

House Passes Wall Street Reform Act

Highlights

- ✓ Consumer Financial Protection Agency created
- ✓ Financial Stability Council established as systemic risk regulator
- ✓ Dissolution authority created to dismantle large, failing financial institutions
- ✓ Shareholder advisory vote on executive compensation mandated
- ✓ SEC enforcement powers expanded
- ✓ OTC derivatives brought under harmonized SEC-CFTC oversight
- ✓ Mortgage lending reforms established
- ✓ Credit rating agencies face new duties and liabilities
- ✓ Hedge funds subjected to registration
- ✓ Office of Insurance created

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On December 11, 2009, the U.S. House of Representatives passed legislation to restructure the financial services regulatory system, the Wall Street Reform and Consumer Protection Act of 2009 (HR 4173), by a vote of 223-202. As discussed below, the sweeping array of reforms includes the Financial Stability Improvement Act, which would create a systemic risk regulator, strengthen regulation of depository institutions and bank holding companies, improve the asset-backed securitization process, and provide for an enhanced dissolution authority. The legislation also would create a Consumer Financial Protection Agency, reform the over-the-counter derivatives market, subject hedge funds to stricter scrutiny, impose new corporate governance mandates, adopt heightened requirements for credit rating agencies and expand regulatory enforcement powers. Among other measures, the legislation features expansive consumer mortgage protections and creates a Federal Insurance Office.

Systemic Risk Regulator

Title I, Subtitle A, of the legislation creates a systemic risk regulator called the Federal Stability Oversight Council. Under Section 1001, the Council has the fundamental role of monitoring the marketplace to identify potential threats to the stability of the financial system. It would be chaired by the Secretary of the Treasury, and the remaining members would be the heads of the Federal Reserve Board (Fed), Comptroller of the Currency, Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corp. (FDIC), Federal Housing Finance Agency (FHFA), National Credit Union Administration (NCUA) and Consumer Financial Protection Agency. The Director of the Federal Insurance Office, a state insurance commissioner and a state banking supervisor would serve as nonvoting members in an advisory capacity.

The Council would subject financial companies and financial activities posing a threat to financial stability to much stricter standards and regulation, including higher capital requirements, leverage limits, and on concentrations of risk.

Senate contrast: *The Senate draft legislation, by way of comparison, would establish an "Agency for Financial Stability" with an independent chair appointed by the President.*

The House legislation removes outmoded Gramm-Leach-Bliley Act restraints on the consolidated supervision of large financial companies by the Federal Reserve, and provides specific authority to the Fed and other federal financial agencies to regulate for financial stability purposes and quickly address potential problems.

The Fed will serve as the agent of the Council in regulating systemically risky firms on a consolidated basis and systemically risky activities wherever they occur, ensuring broad accountability for this regulation.

Among its other duties, the Council must monitor the financial services markets to identify potential threats to the stability of the U.S. financial system and identify financial companies and activities that should be subject to heightened prudential standards in order to promote financial stability and mitigate systemic risk. The Council must also issue formal recommendations to Council members to adopt heightened prudential standards for the firms they regulate in order to mitigate system risk.

Regulators' inability to see developments outside their narrow "silos" allowed the current economic crisis to grow unchecked. The legislation's information gathering and sharing requirements for the Council and all of the financial regulators will ensure constant communication and the ability to look across markets for potential risks. The Council will facilitate information sharing and coordination among its members regarding financial services policy development, rulemaking, examinations, reporting requirements and enforcement actions. Also, the Council must provide a forum for its members to discuss and analyze emerging market developments and financial regulatory issues.

An important duty of the Council is to advise Congress on financial regulation and make recommendations that will enhance the integrity, efficiency, orderliness, competitiveness and stability of the U.S. financial markets. The Council must meet at least quarterly.

Title I, Subtitle B, of the legislation calls for the prudential regulation of companies and activities to ensure financial stability. Under Section 1101, the Council may require the submission of periodic and other reports from any financial company solely for the purpose of assessing the extent to which a financial activity or market in which the financial company participates, or the company itself, poses a threat to financial stability. In an effort to mitigate this reporting burden, the provision directs the Council to rely, whenever possible, on information already being collected by the financial regulators.

Under Section 1105, the Council may issue formal recommendations, publicly or privately, that the federal financial regulators adopt heightened prudential standards for firms they regulate in order to mitigate systemic risk. Within 60 days of receiving a Council recommendation, the regulators must notify the Council of any actions taken in response to the recommendation or explain why the regulator failed to respond.

The Council may subject a financial company to stricter prudential standards upon determining that material financial distress at the company, or the nature of its activities, could pose a threat to financial stability. In making this determination, the Council must consider a number of factors specified in Section 1105(c), including the amount and nature of the firm's financial assets and liabilities and its off-balance sheet exposures, as well as its transactions with other financial companies. The company's importance as a source of credit for households, businesses, and state and local governments must also be considered, as well as its source of liquidity for the financial system.

A financial company subject to stricter standards that does not own a bank would be treated as a bank holding company that has elected to be a financial holding company. A financial holding company subject to stricter standards that conducts activities that do not comply with Bank Holding Company Act requirements must establish or designate an intermediate holding company through which it conducts financial activities, unless an exemption is granted by the Fed. This intermediate holding company would be treated as a financial holding company.

The Fed is authorized to impose safeguards on a financial holding company subject to stricter standards to mitigate risks to the financial system, including capital, liquidity and risk-management requirements. Also, should its capital levels decline, the financial holding company would be subject to a prompt corrective regime. In addition, a financial holding company subject to stricter standards must have in place a plan for its rapid resolution.

The FDIC may extend emergency financial stabilization loan guarantees to solvent banks and predominantly financial companies only in a liquidity crisis. This facility, which will only result in a government payout if a guaranteed loan defaults, will be funded by fees paid by financial companies that request guarantees. This authority sunsets on Dec. 31, 2013, unless extended by Congress.

