New Federal Initiatives Project

Financial Reform – The Senate Version

By

John Shu*

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On March 15, 2010, Senator Christopher J. Dodd (Chairman, Senate Committee on Banking, Housing & Urban Affairs) unveiled his "Restoring American Financial Stability Act of 2010" ("Dodd Bill"). The Committee approved the 1,336 page bill and a 114-page manager's amendment package on a 13 - 10 party-line vote.[1] In addition to Senator Dodd, the other primary negotiators have been Senators Mark Warner, Richard Shelby (Ranking Member), Judd Gregg, and Bob Corker.

On December 11, 2009, with a 223-202 vote, the House passed a similar bill on a party-line vote, the "Wall Street Reform and Consumer Protection Act of 2009" ("Frank Bill"). Congressman Barney Frank, chairman of the House Financial Services Committee, shepherded that bill through the House.

The Dodd Bill has several components and proposals. Among its more notable elements are the following:

A) **Creates a "Consumer Financial Protection Bureau" ("CFPB")**[2], which will be housed within the Federal Reserve ("Fed"); the Federal Reserve Board will pay the CFPB's dedicated budget. The CFPB is to be otherwise independent of Fed supervision, jurisdiction, or oversight. The CFPB will take over and presumably consolidate consumer protection responsibilities from Office of the Comptroller of the Currency ("OCC"), Office of Thrift Supervision ("OTS"), Federal Deposit Insurance Corporation ("FDIC"), National Credit Union Administration ("NCUA"), the Federal Trade Commission ("FTC"), and the Fed. The CFPB will have autonomous rule-writing power regarding consumer protection for entities currently under those agencies' jurisdiction which offer consumer financial services and/or products.[3] It is to have primary authority to examine/enforce regulations for banks and credit unions with assets over $10 billion, all mortgage-related businesses, and "large" non-bank financial companies such as payday lenders, debt collectors, and consumer reporting agencies. The CFPB is also to have back-up examination and enforcement authority for any firm within its jurisdiction, regardless of size, exercisable at its discretion. The Dodd Bill creates an **Office of Financial Literacy** within the CFPB and a toll-free telephone number for consumers to report complaints/problems regarding financial products and services. The CFPB director will be a Presidential nominee requiring Senate confirmation.

B) **Creates a "systemic regulator," the "Financial Stability Oversight Council" ("FSOC")** of which the Secretary of the Treasury will be chairman. Other FSOC members will include the heads of the Securities & Exchange Commission ("SEC"), Commodities Futures Trading Commission ("CFTC"), Federal Housing Finance Agency ("FHFA"), OCC, FDIC, CFPB, the Federal Reserve Board, and another member.

   1) **The FSOC is to act as a "systemic regulator,"** identifying and responding to emerging financial system risks. The FSOC will advise the Fed on rules, minimums, and maximums regarding factors such as capital, leverage, liquidity, and risk management, and identify which systemically important clearing, payments, and settlements systems it believes the Fed should regulate. The FSOC has the power to

(a) require, with 2/3 vote, the Fed to regulate non-bank financial companies whose failures pose a risk to U.S. financial stability (*e.g.* AIG); (b) approve, with 2/3 vote, a Fed decision to require a company to divest certain of its holdings if the Fed determines that the company poses a "grave threat" to U.S. financial stability; and (c) override, with 2/3 vote, CFPB regulations or actions that the FSOC finds would increase systemic risk. The Dodd Bill creates the **Office of Financial Research** ("OFR") within the Department of the Treasury ("Treasury") to assist the FSOC; this office will collect, analyze, and provide data on the financial system and any emerging risks. The Dodd Bill also creates an **Office of Financial Research Fellowship Program**, which is intended to bring together top financial academics and leaders for a paid two-year period in which they will instruct OFR staff and increase their capabilities. The Dodd Bill provides that state attorneys general may sue violators of the new consumer rules and intends to limit federal preemption of state consumer protection laws to the standards enunciated in *Barnett Bank of Marion County, N.A. v. Nelson, Fla. Ins. Commissioner*, 517 U.S. 25 (1996). The Dodd Bill contains a so-called "**Hotel California**"[4] provision which refers to language prohibiting large bank holding companies that received TARP funds from avoiding Fed supervision by dropping their banks, and a so-called "**Volcker Rule**"[5] which is intended to sharply curtail Fed-regulated entities from proprietary trading and participating in hedge and private equity funds.

2) **The FSOC is to prevent "Too Big To Fail,"** and thus, in addition to the aforementioned, will attempt to discourage the growth and complexity of financial companies, but without the specific leverage caps that the Frank Bill contains.

