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Wall Street Reform and Consumer Protection Act

December 15, 2009

House Passes Financial Reform Legislation

On December 11, 2009, the House of Representatives approved The Wall Street Reform and Consumer Protection Act (H.R. 4173). The bill, passed by a vote of 223-202, seeks to address many of the financial practices believed to have caused the crisis in financial markets in September of 2008. This alert briefly summarizes the provisions of the bill.

Financial Stability

Financial Stability Council. The bill establishes the Financial Stability Council made up of a council of regulators to identify financial firms that pose a systemic risk to the entire financial system at risk. The Financial Stability Council would subject such companies to stricter standards and regulation, including higher capital requirements, leverage limits and limits on concentrations of risk.

Congressional Oversight of the Federal Reserve. The bill would grant the Government Accountability Office the authority to examine the decisions of the Federal Reserve and require greater transparency with respect to the Federal Reserve's programs and facilities. The bill also imposes new restrictions on the ability of the Federal Reserve's to invoke its authority under Section 13(3) of the Federal Reserve Act to extend credit to certain entities under unusual and exigent circumstances. If enacted, the Federal Reserve could invoke its Section 13(3) authority only if 1) such action is approved by two-thirds of the members of the Financial Stability Council, 2) the Treasury Secretary consents to the proposed action and 3) the President has certified that an emergency exists. The bill would prohibit assistance to individual companies, and enables Congress to disapprove further use of the authority.

Consolidated Regulation. The bill consolidates the Office of Thrift Supervision with the Office of the Comptroller of the Currency and subjects thrift holding companies to supervision by the Federal Reserve, but preserves the thrift charter for thrifts dedicated to mortgage lending. The bill would subject previously exempted non-bank banks, such as industrial loan corporations, to the consolidated regulatory framework; going forward, no commercial companies could own ILCs but existing ILC owners are grandfathered.

Risk Retention Requirements. The bill would require all lenders/creditors to retain a minimum of 5 percent of the credit risk associated with any loans that are transferred, sold or securitized.

Prohibits Taxpayer Bailouts; Establishes Dissolution Process. In addition to the restrictions of the Federal Reserve Section 13(3) authority, the bill would restrict the ability of the FDIC or Federal Reserve to bail out failing financial institutions. The FDIC would be permitted to extend Emergency Financial Stabilization loan guarantees only to solvent banks and predominantly financial companies and only in a liquidity crisis. The bill replaces these bailout mechanisms with a mechanism for the orderly dissolution of failing firms. Financial regulators will be authorized to dissolve large, highly complex financial companies in a manner that allocates losses to both shareholders and creditors.

Upon the dissolution of a financial institution, dissolution costs will be borne first from the assets of the failed firm. The bill establishes a Systemic Dissolution Fund (SDF) to pay the costs of dissolution to the extent such costs exceed the assets held by the failed firm. The SDF will be pre-funded by assessments on financial companies with assets in excess of $50 billion and hedge funds with assets in excess of $10 billion.

Executive Compensation

The bill imposes the following restrictions on executive compensation practices.

Say-on-Pay (applicable to all public companies)

- Requires annual shareholder advisory vote on compensation
- Requires shareholder advisory vote on golden parachutes

- Requires at least annual reporting of annual say-on-pay and golden parachutes votes by all institutional investors not otherwise required to report to the SEC
- Exempts compensation approved by a majority say-on-pay vote from clawback (subject to certain exceptions such as fraud or contractual provisions)

Independent Compensation Committee Requirement (applicable to all public companies)

- Requires compensation committees to be made up entirely of independent directors
- Requires that compensation consultants satisfy independence criteria established by the SEC

The bill permits the SEC to exempt certain categories of public companies from these requirements.

Incentive Based Compensation Standards and Disclosure Requirements (applicable to all "financial institutions" with assets of more than $1 billion)

- Requires federal regulators to establish standards to proscribe inappropriate or imprudently risky compensation practices
- Requires all "financial institutions" to disclose compensation structures that include any incentive based elements

Derivatives Regulation

The bill would subject over-the-counter (OTC) derivatives markets to the jurisdiction of both the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). The SEC would have jurisdiction over swaps based on underlying securities, such as credit-default swaps. The CFTC would have jurisdiction over all other swaps.

The bill would also require:

- All standardized swap transactions between dealers and "major swap participants" (persons that maintain a substantial net position in swaps, exclusive of hedging for commercial risk, or whose positions create such significant exposure to others that it requires monitoring) to be cleared and traded on an exchange or electronic platform.

- Clearing organizations to seek approval from the CFTC or SEC, as appropriate, before a swap or class of swaps could be accepted for clearing.
- Registration by swap dealers and major swap participants with the appropriate regulator, including dual registration if applicable.
- Imposition of capital requirements for swap dealers' and major swap participants' positions in cleared swaps.
- Imposition of margin levels for counterparties in transactions that are not cleared.

Consumer Financial Protection Agency

The bill would establish the Consumer Financial Protection Agency (CFPA) to protect the public from unfair and abusive financial products and services. The CFPA will have jurisdiction over all financial providers, including banks, thrifts, credit unions and non-bank financial institutions and will implement rules under existing consumer finance laws to stop unfair, deceptive and abusive consumer financial products and services.

The bill provides an exemption for banks and thrifts with assets under $10 billion and credit unions with assets under $1.5 billion. These institutions will continue to have consumer protection examinations done by existing regulators.

The bill also provides an exemption for merchants, retailers and other nonfinancial businesses that extend credit directly to consumers for the purchase of goods or services, provided that such businesses do not resell the credit.

Increased Regulation of Capital Markets

Mandatory Registration of Investment Advisers. The bill requires all advisers to private pools of capital with more than $150 million in assets to register with the SEC. The bill eliminates the private adviser exemption and limits other exemptions for foreign private fund advisers. The bill exempts venture capital companies and Small Business Investment Companies.

Expanded SIPC Protection for investors. The bill provides expanded protection to investors by the Securities Investor Protection Corporation (SIPC). The bill increases SIPC cash advance limits, provides coverage for futures contracts held in margin accounts and expands SIPC's borrowing authority. The bill also increases the minimum assessments paid by SIPC members.

Credit Rating Agency Reform. The bill amends Rule 436(g) of the Securities Act of 1933 to remove the "expert" exemption for credit ratings included in a registration statement and grants investors a private right of action against ratings agencies for knowing or reckless violations of securities laws. The bill also increases investor access to the internal operations and procedures of ratings agencies, including their methodologies, ratings performance and compensation structure. The bill also calls for the implementation of a "standard of creditworthiness" to replace agency ratings in rules and regulations.

Small Company Exemption from External Audit Requirements. The bill exempts public companies with a market capitalization of less than $75 million from the external audit of internal control requirements of the Sarbanes-Oxley Act.

Expanded SEC Authority. The bill also expands the SEC's rule-making authority to cover municipal financial advisors, illiquid investments by mutual funds, information collection and anti-fraud with respect to short sales. The SEC would be authorized to restrict the use of mandatory arbitration clauses in contracts with broker-dealers. In addition, the SEC would be granted rulemaking authority with respect to the lending and borrowing of securities, but the bill expressly states that such rulemaking shall not limit the authority of federal banking regulators to regulate the securities lending and borrowing activity of a financial institution on safety and soundness grounds or to protect the financial system from systemic risk.

Office of Insurance

The bill creates a Federal Insurance Office that will monitor all aspects of the insurance industry and identify regulatory issues that could contribute to a systemic crisis and undermine the financial system as a whole.

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