Thrift Supervision

Title I, Subtitle C, of the Act would discontinue the Office of Thrift Supervision (OTS) by amending the Home Owners' Loan Act (12 U.S.C. 1463) to transfer most of the OTS functions to a newly created Division of Thrift Supervision within the Office of the Comptroller of the Currency (OCC). The new division would be led by a Senior Deputy Comptroller for Thrift Supervision, ap-

pointed by the Secretary of the Treasury, who would serve under the general oversight of the Comptroller of the Currency. The Senior Deputy Comptroller for Thrift Supervision would oversee the regulation and supervision of federal savings associations. The Treasury Secretary would also have to appoint a Senior Deputy Comptroller for National Banks, who would be responsible for regulation and supervision of national-chartered banks. Importantly, the legislation would leave the thrift charter as a viable option for organization as a financial institution.

All powers, authorities, rights and duties that were invested in the Director of the OTS would transfer to the OCC, with three exceptions:

1. powers, rights, authorities and duties pertaining to savings and loan holding companies and their affiliates would transfer to the Federal Deposit Insurance Corporation (FDIC);
2. powers, rights, authorities and duties pertaining to savings and loan holding companies that are, on a consolidated basis, predominantly engaged in the business of insurance would transfer to the Federal Reserve Board; and
3. the consumer financial protection functions of both the OTS and OCC would shift to the new Consumer Financial Protection Agency.

Effect on OCC

As of the date of the enactment of the legislation, the term of the present Comptroller of the Currency would end and that person would be replaced by an acting Comptroller designated by the President until a new Comptroller is appointed by the President and confirmed by the Senate.

Transfer Date

The legislation calls for the unwinding of the OTS to be completed within one year of the date of enactment. However, the Treasury Secretary may extend the time limit by up to six additional months by submitting certain documentation to both the Senate Committee on Banking, Housing, and Urban Affairs and the House Financial Services Committee. Ninety days following the transfer date, the OTS and OTS Director would be abolished.

Continuation of Existing OTS Regulations

Although the OTS would be abolished by the legislation, all of its orders, regulations and any other regulatory or

advisory issuances in existence would continue in effect and would be enforced by, and be enforceable against, the OCC and the FDIC, in their respective roles. To clarify this matter, both the OCC and FDIC would have to publish in the *Federal Register* those OTS regulations that each agency would continue to enforce. OTS proposed regulations would become proposed regulations of either the OCC or the FDIC, and OTS regulations that have not yet become effective would take effect as scheduled as either OCC or FDIC regulations.

Impact on Savings Associations

Savings associations must become or remain qualified thrift lenders or they would immediately be subject to certain restrictions under the Home Owner's Loan Act, as amended by the legislation. Among such restrictions would be a prohibition on the payment of dividends, with some exceptions. A savings association that fails to become or remain a qualified thrift lender would also have to become a bank (other than a savings bank), or more than one bank, within one year of the "failure" date.

FDIC Board of Directors

The OTS Director would be replaced on the board of directors of the FDIC by the Chairman of the Federal Reserve Board or a member of the Fed designated by the Fed Chairman. In addition, any acting Comptroller of the Currency would serve as a member of the FDIC board of directors in place of the Comptroller of the Currency.

Fed Audit

The legislation would require an audit of the Federal Reserve Board and Federal Reserve Banks to be completed by the Comptroller General within 12 months of the enactment of the Financial Stability Act of 2009.

Countercyclical Capital Requirements

Federal prudential banking regulators would have to increase required capital levels for banking institutions during periods of economic expansion. Such action would lower the amount of capital available for lending to businesses and individuals in good economic times to prevent asset and other potential financial "bubbles" from forming. The federal banking regulators would likewise be allowed to lower capital requirements during periods of economic contraction in order to free up capital for lending to the private sector and spur growth,

though there is no requirement to do so. In making decisions about required capital levels, the regulators would still consider each banking institution's safety and soundness first.

Senate contrast: *The House legislation is markedly different from a financial regulatory reform proposal issued by the Senate Committee on Banking, Housing, and Urban Affairs. The Senate proposal would combine the functions of the OCC and the OTS, the state bank supervisory functions of the FDIC and the Federal Reserve, and the bank holding company supervision authority from the Federal Reserve into a single federal bank regulator.*

Bank Holding Company and Depository Institution Regulation

Title I, Subtitle D, of the legislation would bring further stability to the nation's financial system by providing enhanced regulation for non-bank banks, closing loopholes in the Bank Holding Act (BHCA) and improving the regulation of depository institutions by amending several other federal banking statutes.

Section 6 Holding Companies

The legislation would amend the BHCA by creating a "special purpose holding company" or "Section 6 holding company." This new type of holding company is also referred to as an "intermediate holding company."

The following entities would have to register with the Federal Reserve Board as a Section 6 holding company: companies that control CEBA non-bank banks, namely: industrial loan companies (ILCs); unitary savings and loan holding companies (SLHCs); and certain financial companies subject to the stricter prudential standards of the Act.

Congress created the Section 6 holding company with the intent to provide consolidated supervision of these financial companies by the Fed and thereby close off a number of loopholes in the BHCA regarding unitary SLHCs and ILCs.

A company that establishes itself as a Section 6 holding company would only be permitted to engage in activities that are permissible for a financial holding company, namely an activity that is "financial in nature," "incidental to a financial activity" or "complementary to a financial activity." Examples of activities that are financial in nature include, among other things: lending, exchang-

ing, transferring, investing for others, or safeguarding money or securities; providing insurance; and underwriting, dealing in, or making a market in securities.

The Section 6 holding company would be prohibited from conducting any nonbanking activities or investing in any nonbank company except for those activities and investments permissible for financial holding companies. Any impermissible activity that the company was engaged in continuously during the six months prior to the enactment of the legislation would be grandfathered.

In addition to the activities and investment limitations, a Section 6 holding company would also be subject to the transaction with affiliate requirements found in Sections 23A and 23B of the Federal Reserve Act (FRA), which requires "covered transactions" to meet certain quantitative limits, based on capital stock, and be made in accordance with prevailing market conditions. For purposes of the legislation, a transaction would generally not be considered to be a "covered transaction" if the transaction is in connection with the bona fide acquisition or lease by an unaffiliated person of assets, goods or services.

Finally, the Act would impose a number of other requirements on a Section 6 holding company. First, no less than 25 percent of the Section 6 holding company's board of directors must be independent of the Section 6 holding company's parent company or a subsidiary of the parent. In addition, the Section 6 holding company's parent would be subject to the tying provisions of the Bank Holding Company Act Amendments Act of 1970, and the parent would have to serve as a source of financial strength to its subsidiary Section 6 holding company.