3) **The FSOC is to prevent future "bank bailouts."** The FSOC will require large financial companies to periodically self-submit rapid and orderly liquidation plans. For liquidation to begin outside of traditional bankruptcy proceedings or FDIC failed bank resolution authorities, the Dodd Bill requires Treasury, FDIC, and the Fed to all agree to place a company into liquidation and petition an "Orderly Liquidation Authority Panel" ("Panel") made up of 3 judges from the U.S. Bankruptcy Court for the District of Delaware, appointed by the Chief Judge. The Panel, without any prior public disclosure and within 24 hours of receiving Treasury's petition, is to determine whether the company is indeed in default or in danger of default. The Dodd Bill expedites the appeals process all the way to the U.S. Supreme Court. The Dodd Bill also requires the largest financial firms to pre-pay into a $50 billion fund that would be used to liquidate large, troubled firms; permits the FDIC to borrow from Treasury for working capital; prohibits the Fed from using its Federal Reserve Act § 13(3) (*see also* 12 U.S.C. § 343) authority to support individual companies; and permits the FDIC to guarantee the debt of solvent banks, thrifts, and their holding companies subject to certain requirements.

C) **Will re-organize bank regulation responsibilities**:

1) FDIC: state banks and thrifts of all sizes, and holding companies of state banks and thrifts with assets less than $50 billion.

2) OCC: national banks and federal thrifts of all sizes and the holding companies of national banks and federal thrifts with assets below $50 billion.

3) OTS: eliminated; responsibilities and staff merged into the OCC.

4) Fed: bank and thrift holding companies with assets of over $50 billion. Fed's vice-chairman will be responsible for supervision and report semi-annually to Congress.

5) Leaves in place the dual federal/state banking systems.

D) **Will regulate derivatives**:

1) The SEC and CFTC will have authority to regulate OTC derivatives. The FSOC is to mediate any rule-making disagreements between SEC and CFTC.

2) Will require central clearing and exchange trading for derivatives, with exceptions. SEC and CFTC must pre-approve contracts prior to clearance.

3) Will require margin for un-cleared trades, and subjects major swap dealers and participants to certain capital requirements.

4) Will require data collection and publication through clearing houses and swap repositories.

E) Will make changes to the Securities & Exchange Commission ("SEC")

1) Hedge funds which manage more than $100 million will be required to register with the SEC as investment advisers, and the assets threshold for federal regulation of investment advisers will go from $25 million to $100 million, placing more investment advisers under state jurisdiction.

2) Will require municipal financial advisers, swap advisers, and investment brokers to register with the SEC. The SEC is to have the authority to enforce Municipal Securities Rulemaking Board (MSRB) rules against these entities. The MSRB is to have a majority comprised of investor and public entity representatives.

3) Creates an **Office of Credit Rating Agencies ("OCRA")** within the SEC to supervise the functions and actions of credit rating agencies. OCRA is to have its own compliance staff and power to levy punishment, including fines and de-registration, if agencies do not perform to standard. Also will permit investors to bring private rights of action against the ratings agencies under a knowing or reckless failure/disregard standard.

4) Creates an **Office of the Investor Advocate** to liaise between the SEC and investors.

5) Creates an **Investor Advisory Committee,** to be comprised of investors.

6) Creates a whistleblower program, with a reward of up to 30% of funds recovered for information provided regarding securities violations.

7) Brokers who provide financial advice are not to be held to the same fiduciary duty standard as investment advisers.

8) Frees the SEC from the annual appropriations process.

F) With respect to **Executive Compensation**, the Dodd Bill gives shareholders a non-binding vote on executive compensation, gives the SEC authority to grant shareholders proxy access to nominate directors, requires directors to win by majority vote in uncontested elections, requires compensation committees to include only independent directors with authority to hire compensation consultants, and requires public companies to rescind or "clawback" executive compensation if such compensation was based on inaccurate/non-compliant accounting standards.

G) **Makes changes to the Fed.** The Dodd Bill gives new authority to the Fed, even though both ends of Pennsylvania Avenue originally planned to strip the Fed of responsibility.[6] It gives the Fed Board of Governors formal responsibility over monitoring and mitigating systemic risk. It creates a **Vice-Chairman for Supervision**, who is to have a policy advisory role and report to Congress. The President is to designate a Board Governor to this position. The Dodd Bill, however, gives the Government Accountability Office ("GAO") authority to audit the Fed's Federal Reserve Act § 13(3) emergency lending facilities. The Dodd Bill prohibits any entity which the Federal Reserve Board supervises from voting for directors of the Federal Reserve Banks, and also prohibits past or present officers, directors and employees from serving as directors on the boards of the regional Fed banks. The Dodd Bill makes the president of the New York Federal Reserve Bank a presidential nominee requiring Senate confirmation; the term is five years.

