



Financial Reform Legislation - A Work in "Process" Presently in Conference Committee

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The U.S. House and Senate have convened a Conference Committee to iron out the differences between financial reform bills passed the respective Houses. The House Bill H.R. 4173 was passed by the House on December 11, 2009. The Senate Bill S. 3217 was passed by the Senate on May 20, 2010. While there are significant differences between the bills, it appears that there is a substantial chance that such differences can be resolved into a bill text respectively acceptable to both the House and the Senate. The Conference Committee is working from the text of the Senate bill. The provisions of financial reform discussed below are in the midst of negotiation by the conferees and change to the some of the terms is anticipated. We will update the discussion below as the process progresses.

Banking Regulatory Reform.

Both bills create a new banking regulatory agency but differ on whether it should be independent or an arm of the Federal Reserve. The Senate bill would provide that the Consumer Financial Protection Bureau (CFPB) would be part of the Federal Reserve. Pursuant to the Senate bill, all consumer financial protection rules would be transferred to the CFPB. Banks with assets over \$10 billion would be subject to the CFPB's consumer financial protection rules. Banks with \$10 billion or less in asset size would remain subject to their present banking regulators. CFPB would have jurisdiction to enforce federal consumer financial laws such as the Truth in Lending Act and the Real Estate Settlement Procedures Act. On the House side, a Consumer Financial Protection Agency (CFPA) independent of other agencies would be created.

A Financial Stability Oversight Council would be created pursuant to the Senate bill. This Council would be required to identify risks and respond to threats to the stability of U.S. financial markets. The Council would be able to make recommendations to the Federal Reserve regarding proper capital levels for certain bank holding companies and non-bank financial companies. In addition, the Council would be able to require non-bank financial holding companies to become regulated by the Federal Reserve particularly when they are deemed to be systemically important, such as those with assets of \$50 billion or more. Mergers of bank holding companies and non-bank financial companies as a general matter would require the approval of the Federal Reserve particularly when consolidated assets would exceed 10% of the aggregate consolidated liabilities of all U.S. financial companies.

Glass Steagall and Concentration Limits.

The Glass-Steagall Act prohibitions would not be explicitly resurrected. Therefore, the Gramm-Leach-Bliley 1999 Act's authorization for commercial banks and investment banks to be affiliated would remain in effect. While neither the House nor Senate bill resurrects Glass-Steagall, other provisions such as the Volcker Rule would mandate a restructuring of certain investment and securities activities. Pursuant to the Volcker Rule as initially proposed in the Senate bill,

federally deposit-insured banks and their holding companies would be prohibited from sponsoring or investing in hedge funds and private equity funds.

The Federal Office of Thrift Supervision (OTS) would be eliminated. In the Senate bill, the OTS authority and responsibilities would be transferred to the Federal Office of Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) would become responsible for supervision of state-chartered thrift institutions. Regulation of thrift holding companies would become the responsibility of the Federal Reserve. The House bill also eliminates the OTS, but transfers certain OTS regulatory functions to the FDIC, the Federal Reserve and a new CFPB.

The Federal Reserve would be provided specific authority to create emergency lending facilities for financial companies not at specific risk of failing. Federal Reserve authority would be expanded to allow examination and enforcement authority beyond the current bank holding company authority by adding such powers regarding systemically important non-bank financial companies as determined by the Fed. A fund would be created to pay for dissolution of systemically important financial firms. Pursuant to the House bill, the largest firms would pay into a \$150 billion fund to handle such dissolutions.

The lending limits applicable to national banks pursuant to the National Bank Act would be made the standard for state-chartered banks pursuant to the bills. This would be done by embedding those standards in the Federal Deposit Insurance Act. The OCC would be responsible for issuing regulations applicable to all insured depository institutions. State-chartered banks and national banks utilizing most favored lender principles will likely want to be allowed to follow state rules that may allow greater concentration of assets and legal lending limit than the proposed federal banking reform legislation would allow.

Capital.

There is great concern in the banking industry regarding whether capital requirements will become more difficult to meet. In the Senate bill, the Collins Amendment appears to provide for consolidated capital requirements for small bank holding companies, thus eliminating the small bank holding company exemption. The ability to count trust preferred securities as Tier 1 capital has been threatened by the bill. But the Conference Committee agreed June 17, 2010 to exempt all institutions with less than \$500 million of assets and to grandfather existing trust preferreds for small bank holding companies with less than \$10 billion assets.

The Conference Committee is working toward reconciling capital rules that would be applicable to the banking industry.

Restrictions on Proprietary Trading – The Volcker Rule.