Certain unitary SLHCs and other companies that had an application pending with the Federal Deposit Insurance Corp. to control a federally-insured, state-chartered ILC, industrial bank, or similar institution, would not be treated as a bank holding company solely by virtue of its control of a unitary thrift or ILC and control of a Section 6 holding company. A company could lose this exemption if it fails to establish, register and maintain a Section 6 holding company or the company acquires control of an additional bank or insured depository institution. If the company loses its exemption it would also have to divest control of each bank it controls unless the company submits a corrective plan to the Fed.

Supervision and Examination Authority

The legislation would also curtail the Fed's existing authority to examine, supervise or regulate a bank hold-

ing company's depository institution and functionally regulated subsidiaries.

Examination reports. For example, the legislation would remove the Fed's ability to request certain types of reports of functionally regulated subsidiaries from a federal or state regulator. Also, the Fed would have to use reports of examination of functionally regulated subsidiaries and subsidiary depository institutions made by other federal or state regulators.

Examination fees. The Fed and Federal Reserve Banks would have to assess fees on "large bank holding companies" to defray the cost of examining these holding companies. For purposes of this requirement, a "large banking holding company" is a company that has consolidated assets totaling \$10 billion or more.

GAO audits. The Comptroller General of the United States would have to perform an audit of all actions taken by the Fed and Federal Reserve Banks during the current economic crisis pursuant to the authority granted under FRA Section 13(3) (12 USC 343).

This provision is based on H.R. 1207, the "Federal Reserve Transparency Act of 2009," which was introduced by Rep. Ron Paul, R-Texas.

Currently, 31 USC 714(e) allows the Comptroller General to conduct an onsite examination of "any action taken by the Board under the third undesignated paragraph of Section 13 of the Federal Reserve Act (12 U.S.C. 343); with respect to a single and specific partnership or corporation."

Capitalization and Management

Several provisions would strengthen the operations of financial holding companies and the standards for interstate acquisitions under the BHCA. For example, a bank holding company must be "well capitalized and well managed" before undertaking certain activities permissible for financial holding companies, limited non-financial activities and affiliations, or grandfathered commodities activities. Likewise, the Act would require a bank holding company to be "well capitalized and well managed" before seeking control of a bank located in another state.

The legislation would also require the Fed to take into consideration whether a bank acquisition, made pursuant to Section 2(c) of the BHCA, may pose a risk to the stability of the nation's financial system. A similar analysis would be required by the Fed when considering nonbank acquisitions under BHCA Section 4(j)(2), as well as transactions under the Bank Merger Act (12 USC 1828(c)).

Transactions with Affiliates and Insiders

The legislation would make several important changes to the transactions-with-affiliate requirements found in FRA Sections 23A and 23B. In addition, the legislation would amend the lending limits found in the National Bank Act—12 USC 84 and the insider lending restriction found in FRA Section 22(h)—12 USC 375b. Each of the amendments made by the Act would recognize the role derivatives played in the financial crisis.

Affiliate transactions. The definition of "covered transactions" would be amended in a number of ways; especially providing that a "covered transaction" would occur when any securities borrowing and lending transactions with an affiliate creates credit exposure in a member bank to its affiliate or current and potential future credit exposure to the affiliate on derivative transactions with the affiliate.

The Fed's exemptive authority under FRA Section 23A would also be affected. Specifically, before the Fed grants an exemption under FRA Section 23A, it must obtain the concurrence of the FDIC chairman. Also, if the exemption involves a national bank, the Fed must obtain the concurrence of the Comptroller of the Currency, as well as the FDIC chairman. The Fed would also have to obtain the FDIC chairman's approval for any exemption under FRA Section 23B.

Lending limits. An amendment to the National Bank Act lending limits would revise the definition of "loans and extensions of credit" to include credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction between a national bank and the person. The Comptroller of the Currency would also have to issue regulations to carry out the amendment.

Insider lending limits. Finally, an amendment to FRA Section 22(h), dealing with loans to insiders, explicitly provides that an "extension of credit" would have occurred between a member bank to a person if the member bank has credit exposure to the person arising from a derivatives transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction between the member bank and the person.

Charter Conversions

Charter conversions by national banks, state banks and savings associations would be impacted by amendments

made by the legislation. In each instance, if the converting institution was subject to an enforcement action initiated by its primary state or federal regulator, the conversion transaction would be prohibited. In essence this would end the use of regulatory arbitrage and allow the institution “no place to hide” by switching charters.

Investment Bank Holding Companies

The investment bank holding company supervisory framework found in Section 17 of the Securities Exchange Act of 1934 (15 USC 78q) would be eliminated.

The creation of the investment bank holding company supervisory scheme was one of the many hallmark elements of the Gramm-Leach-Bliley Act (GLB Act). Under the GLB Act, securities firms were given the opportunity to be voluntarily supervised by the Securities and Exchange Commission as holding companies. It was envisioned that this supervisory regime would have been useful for firms seeking to engage in global financial activities.

Deposit Insurance Fund

As of December 11, 2009, the FDIC has been appointed receiver of 133 failed banks. Given the rate of bank closings, the balance of the Deposit Insurance Fund (DIF) actually became negative as of Sept. 30, 2009. The FDIC projects that the DIF will incur approximately \$100 billion in failure costs over the period 2009 through 2013. Some of this amount has already been realized, and most of these losses are expected to occur before year-end 2010. The FDIC has a statutory line of credit with the Treasury Department of \$100 billion and could borrow up to \$500 billion through the end of 2010 if certain conditions are met. The FDIC has also required insured depository institutions to prepay their deposit insurance assessments to ensure that the deposit insurance system remains directly industry-funded and preserves its Treasury borrowing for emergency situations.

Subtitle E of Title I would seek to address the problems with the DIF.

The definition of “risk-based assessment system,” found in Section 7(b) of the Federal Deposit Insurance Act (FDIA), would be revised. The new risk assessment would focus not only the insured depository institution, but also its affiliates. Factors that would be considered include, among other things, the concentration of both on-balance sheet and off-balance sheet assets and the amount of liabilities.

