial institution.

Upon receiving this written recommendation, if the Secretary of the Treasury agrees with the assessment, the FDIC shall be appointed as the receiver for the covered financial company. While acting as receiver, the FDIC will be successor to all rights, titles, powers and privileges of the covered financial company and take all authorized actions necessary to ensure an orderly resolution of the covered financial company. These actions would include notifying all creditors to allow a presentment of claims and requesting stays in all non-criminal judicial actions or proceedings for up to 90 days. Also, with the approval of the Secretary of the Treasury, the FDIC may provide emergency stabilization measures for the covered financial company, such as purchasing debt obligations, assuming or guaranteeing the obligations of the covered financial company, and selling/transferring all or any part of the acquired assets, liabilities, obligations, equity interests or securities of the covered financial company, among others.

Additionally, at the FDIC's discretion, the FDIC may establish a bridge financial company to aid in the resolution process. This bridge financial company will assume any rights, powers, authorities or privileges of the covered financial company, as well as the covered financial company's assets and liabilities. Such bridge financial companies, however, will not become permanent, but rather must terminate either by merging/consolidating with a non-bridge financial company or at the discretion of the FDIC no more than 2 years after the date in which it was granted charter.

The fee structure for this enhanced resolution authority shall be funded by the Systemic Resolution Fund (the "Fund"). The amounts expended from the Fund by the FDIC for receiver actions will then be repaid in full to the fund from the amounts received through the resolution process. These sources would include the proceeds from the sale of assets of the covered financial company and the transfer of any securities obtained during the emergency securitization process. If these sources are insufficient to repay the amount used from the Fund in full, the difference shall be recouped through assessments on financial companies.

4. Consumer Financial Protection Agency

Chairman Dodd's proposal would establish the Consumer Financial Protection Agency (CFPA) to regulate consumer financial services and products, including mortgages, credit cards and other loan products.

Under the proposal, the CFPA would act as the consolidated regulator of consumer financial protection, assuming certain related functions of the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Federal Trade Commission (FTC), the National Credit Union Administration, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Department of Housing and Urban Development (HUD). The discussion draft would establish a five member board to manage the CFPA. The Director of the Financial Institutions Regulatory Administration (FIRA) would have a seat on the board, with the remaining four members of the board appointed by the President for five-year terms.

Chairman Dodd's proposal would grant the CFPA broad investigatory powers, including the authority to issue subpoenas, and mandate that the CFPA exercise its authority based on an assessment of the risk posed to consumers.

Further, the discussion draft would establish an Office of Financial Literacy responsible for developing and implementing initiatives to improve consumer financial literacy.

5. Role of the Federal Reserve

Under Chairman Dodd's proposal, the Federal Reserve would play a less powerful role than envisioned by both the Obama Administration's proposal, and the House's counterpart legislation.

The press release issued by Senator Dodd's Banking Committee staff on November 10, 2009 summarized the reduced role that Senator Dodd envisions for the Federal Reserve by stating: "The Federal Reserve will focus on monetary policy without being distracted by responsibilities for bank oversight and consumer protections."

What follows is a short list of the various ways that the Dodd proposal would impact the current powers of the Federal Reserve:

- Consumer Protection: the Federal Reserve's current consumer protection authority would be consolidated with other agency's consumer protection powers into the new Consumer Financial Protection Agency;

- Systemic Risk: a new, independent Agency for Financial Stability would be created and tasked with overseeing systemic risks. Prior proposals would have granted the Federal Reserve much of the systemic risk oversight powers that Dodd's proposal will now consolidate under this new regulator. The Agency for Financial Stability would be the front-line regulator for assessing systemic risk, and would have the power to identify systemically important entities for the Federal Reserve to then regulate;

- Lender of Last Resort: Dodd's proposal seeks to limit the Federal Reserve's current 13(3) lender of last resort authority to prevent the Fed from propping-up individual institutions;

- Bank Holding Company Authority: the Federal Reserve's current authority to supervise bank holding companies would be entirely transferred to the new Financial Institutions Regulatory Administration;

- State Bank Supervisory Functions: both the FDIC's and the Federal Reserve's state bank supervisory functions would be transferred to the new Financial Institutions Regulatory Administration.