The Senate bill would prohibit banks and bank holding companies from engaging in proprietary trading, generally meaning trading for their own benefit with federally insured funds. Proprietary trading would continue to be permissible regarding government debt obligations of not only the U.S. Government generally but also Fannie Mae, Freddie Mac, Ginnie Mae, and state and local government entities. The Volcker Rule was not included in the House bill. Thus, this is a significant provision to be resolved in the Conference Committee.

Securitizations requiring issuer to retain risk.

Securitization of products such as mortgages may continue to be engaged in by issuers or originators of such mortgages, however, five (5%) percent of the credit risk for the securitization would be required to be kept by such issuer or originator of the underlying mortgage assets. This "skin in the game" requirement is designed to cause originators and others placing securities into the market place to responsibly underwrite the mortgage assets that would become part of the pool of securitized mortgage products. The five (5%) percent could potentially be divided between the issuer and the third party acting as securitizer of the mortgages. The FDIC, OCC, and the U.S. Securities and Exchange Commission (SEC) are jointly tasked with promulgating regulations in this area.

Sarbanes-Oxley Burden Reduction.

The Conference Committee agreed that section 404(b) of Sarbanes-Oxley Act would be amended to provide that public companies including banking institutions that are under \$75 million in market capitalization would be exempt from compliance with section 404 that requires all publicly-traded companies to establish and maintain expensive internal controls and procedures for financial reporting.

Effects of Financial Reform on the Automobile Industry.

The regulation of automobile dealer financing for consumers was exempted by the House bill. However, the Senate bill would impose the CFPB regulatory regime onto Buy Here Pay Here automobile consumer finance conducted by dealerships. The amendment offered by Senator Brownback to exempt dealerships from the CFPB regulatory jurisdiction was not approved. This issue of regulating Buy Here Pay Here dealers and automobile financing remains for the Conference Committee to resolve. However, we understand that a recent Senate resolution has been adopted to follow the House exemption of dealerships from regulation by the CFPB.

Insurance Industry Regulation.

Insurance companies would continue to be regulated primarily at the state insurance department government level. The Senate bill would create an Office of National Insurance that would be part of the U.S. Treasury Department to provide recommendations to the above-referenced financial stability oversight counsel. However, the federal insurance office would not be a regulator, thus leaving the present regulatory structure for insurance companies in place.

Both the Senate and House bills provide for a federal insurance office.

Credit Rating Agencies.

An office would be created within the SEC to provide oversight and rules applicable to credit rating agencies. The House bill would create an Advisory Board for credit rating agencies.

Derivatives and Hedge Funds.

Derivatives would become regulated by the SEC and the U.S. Commodity Futures Trading Commission (CFTC). Central clearing and exchange trading rules would be required regarding

derivatives. Swap dealers and swap participants would become subject to capital requirements. The House bill would apply the derivatives regulations to funds that have \$150 million or more in assets. The House would exempt venture capital funds.

Investment advisors of hedge funds with \$100 million or more in assets would be required to become registered with the SEC.

Investor Rights and Executive Compensation.

The say-on-pay provision in the Senate bill would provide shareholders with the right to cast non-binding shareholder votes on executive pay. The SEC would be granted authority to allow shareholders a simplified way of promoting their own proxy for the nomination and election of directors. The House bill uniquely would require institutions of \$1 billion or more in assets to disclose their incentive-based compensation terms to regulators.

Arbitration Rules Revisions.

The Senate bill would require a study of mandatory arbitration clauses in financial contracts specifically involving consumers.

Conclusions.

The financial reform legislation represents the most major adjustment to regulation of the financial industry since the Gramm-Leach-Bliley Act of 1999 which lifted the Glass-Steagall Act requirements that were set in place in the 1930s.

The Conference Committee of Senate and House conferees is working toward a reconciled bill that both legislative houses can accept. Changes to the bills are occurring on a day-to-day basis. July 4, 2010 is the target deadline of certain key legislators for the two legislative houses to have a bill on the President's desk for his consideration and signature into law.

Depending on the size and situation of the respective financial institution, strategic and operational options will need to be considered. Our firm stands ready to assist our clients in anticipating and successfully navigating financial reform. If you would like additional information regarding financial reform and its potential effect on your financial institution or company, please contact us directly. Changes are occurring daily. This article has provided a general discussion of the financial reform bills that are being negotiated by the members of the Conference Committee. We will update this article as the legislative process progresses.

For any questions about the Dodd-Frank Act of 2010 and financial reform, please contact the author at 717-763-1121 or at adams@shumakerwilliams.com or evans@shumakerwilliams.com.

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