A risk-focused assessment base would be created. This new assessment base of an insured depository institution would be the product of an assessment rate established by the FDIC and the amount of the insured depository institution’s average total assets during the assessment period minus the amount of the insured depository institution’s average tangible equity during the assessment period.

The legislation would seek to eliminate procyclical assessments. This would be accomplished by allowing the FDIC, in its sole discretion, to suspend or limit a payment of dividends if the DIF reserve ratio was in excess of 1.5 percent of estimated insured deposits. This provision would also eliminate the payment of a prorated dividend if the reserve ratio was between 1.35 percent and 1.5 percent.

Finally, a transition reserve ratio requirement would be established to reflect the new risk-focused assessment base. This new minimum reserve ratio for any year may not be less than 1.15 percent of estimated insured deposits, or the comparable percentage of the assessment base.

Securitization

Title I, Subtitle F, offers improvements to the asset-backed securitization process. It reforms the process by requiring companies that sell products like mortgage-backed securities to retain a portion of the risk to ensure that they will not sell garbage to investors, because they have to keep some of it for themselves. The legislation would require companies that sell products like mortgage-backed securities to keep some “skin in the game” by retaining at least five percent of the credit risk so that, if the investment does not pan out, the company that made, packaged and sold the investment would lose out right along with the people they sold it to. In addition, the legislation would require issuers to disclose more information about the assets underlying asset-backed securities.

The SEC would have to adopt regulations requiring issuers of asset-backed securities to disclose, for each tranche or class of security, information regarding the assets backing that security. In adopting these regulations, the SEC must set standards for the format of the data provided by issuers of an asset-backed security, which must, to the extent feasible, facilitate comparison of such data across securities in similar asset classes.

To help investors perform independent due diligence, the SEC regulations must require issuers of asset-backed securities, at a minimum, to disclose asset-level or loan-level data, which data would identify the loan brokers or

originators. The issuer must also disclose the nature and extent of the compensation of the broker or originator of the assets backing the security and the amount of risk retained by the originator or the securitizer of the assets.

The SEC must also adopt regulations for asset-backed securities that require each credit rating agency to include in any report accompanying a credit rating a description of the representations, warranties and enforcement mechanisms available to investors, and an explanation of how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities. The regulations must also require any originator to disclose fulfilled repurchase requests across all trusts aggregated by the originator, so that investors may identify asset originators with clear underwriting deficiencies.

Dissolution Authority

Title I, Subtitle G, would establish an enhanced dissolution authority for failed institutions. The legislation provides for a resolution authority to wind down large, interconnected financial companies in an orderly manner. Currently, there is no system in place to responsibly shut down a failing financial company like AIG or Lehman Brothers. According to Treasury, the lack of a federal regulatory regime and resolution authority for non-bank financial institutions contributed to the financial crisis and, unless addressed with legislation, will constrain a federal response to future crises.

Regulators would be able to dissolve large, highly-complex financial companies in an orderly and controlled manner, ensuring that shareholders and unsecured creditors, not taxpayers, would bear the losses. When a financial firm enters the dissolution process, management responsible for the failure would be dismissed, parties that should bear losses, particularly shareholders and unsecured creditors, would do so, and the firm would cease as a going concern. Thus, the legislation establishes an orderly process for dismantling any large failing financial company in a way that protects taxpayers and minimizes the impact to the financial system.

Any costs for dismantling a failed financial company will be repaid first from the assets of the failed firm at the expense of shareholders and creditors. Any shortfall would then be covered by a dissolution fund pre-funded by financial companies with assets exceeding \$50 billion and hedge funds with assets exceeding \$10 billion.

Comment: *In this instance the legislation follows the “polluter pays” model where the financial industry has to pay for its mistakes, not taxpayers.*

The FDIC will be able to unwind a failing firm so that existing contracts can be dealt with and creditors’ claims can be addressed. Unlike traditional bankruptcy, which does not account for complex interrelationships of such large firms and may endanger financial stability, this more flexible process will help prevent disruption to the entire system and the overall economy.

Financial Crisis Management

The Federal Reserve’s use of its emergency lending authority would be subject to significant new restrictions by Title I, Subtitle H. Use of this authority will require approval by two-thirds of the members of the Council and the consent of the Treasury Secretary after certification by the President that an emergency exists. This authority may not be used to provide assistance to individual companies, and Congress will be able to disapprove further use of the authority.

Corporate Governance and Compensation

Title II of the legislation addresses executive compensation and governance matters. Section 2002 requires a non-binding annual shareholder advisory vote on executive compensation. Similarly, there must also be a shareholder advisory vote on golden parachutes. The SEC is allowed to exempt categories of public companies and, in determining the exemptions, must take into account the potential impact of an advisory vote on smaller companies. The legislation also requires at least annual reporting of say-on-pay and golden parachute votes by all institutional investors, unless these votes must otherwise be reported publicly by SEC rule. The measure also provides that compensation approved by a majority say-on-pay vote is not subject to clawback, except as required by contract or by law due to fraud.

Comment: *The measure would not set any limits on pay, but would ensure that shareholders have a voice on their company’s executive pay practices without micromanaging the company. Knowing that they will be subject to some collective shareholder action should give boards pause before approving a questionable compensation plan.*

In a major governance reform, Section 2003 mandates that public companies have a compensation committee composed of independent directors. Similarly,

compensation consultants must satisfy independence criteria established by the SEC. The SEC could exempt categories of public companies, taking into account the potential impact on smaller companies.

To be considered independent, a compensation committee member cannot accept any consulting, advisory, or other compensatory fee from the company and cannot be an affiliated person of the company or any of its subsidiaries. The SEC could exempt a particular relationship with a compensation committee member from these independence standards.

The legislation gives the compensation committee sole discretion to retain compensation consultants meeting the independence standards. The compensation committee would be directly responsible for the consultant's appointment, compensation and oversight. However, there is no requirement that the committee implement or act consistently with the recommendations of the compensation consultant. In addition, the hiring of a compensation consultant would not affect the committee's ability or obligation to exercise its own judgment in carrying out its duties.

The compensation committee would also be authorized to retain independent counsel and other advisers meeting SEC independence standards. As with compensation consultants, the compensation committee would be directly responsible for the appointment, compensation, and oversight of such independent counsel and other advisers. But the compensation committee would not have to implement or act consistently with the advice or recommendations of such independent counsel and other advisers, and the retention would in no way affect the committee's ability or obligation to exercise its own judgment.