6. Regulation of the Insurance Industry

The discussion draft of Chairman Dodd's proposed legislation includes the National Office of Insurance Act of 2009. (Section 501) This provision creates a new office, the Office of National Insurance (ONI), within the Treasury Department to monitor the insurance industry and coordinate international insurance issues. However, the bill explicitly states that the ONI is not an insurance regulator. (Section 502).

Additionally, the proposed legislation provides the new agency little authority to preempt state laws, or actions by other federal agencies that relate to insurance. The discussion draft would grant the Office of National Insurance the authority to preempt state insurance regulations to the extent that a non-United States insurer domiciled in a foreign jurisdiction is treated less favorable than a similarly situated United States based insurer. The draft also requires the Treasury Secretary to consult with the U.S. Trade Representative before initiating or concluding any international insurance agreements on prudential measures or measures concerning financial stability. (Section 502).

The National Office of Insurance Act requires a study on ways to modernize insurance regulation. Large insurers and their affiliates must provide certain information to the newly created office to assist in the completion of this study. Small insurers are expressly exempted from this requirement. (The term "small insurer" is not defined. Additional regulations will be promulgated to address the difference between a "large" and "small" insurer.)

Chairman Dodd's proposed bill also incorporates the Nonadmitted and Reinsurance Reform Act of 2009. (Section 511) This provision seeks to streamline the regulation of surplus lines

insurance and reinsurance through state-based reforms. The Nonadmitted and Reinsurance Reform Act of 2009 would put a reinsurer's state of domicile in charge of regulating the reinsurer's solvency. To that end, a state may not impose insurance eligibility requirements or criteria for nonadmitted insurers domiciled in another United States jurisdiction. (Section 524).

7. Regulation of Derivatives

The general framework of Senator Dodd's "Over-the-Counter Derivatives Markets Act of 2009" within the "Restoring American Financial Stability Act of 2009" is similar to that originally offered by the Obama Administration. Among the notable provisions included is the designation of the Agency for Financial Stability to resolve any inability for the SEC and CFTC to jointly prescribe uniform rules. Previous proposals assigned such authority to the Treasury Department or the Court of Appeals for the District of Columbia.

The proposal requires all swaps previously approved by the CFTC or SEC to be cleared through a derivatives clearing organization or clearing agency. It further requires that all "functionally or economically similar" products shall be treated similarly. Once reported, a registered swap repository must provide data to the regulatory agencies to minimize systemic risk, and also provide certain aggregate information to the public.

With respect to reporting of transactions, cleared trades must be reported by the derivatives clearing organization or clearing agency to the CFTC or SEC and any swap repository designated by the CFTC or SEC. For non-cleared derivatives, both counterparties must report the swap either to a registered swap repository or to the CFTC or SEC.

Swaps are required, with limited exception, to be executed through a board of trade designated as a contract market or a registered alternative swap execution facility (ASEF). This legislation does not define an ASEF, and requires registration with the CFTC or SEC even if an ASEF is already registered with and subject to the supervision of the other agency (though it may seek an exemption from registration). Further, the proposed legislation requires than each ASEF comply with a list of core principles, which include adopting position limits, monitoring for market manipulation, and prohibiting trades in swaps readily susceptible to manipulation.

Additionally, the legislation permits the CFTC and SEC to adopt rules and regulations requiring registration of a foreign board of trade that provides the members of a foreign board of trade located in the United States direct access to the electronic trading and order matching system of the foreign board of trade. The legislation does include an exemption to this requirement for any foreign board of trade granted direct access by the CFTC or SEC prior to enactment of this legislation.

8. Regulation of Hedge Funds

Title IV of the RAFSA of 2009, the "Private Fund Investment Adviser Registration Act of 2009" (PFIAR) contains some similarities to the legislation approved by the House Financial Services Committee on October 27th and pending a vote on the House floor (the "Kanjorski Bill"), but in some sense it undoes much of the lobbying work done in the House, especially that expended

on exemptions. The PFIAR reverts to language similar to the Kanjorski Bill discussion draft definition of "private fund" and restricts covered funds to onshore funds that have either a domestic origin or ten percent of the fund's outstanding securities are owned by US person. This is a retraction from the House's attempt to extend the SEC's reach to offshore tax-havens, for example. The bill would include advisers to private funds in the registration requirements, unless otherwise exempted (discussed below).

Like the Kanjorski Bill, the PFIAR also creates a foreign adviser exemption where an adviser has no US place of business, has less than 15 clients that are resident in the US and these clients hold AUM less than $25 MM (or such higher amount as determined by the SEC), and finally, do not hold themselves out as investment advisers or as business development companies.