H) **The Dodd Bill also**:

1) Creates an **Office of National Insurance** within Treasury to monitor and have oversight over the insurance industry and coordinate international insurance issues. Health insurance companies are excepted. Insurance companies will largely remain under state supervision unless the Fed and/or FSOC deems them systemically important (*e.g.* AIG).

2) Requires companies that sell products such as mortgage-backed securities to retain at least 5% of the credit risk unless the underlying loans meet certain standards.

As of this writing, a number of interest groups, federal and state regulatory agencies, and other organizations are preparing to heavily lobby both for and against elements of financial regulatory reform legislation.[7] Critics of the Dodd Bill mainly decry the CFPB, the $50 billion pre-paid fund, and the regulation of derivatives and hedge funds. Supporters seek stronger measures, particularly with respect to executive compensation, corporate board make-up, hard leverage caps, and the break-up of the largest financial institutions. President Obama's and Congressional Democrats' recent success in passing health-care reform (the Patient Protection & Affordable

Care Act) embolden them to aggressively pursue financial reform with respect to both scope and time frame. President Obama will very likely take a more hands-on approach to financial regulatory reform than he did for health care reform.

* *John Shu is a corporate and securities attorney in Newport Beach, California. He served as a law clerk to Judge Paul H. Roney, U.S. Court of Appeals for the 11th Circuit. Mr. Shu also served both President George H.W. Bush and President George W. Bush. Mr. Shu's bio may be found here: http://www.sycr.com/index.php?attorney_profile=show&attyid=141&qsn=shu*

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[1] The manager's amendment package is beyond the scope of this paper. Information regarding the amendment may be found here: http://banking.senate.gov/public/.

[2] The general idea of a consumer financial protection agency comes largely from the work and advocacy of Elizabeth Warren, a bankruptcy expert from Harvard Law School who currently serves as head of Congressional oversight for the Troubled Asset Relief Program ("TARP").

[3] There will likely be some future entanglements over which agency has jurisdiction over what.

[4] "Hotel California" refers to the 1970's Eagles song which says, "[y]ou can check out any time you like, but you can never leave." Perhaps Senator Dodd intentionally avoided Black Flag - Roach Motel's advertisement slogan, "[r]oaches check in, but they don't check out!"

[5] Paul Volcker who served as President of the New York Federal Reserve Bank from 1975 – 1979 and as Chairman of the Federal Reserve from August 1979 – August 1987. Currently he serves as chairman of President Obama's Economic Recovery Advisory Board.

[6] Senator Dodd originally wanted to end all of the Fed's regulatory duties and confine the Fed only to setting monetary policy and acting as the lender of last resort.

[7] Not all groups are in the financial industry. Examples include beer makers, cruise ship operators, and grocery store chains. Moreover, not all corporate or financial interests are aligned. For example, smaller community banks and large Wall Street banks have opposing interests.

Related Links:

U.S. Senate Banking Committee Mark-Ups:
http://banking.senate.gov/public/index.cfm?FuseAction=MarkUps.Home&HearingType=Mark Up

U.S. Senate Banking Committee Key Issues & Bill Text:
http://banking.senate.gov/public/index.cfm?FuseAction=Issues.Home

President Obama's April 22, 2010 speech on financial regulatory reform:
http://www.whitehouse.gov/the-press-office/remarks-president-wall-street-reform

"President Obama Proposes Size and Activities Limits for Financial Institutions" by John Douglas, *New Federal Initiatives Project*, March 29, 2010: http://www.fed-soc.org/publications/pubid.1813/pub_detail.asp

"A Conversation on Proposed Systemic Risk Regulation" - Podcast featuring Peter J. Wallison, Wayne A. Abernathy, and John L. Douglas, July 24, 2009: http://www.fed-soc.org/publications/pubid.1546/pub_detail.asp

"Resolution Authority over Systemically Important Financial Companies" by John Douglas, New Federal Initiatives Project, September 25, 2009: http://www.fed-soc.org/publications/pubid.1654/pub_detail.asp

"Executive Compensation" by J.W. Verret, New Federal Initiatives Project, September 22, 2009: http://www.fed-soc.org/publications/pubid.1650/pub_detail.asp

"The Obama Administration's Proposed New Consumer Regulator (CFPA)" by Wayne A. Abernathy, New Federal Initiatives Project, August 13, 2009: http://www.fed-soc.org/publications/pubid.1586/pub_detail.asp