Financial institutions with more than \$1 billion in assets must disclose compensation structures that include any incentive based elements. Under Section 2004, federal financial regulators, including the Fed, SEC and FDIC, will jointly determine the disclosure requirements and incentive-based compensation standards. Also, federal regulators must proscribe inappropriate or imprudently risky compensation practices as part of solvency regulation.

Separately, under Title V, Section 7222, the SEC may issue proxy access regulations regarding the nomination of directors by shareholders to serve on a company's board of directors, thereby further democratizing corporate governance. This provision is needed because, without it, the SEC could have faced a lawsuit from corporations and industry groups alleging that the Commission lacked the authority to grant shareholders this

right. Congress believes that proxy access is necessary for shareholders to have a meaningful choice in exercising their right to vote for board members, and thus to hold boards accountable. Regulation of proxy access and disclosure is a core function of the SEC and is one of the original responsibilities that Congress assigned to the Commission when it was created in 1934. The legislation would create a new federal right to proxy, but would also ensure that existing laws on the right to proxy are upheld.

OTC Derivatives

Title III of the House legislation would reform the over-the-counter derivatives market. For the first time, the markets for credit default swaps and all other OTC derivatives would be subject to comprehensive federal regulation under an SEC-CFTC regime. The purpose is to guard against activities in those markets that pose excessive risk to the financial system and to promote the transparency and efficiency of those markets.

Senate comparison: *The Senate draft would also authorize the federal regulation of derivatives under a dual SEC-CFTC regime.*

In setting out the first comprehensive system of regulation of the OTC derivatives market, the House legislation would establish a central clearing requirement for swaps transactions between dealers and large market participants that are accepted by a clearinghouse. Non-cleared swaps must be reported, with major participants and dealers adhering to strengthened capital and margin requirements. OTC derivatives include swaps, which are financial contracts that call for an exchange of cash flows between two counterparties based on an underlying rate, index or credit event or on the performance of an asset.

Title III divides jurisdiction over swaps between the SEC and the CFTC. The SEC oversees activity in swaps that are based on securities such as equity and credit-default swaps. The CFTC is responsible for all other swaps.

The legislation would exempt commercial end-users from the clearing requirement. These firms, such as airlines, manufacturers and other small- to medium-sized businesses, often use derivatives markets to hedge their price risk. Regulators would have to define the types of risk a company may hedge and remain eligible for the limited exception to clearing. The legislation would hold swap dealers such as large banks accountable to new standards for capital, margin and business-conduct

requirements and would benefit end-users' ability to hedge their price risk by not subjecting them to onerous cash collateral requirements.

The legislation would resolve jurisdictional issues between regulators that have compromised past efforts at financial regulation. It would also strengthen confidence in trader position limits on physically deliverable commodities as a way to prevent excessive speculative trading.

Heeding the G-20's advice to prevent regulatory arbitrage, the legislation calls for international harmonization by requiring foreign boards of trade to share trading data and adopt speculative position limits on contracts that trade U.S. commodities similar to U.S.-regulated exchanges. The SEC and CFTC would have to consult and coordinate with foreign regulators to create consistent international standards on derivatives regulation. The SEC and CFTC are authorized to engage in information-sharing arrangements with foreign regulators consistent with the public interest and the protection of investors and counterparties. In addition, the SEC and CFTC may prohibit a foreign entity from participating in the United States in any swap or security-based swap activities upon determining that the regulation of derivatives in the entity's foreign jurisdiction undermines the stability of the U.S. financial system.

The legislation specifically forbids federal assistance to support derivatives clearing operations or the liquidation of a derivatives clearing organization established under the Commodity Exchange Act or a clearing agency described in the Exchange Act unless Congress expressly authorizes this assistance.

The legislation ensures that the expansion of the CFTC's authority over derivatives will not in any way limit the Federal Energy Regulatory Commission's authority to regulate energy markets. In any area where FERC and the CFTC have overlapping authority, the legislation requires the two agencies to conclude a memorandum of understanding delineating their respective areas so as to avoid conflicting or duplicative regulation. Where FERC has regulatory authority, the CFTC may step back and let FERC do its job.

The legislation also implements important corporate governance reforms in the derivatives markets. In addition to complying with several core principles listed in the Act, such as having adequate financial resources and effective risk management, derivatives clearing organizations registered with the SEC must designate a compliance officer to review compliance with the core principles and establish procedures to remediate non-

compliance. The compliance officer must also prepare an annual report, certifying its accuracy, on the clearing organization's compliance efforts. The compliance report will accompany the financial reports that the clearing organization must furnish to the SEC.

Consumer Financial Protection Agency

Title IV of H.R. 4173—like the bill offered in the Senate Banking Committee—would create a Consumer Financial Protection Agency (CFPA). This proposal has drawn as much criticism as any part of the bill, with strong and united opposition coming from congressional Republicans, as well as from large banks and banking industry trade groups. Consumer protection advocates generally support the proposal, although they disagree with some compromises that have been made in an effort to attract broader support.

According to the bill, the CFPA's goal would be to “seek to promote transparency, simplicity, fairness, accountability, and equal access in the market for consumer financial products and services.” To achieve this goal, the bill would give the agency all of the consumer protection authority of the current bank, thrift and credit union regulatory agencies, as well as some of the authority currently exercised by the Federal Trade Commission. Additionally, the agency would exert authority over businesses not currently regulated by the federal government.

The CFPA's authority would extend to 15 listed consumer protection laws, including consumer protection provisions in the Gramm-Leach-Bliley Act and the Federal Deposit Insurance Act. It also would have a general authority to act to prevent unfair, deceptive or abusive acts or practices.

Scope of CFPA

A key factor in understanding the CFPA is understanding its proposed area of operations. The agency's task would be to regulate the provision of consumer financial products and services. These are any financial products or services, other than a federal tax return, used by a consumer primarily for personal, family or household purposes.

What would be considered to be a financial product or service? Under the bill, it would be a product or service that resulted from or was related to engaging in a financial activity, and the list of what would be deemed

to be financial activities reveals the true scope of the CFPA's authority.