The information that registered advisers will be required to provide will be, as in the House bill, that information that the Commission determines as necessary and appropriate in the public interest, for the protection of investors or for the assessment of systemic risk by the Agency for Financial Stability (AFS), with which such information will be shared.

As in the Kanjorski Bill and other iterations of the revisions to the Advisers Act, the PFIAR provides that any records of funds of registered advisers will be considered to be the adviser's records as well for reporting purposes. Among the information that will be required to be reported will be: (i) AUM, (ii) counterparties, (iii) trading and investing positions, (iv) valuation method of the underlying funds, (v) the types of assets the funds hold, (vi) side arrangements of the fund and side letters with underlying investors (NOTE: this will be a large point of resistance from fund managers), (vii) trading practices and (viii) other information deemed relevant.

The registered advisers will be subject to periodic and special examinations of their books and records by the SEC and the SEC will be required to provide its data to the AFS that is necessary for assessing systemic risk (such information will be confidential, however). Further, the information filed with the SEC will be confidential except that disclosure will be required to Congress when accompanied by the proper confidentiality agreement, and will also be required to be disclosed to any other federal department or agency or a potential self-regulatory fund body. Data will also be required to be disclosed upon court order, etc.

As in the House bill, the PFIAR also deleted the Adviser Act's prohibition against disclosing underlying fund and investor information and permits the SEC to create different classifications of funds and definitions of terms such as "private equity fund", "venture capital fund" and "client" in order to tailor the information requirements for different classes of funds. Like the original Kanjorski draft, the Dodd draft only provides the SEC and CFTC with 6 months to draft registration rules for dually registered investment advisers.

The PFIAR exempts advisers to "venture capital funds" (to the extent of the provisions of investment advise to venture capital funds) and "private equity funds" from registration, although private equity funds will have to provide reports and records as determined as necessary by the Commission. The act also excludes investment advisers to "family offices" from the definition of "investment advisers" under the act and thus exempts these advisers from registering with the SEC.

In addition, the threshold for hedge funds registering with the SEC has been increased from $25 million to $100 million.

The PFIAR also calls for several GAO studies: (i) within 1 year, whether a self-regulatory fund body could work, (ii) within 1 year, on the appropriate thresholds for "accredited investor" status and any necessary adjustments for inflation, and (iii) within 2 years, the state of short selling including the effect of the newer short sale rules and subsequent trading behaviors. The act also requires the SEC to report to Congress within a year of enactment as to how it has used the data it has collected from hedge funds and their advisers.

Finally, the act requires the SEC to promulgate rules requiring advisers to have custodians only hold the advisers' clients' assets, and the act also changes the standard for natural persons to achieve "accredited investor" status to $200K in income for each natural person (or $300K for a couple) plus $1 million in assets, both adjusted every three (3) years for inflation.

9. Executive Compensation

The following is a brief summary of provisions governing executive compensation:

Nonbinding Shareholder Votes on Compensation (Sections 951 and 952). The bill provides for nonbinding shareholder votes to approve the compensation of executives as well as golden parachute packages entered into as a result of a merger, sale, or other disposition of an issuer.

Compensation Committee Independence (Section 953). National securities exchanges and national securities associations would be required to prohibit the listing of a security on an exchange unless each member of the issuer's compensation committee is "independent." Independence would be defined by, among other factors, the source of the board member's compensation and whether the member is otherwise affiliated with the issuer. An exchange would have some discretion to allow certain issuers flexibility in meeting this independence requirement, such as with respect to smaller issuers. In addition, all advisors or legal counsel to the compensation committee must be independent as well, pursuant to rules to be promulgated by the SEC. Additional rules govern the appointment, compensation, and oversight of compensation consultants and legal counsel hired by a compensation committee, including a requirement that the SEC study and report on the use of compensation consultants over the next several years.

Compensation Disclosures (Sections 954, 956). Each issuer must describe its executive compensation policies in its annual proxy statement, and must provide a clear description of the relationship between executive compensation and financial performance of the company, and a chart or other graphic representation that shows the amount of executive compensation along with the financial performance of the issuer or the return to investors of the issuer during a defined period. Further, issuers must disclose in its proxy statement whether employees of the issuer are allowed to purchase financial instruments (e.g., prepaid variable forward contracts, swaps, collars, exchange funds) that are designed to hedge or offset decreases in market value of securities that are granted to the employees as part of their compensation.