Financial activities, of course, would include activities such as taking deposits, extending credit, servicing loans and cashing checks. It also would extend beyond traditional banking activities to include activities such as consumer reporting services, real estate settlement services, personal property leasing, some real estate leasing, property appraising, investment or financial advisory services, financial data processing, and debt management or counseling. There is a "catch-all" ability under which activities incidental or complementary to financial activities could be declared to be covered financial activities.

Insurance would be excepted from the list, as would be investment advice provided by a person registered with the Securities and Exchange Commission. Other exceptions would apply to providing fraud detection or anti-money laundering services.

In general, anyone who engages in any financial activity in connection with providing a consumer financial product or service would be covered by the bill. In the case of nonbanking organizations, directors, officers, managers and controlling shareholders also would be regulated by the agency.

CFPA Powers

The CFPA would have the ability to regulate financial products and services in a number of ways.

Regulatory authority. The CFPA could adopt regulations to implement any of the laws under its authority, and would have the exclusive authority to do so. It also would have the authority to issue related orders and guidance, comparable to the bulletins or letters issued by the federal banking regulatory agencies.

Supervisory authority. The agency would have supervisory and visitorial authority over the companies that were subject to its power. However, in an effort to reduce regulatory burden, the CFPA's examination authority ordinarily would be restricted to larger institutions. Also, the agency could require periodic reports from the companies it regulated and exchange information with the banking regulatory agencies.

A bank or credit union with assets of \$10 billion or less would be examined for compliance with consumer protection obligations by its primary regulator, similar to the current examination process. Only larger institutions would be examined separately by the CFPA. Moreover, the bill would give the CFPA the ability to transfer examination authority over larger

institutions to the other regulatory agencies if those agencies requested.

However, the CFPA would not be excluded from examinations. It would have the authority to include its own examiner who could participate fully in an examination. Also it could, in extreme cases, supplant an institution's primary regulator if that regulator was not enforcing the consumer protection laws and regulations adequately.

The agency would be directed to coordinate its examinations with any relevant state regulators.

Enforcement authority. The CFPA would have primary enforcement authority over larger institutions if violations were found. Enforcement powers would include the ability to demand that documents be produced or that persons testify. The agency could impose appropriate sanctions, including ordering restitution, placing restrictions on an institution's future activities, and imposing civil money penalties that could rise as high as \$1 million per day in extreme cases. A smaller institution's primary regulator would maintain enforcement authority over it.

The existing banking regulatory agencies would have primary enforcement authority over smaller institutions. The CFPA would have "back-up" authority to enforce consumer protection laws and regulations if an institution's primary regulator did not act and also could investigate and resolve any potential violations learned of through its consumer complaint system.

Risk-based program authority. The agency would be required by the bill to develop risk-based programs, including registration and reporting duties and examinations, to enable it to supervise nearly anyone covered by its authority that was not a bank, thrift or credit union. These programs would extend to attorneys who provide financial products or services (other than preparing or filing a bankruptcy petition or litigation to prevent a foreclosure).

Specific authorities. As noted, the CFPA would have the power to prohibit unfair, deceptive or abusive acts or practices. This could include regulating sales and compensation practices, imposing duties of fair dealing and establishing registration and licensing standards.

The agency could create model forms for consumer disclosures. As with many of the forms created by the Federal Reserve Board, a person who used an appropriate form would be deemed to have complied with the relevant disclosure requirement. The bill would specifically require the adoption of a unified Truth in Lending Act/Real Estate Settlement Procedures Act disclosure form. In addition to imposing disclosure duties, the

agency would be able to take steps to ensure that consumers had access to necessary information.

The bill would require the CFPB to adopt regulations on reverse mortgages. It also would give the agency the discretion to restrict or ban the use of predispute mandatory arbitration clauses in contracts.

Exceptions from CFPB Authority

The bill would exempt a number of businesses or financial activities from the CFPB's regulatory jurisdiction. Significant exemptions would include:

- A merchant giving credit to purchasers of the merchant's nonfinancial products or services, as long as the account was not later sold;
- Persons regulated by the Securities and Exchange Commission, Commodities Futures Trading Commission, Federal Housing Finance Agency or a state insurance regulator;
- Qualified retirement plans;
- Accountants and tax return preparers;
- Real estate licensees;
- Most motor vehicle dealers;
- Manufactured home and mobile home dealers;
- Licensed pawnbrokers; and
- Consumer reporting agencies providing reports to be used for employment purposes.

The bill also explicitly would deny the agency the authority to take two specific actions. First, it would not be able to impose a national usury limit. Second, it would not have the power to require anyone to offer any specific financial product or service, which would exclude the "plain vanilla" financial product requirement contained in the Obama administration's draft reform proposal.

Effect on State Law

A manager's amendment to the original bill greatly changed the bill's effect on the preemption of state law. Originally, the bill would have given states considerable authority to impose consumer financial protection laws on federal banking institutions and undermined the ability of federal law to preempt those state laws. However, the manager's amendment went far toward preserving the current balance of power between state and federal law.

State consumer financial protection laws could be preempted under any of three circumstances:

- If the state law discriminated against a federally chartered institution;

- If the state law prevented, significantly interfered with or materially impaired the ability of the federal institution to engage in the business of banking; or
- If the state law were preempted by a federal law other than the Wall Street Reform and Consumer Protection Act.

The second basis for preemption was not included in the original bill.

The manager's amendment to the bill would make it easier for a federally chartered institution to obtain a ruling that a state law was preempted and harder for an opponent of that preemption to challenge it. It restores the ability of the courts to rule in favor of preemption that was not found in the original bill, and it requires the courts to use a more deferential standard when reviewing preemption determinations by a federal banking regulatory agency.

However, the bill continues to make clear that state law would be shielded from preemption by federal law or regulation as long as the state law offered consumers at least as much protection as the federal law. The bill also would explicitly protect the ability of states to enforce their own consumer protection laws against federally chartered institutions and to demand that those institutions produce some relevant information.

In addition, state regulators would be able to enforce federal consumer protection laws and the CFPB's regulations. To do so, the state regulator would have to give the CFPB prior notice. The federal agency would have the power to intervene in the state regulator's suit and act as a party, but not to replace the state regulator.