Clawback (Section 955): Where an issuer becomes aware of material noncompliance with financial reporting requirements, the issuer must have a policy to recover any incentive-based compensation paid to an executive that is attributable to the erroneous financial reporting. This clawback rule would apply to stock options that were awarded as compensation.

Compensation at Bank Holding Companies and Insured Depository Institutions (Sections 957, 958, 959). The Financial Institutions Regulatory Administration (FIRA) and other Federal banking agencies will establish rules to prohibit unsafe or unsound compensation practices at bank holding companies and insured depository institutions.

Notably, some provisions in the corporate governance section of the draft are related to the executive compensation provisions, such as the requirement that proxy statements must disclose the reasons for having the same person or different persons serve as chairman and CEO of an issuer (Section 973).

10. SEC Self-Funding

The proposed legislation would amend Section 4 of the Securities Exchange Act of 1934 to allow the SEC to fund itself from fees it collects from financial institutions. Rather than being part of the annual appropriations process, each fiscal year the Chairman of the SEC will prepare and submit to Congress a budget for the Commission. These changes come in response to the recent Madoff scandal, which Chairman Dodd believes exposed the SEC's need for additional funding and to become more self-competent in order to provide the aggressive oversight and regulation necessary to carry out its mission of protecting investors.

Under the Chairman's proposal, the Commission will collect transaction fees and assessments to cover the reasonable costs and expenses of the SEC and to maintain a reserve fund. Each year, the Commission will adjust the fee rates to meet their budget and cover the reserve amount. On March 1 of each year, the fees collected to that point will be assessed and adjusted to ensure that it is reasonably likely that the actual aggregate dollar volume of fees generated in the remaining year will be within 10 percent of the budget assessment provided to Congress.

The new budget structure would provide that the Treasury will pay the budget amount that was submitted by the Chairman of the Commission on the first day of each fiscal year. Then, at or prior to the end of each fiscal year, the Commission will pay that same amount back to the Treasury from the fees and assessments deposited in their account throughout the year. If the Commission has not collected the total amount due, the payment shall be made in a subsequent fiscal year with the notification of Congress.

11. Corporate Governance Provisions

The bill provides for strengthened corporate governance. The bill: (1) provides for shareholder proxy access to nominate directors, requiring the SEC issue rules permitting the use by shareholders of proxy solicitation materials to nominate individuals to membership on the board (Section 972); (2) requires companies to provide written justification in proxy statements to the SEC to disclose the reasons for having the Chairman as the same person as the CEO (Section 973); (3)

requires a shareholder vote for "staggered boards" in which a fraction of members are elected annually (Section 974).

Notably, the bill directs the SEC to issue rules to direct for national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with any of the requirements of the corporate governance requirements (Section 971).

12. Credit Rating Agencies

The provisions regarding the regulation of credit rating agencies create new regulations designed to increase transparency and accountability. Most notable is the establishment of a new, standalone Office of Credit Rating Agencies within the SEC. Additionally, the SEC is given the authority to fine the credit rating agencies for certain violations or credit rating agency's registration if the SEC finds that the credit rating agencies lacks adequate financial and managerial resources to consistently produce credit ratings with integrity.

To increase transparency, credit rating agencies will be required to issue a report with each credit rating that discloses key information, including assumptions underlying the credit rating procedure, the data relied upon in its analysis, the use of servicer or remittance reports, and any other information that can assist users of credit ratings. Additionally, credit rating agencies must reveal when they rely upon diligence review services performed by third parties. Similarly, credit rating agencies must notify users of credit ratings of material changes in procedure or methodology, errors made in the formulation of credit ratings and must ensure that changes are applied consistently to all credit ratings.

The legislation further prohibits credit rating agency compliance officers from working on the formulation of credit rating or methodologies, to minimize any potential conflict of interest. Finally, the legislation includes a provision permitting a private right of action by an investor if a credit rating agency knowingly or recklessly fails to investigate the quality of data provided or to obtain analysis of the information from a neutral, independent source.

Related to the regulation of credit rating agencies is the creation of a new Office of Federal Insurance within the Department of the Treasury. As noted in summary accompanying the proposed legislation, such an office would be created to monitor the insurance industry, coordinate international insurance issues, and the legislation further requires a study on ways to modernize insurance regulation and provide Congress with recommendations.

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