Composition of Agency

The CFPB would be led by a director who would be appointed by the President, subject to confirmation by the Senate. There also would be a Consumer Protection Oversight Board, but the board would have only an advisory role with no executive power.

There would be seven permanent members of the oversight board: the heads of the Fed, OCC, FDIC, NCUA and FTC; the Secretary of Housing and Urban Development; and the chairman of the Federal Financial Institution Examination Council State Liaison Committee. In addition, the President could appoint up to five other members described as experts in consumer protection, fair lending and civil rights, or who would represent depository institutions that serve underserved communities or communities significantly harmed by higher-priced loans. These additional members also would require confirmation by the Senate.

The bill would require the CFPB to establish four specific divisions. These would address research, community affairs, consumer complaints and consumer financial education. Also, an Office of Fair Lending and Equal Opportunity would be created to coordinate the enforcement of those laws, and a Consumer Advisory Board would be created to advise the CFPB Director.

Additionally, the agency would have to create a single toll-free telephone number to receive consumer complaints and inquiries. Callers would be routed to the appropriate federal banking regulatory agency or, when possible, to the appropriate state regulator.

The CFPB's operations would be funded from two sources. First, the Fed annually would transfer to the CFPB an amount equal to 10 percent of the Federal Reserve System's total expenses. Second, the agency could impose fees and assessments on the companies it regulates.

Hedge Funds and Private Equity

Title V, Subtitle A, would greatly expand regulation of hedge funds and other private funds. These funds are not currently subject to the same set of standards and regulations as banks and mutual funds, reflecting the traditional view that their investors are more sophisticated and therefore require less protection. This exemption has enabled private funds to operate largely outside the framework of the financial regulatory system even as they have become increasingly interwoven with the financial markets. As a result, there is no data on the number and nature of these firms and no ability to calculate the risks they pose to the broader markets and the economy.

The legislation requires investment advisers to hedge funds and other private investment funds with assets under management of at least \$150 million to register with the SEC and be subject to significant disclosure and other requirements. Current law generally does not require hedge fund and other private fund advisers to register with any federal financial regulator.

The legislation accomplishes the registration of hedge fund advisers by eliminating the Investment Advisers Act's private adviser exemption, which exempts from registration investment advisers that have fewer than 15 clients, do not hold themselves out to the public as investment advisers, and do not act as investment advisers to registered investment companies or business development companies. The legislation creates a limited exemption for foreign private fund advisers.

The legislation mandates the registration of private advisers to private pools of capital so that regulators can better understand exactly how those entities operate and whether their actions pose a threat to the financial system as a whole. In addition, new recordkeeping and disclosure requirements for private fund advisers will give regulators the information needed to evaluate both individual firms and entire market segments that have until now have largely escaped any meaningful regulation. The Commission cannot, however, compel the private fund to disclose proprietary information about the investment adviser's trading and investment strategies to counterparties and creditors. Under the legislation, advisers to hedge funds, private equity firms, and other private pools of capital will have to obey some basic rules in order to continue to trade in the capital markets. Regulators will have new authority to examine the records of these investment advisers.

The legislation authorizes the SEC to require registered investment advisers to maintain records of, and submit reports about, the private funds they advise in two instances: (1) as the SEC determines is necessary or appropriate in the public interest and for the protection of investors; and (2) as the SEC determines in consultation with the Federal Reserve Board, and with any other entity that the SEC identifies as having systemic risk responsibility, is necessary for the assessment of systemic risk. The records and reports of any private fund are further deemed to be the records and reports of the registered investment adviser.

The SEC may, after considering the public interest and potential to contribute to systemic risk, set different reporting requirements for different classes of private fund advisers, based on the types or sizes of private funds they advise.

The information that hedge funds and private funds disclose to the SEC is confidential, except that the Commission may not withhold information from Congress. Also, the SEC may provide the information to the Fed and the new systemic risk regulator, which in turn must keep the information confidential in a manner consistent with the SEC's confidentiality regime.

The legislation requires hedge fund advisers covered by the asset threshold exemption to maintain the required records and gives the SEC the discretion to require reports in the public interest or for investor protection. In adopting regulations for investment advisers to mid-sized private funds, the SEC must take into account the size, governance and investment strategy of the funds in order to ascertain if they pose a systemic risk to the financial markets.

The House legislation contains a registration exemption for advisers to venture capital funds. The SEC must identify and define the term “venture capital fund” and exempt an adviser to such a fund from the registration requirements. But the Commission must require advisers to venture capital funds to maintain records and provide annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors.

The legislation mandates the confidential reporting to the SEC of the amount of assets under management, borrowings, off-balance sheet exposures, counterparty credit risk exposures, trading and investment positions, and other important information relevant to determining potential systemic risk and potential threats to overall financial stability. The legislation would require the SEC to conduct regular examinations of such funds to monitor compliance with these requirements and assess potential risk.

In addition, the SEC would share the disclosure reports received from funds with the Federal Reserve Board and the new systemic risk regulator, the Financial Services Oversight Council. This information would help determine whether systemic risk is building up among hedge funds and other private pools of capital, and could be used if some of the funds or fund families are so large, highly leveraged, and interconnected that they pose a threat to overall financial stability and should therefore be under the broad oversight of the new federal systemic risk regulator.

The Act would require the SEC to provide guidance to hedge funds, private equity firms and other private pools as they adjust to the new registration requirements. The Comptroller General would have to conduct a study and report to Congress within two years on the costs to the hedge fund industry of the legislation’s registration and reporting requirements. The Act would delay the effective date for one year, although advisers would have discretion to register earlier with the SEC.

Credit Rating Agencies

Title V, Subtitle B, would impose stricter requirements on credit rating agencies, i.e., nationally-recognized statistical ratings organizations or NRSROs. These entities have assumed a central role in the global capital markets. They have faced growing criticism in recent years that reached a crescendo in the recent financial crisis. In response, the Act enhances the SEC’s oversight and regulation of NRSROs.

Under Section 6002, the Commission must establish an office that administers the SEC rules with respect to the practices of credit rating agencies in determining ratings, in the public interest and for the protection of investors, including rules designed to ensure that credit ratings are accurate and are not unduly influenced by conflicts of interest. The new office must be sufficiently staffed to carry out the mission.

Section 6007 directs the SEC to revise Regulation FD to remove the exemption for entities whose primary business is the issuance of credit ratings.

The legislation enhances the accountability of NRSROs by clarifying the ability of individuals to sue NRSROs. It amends the Exchange Act to provide that, in an action for money damages against a rating agency, it is enough for pleading any required state of mind that the complaint state with particularity facts giving rise to a strong inference that the rating agency violated the securities laws. In addition, statements made by rating agencies will not be deemed forward-looking statements for purposes of the Exchange Act’s safe harbor.

In any private action against a rating agency, the same pleading standards with respect to knowledge and recklessness must apply to the rating agency as would apply to any other person in the same or similar private action against that person.

Section 6012 would amend Rule 436(g) of the Securities Act to remove the “expert” exemption for credit ratings included in a registration statement. Thus, NRSROs will now have greater liability under the securities laws if a rating is included in a registration statement. Rating agencies would be liable for omitting information from a registration statement, putting them on the same level as other experts like accountants, auditors, and lawyers.

Transparency is a hallmark of the legislation. Investors will gain access to more information about the internal operations and procedures of NRSROs and their methodologies, ratings performance and shortcomings in ratings assessment. In addition, the public will learn more about how NRSROs get paid. In an effort to achieve differentiation, the legislation authorizes the SEC to prescribe rules requiring credit rating agencies to establish rating symbols distinguishing credit ratings for structured products from credit ratings for other products.

The issuer-pay model has long created inherent conflicts of interest for which NRSROs have been criticized. The legislation contains new requirements designed to mitigate these conflicts of interest. The Act requires each NRSRO to have a board composed of at least one-third independent directors. The independent directors will

oversee policies and procedures aimed at preventing conflicts of interest and improving internal controls, among other things. Moreover, the compensation of the directors cannot be linked to the business performance of the rating agency and must be arranged to ensure the independence of their judgment.

The Act adds a new duty to supervise an NRSRO's employees and authorizes the SEC to sanction supervisors for failing to do so. It also includes revolving-door protections when certain NRSRO employees go to work for an issuer.

Additionally, the bill significantly enhances the responsibilities of NRSRO compliance officers to address conflicts of interest. The compliance officer would report directly to the board, review all of the agency's policies to manage conflicts of interest, and, in consultation with the board, resolve any conflicts of interest that arise.

The compliance officer must also assess the risk that compliance or noncompliance may compromise the integrity of the rating process. Similarly, the compliance officer must review compliance with internal controls with respect to the procedures and methodologies for determining credit ratings, including quantitative models and qualitative inputs used in the rating process, and assess the risk that such compliance with the internal controls or lack thereof may compromise the integrity and quality of the credit rating process.

The measure also requires the compliance officer to administer the policies and procedures required by the legislation and, more broadly, to ensure compliance with securities laws and SEC regulations. The compliance officer must annually prepare and sign a report on the compliance of the rating agency with the securities laws and its own internal policies and procedures, including its code of ethics and conflict-of-interest policies, in accordance with SEC rules. This compliance report must accompany the financial reports of the rating agency that have to be filed with the Commission and must include a certification that the report is accurate and complete.

The legislation removes all references to credit ratings in federal statutes under the jurisdiction of the Committee on Financial Services. The bill directs the agencies to devise a standard of creditworthiness to serve as a substitute for ratings in rules and regulations.

Broker-Dealers and Advisers

Title V, Subtitle C, Part 1, would impose various disclosure reforms, including a harmonized fiduciary duty standard for broker-dealers and investment advisers. The current regulatory regime treats brokers and advisers

differently and subjects them to different standards of care even though the services they provide investors are similar and investors view their roles as essentially the same. This regime was erected during the New Deal and, while amended many times over the years, remains rooted in the last century. Section 7103 brings regulation into today's reality and mandates a harmonized federal fiduciary standard for brokers and advisers in their dealings with retail customers. In the future, every financial intermediary that provides personalized investment advice to retail customers will owe a fiduciary duty to the investor.

The SEC must adopt rules providing that the standard of conduct for all brokers and investment advisers is to act in the best interests of their customers without regard to their own financial or other interest. Any material conflicts of interest must be disclosed to the customer, who must consent.

The receipt of compensation based on commission or fees will not, in and of itself, be considered a violation of the standard applied to a broker or dealer or investment adviser. The legislation defines retail customers as those receiving personalized investment advice from a broker, dealer or investment adviser for use primarily for personal, family or household purposes.

The legislation clarifies that the SEC must not define customer to include investors in a private fund managed by an investment adviser when that private fund has also entered into an advisory contract with the same adviser. This is designed to prevent advisers from being subjected to an irresolvable conflict of interest when they manage a pooled investment with the interest of each individual investor in mind.

Additionally, the SEC must, to the extent practicable, harmonize its enforcement and remedy regulations across brokers, dealers and investment advisers with respect to the provision of investment advice.

Enforcement and Remedies

Title V, Subtitle C, Part 2, addresses SEC enforcement and remedies. As discussed below, these include provisions on arbitration, aiding and abetting liability, enforcement actions, extraterritorial reach of federal securities laws, SEC use of grand jury information, information sharing, and other matters.

Arbitration

The SEC would have power to restrict or even prohibit the use of mandatory arbitration clauses in contracts

with broker-dealers. For too long, pre-dispute mandatory arbitration clauses inserted into brokerage firm contracts have restricted the ability of defrauded investors to seek redress in the courts for wrongdoing.

Aiding and Abetting

The current law for determining aiding-and-abetting violations and the scope of primary liability remains unsettled, resulting in challenges for the SEC in charging people who play substantial roles in fraud cases. Specifically, the Exchange Act provides that the SEC can prosecute people for knowingly aiding and abetting securities fraud. A growing number of courts, however, have held that knowingly means actual knowledge, rather than recklessness, resulting in a standard that is higher for aiding-and-abetting violations than for the primary fraud violation. The legislation clarifies that recklessness is sufficient for bringing an aiding-and-abetting action, thus harmonizing the standard for aiding and abetting and the primary violation.

The Exchange Act and the Investment Advisers Act currently permit the SEC to bring actions for aiding-and-abetting violations of those statutes in civil enforcement actions. The legislation would authorize the Commission to bring similar actions for aiding-and-abetting violations of the Securities Act and the Investment Company Act. In addition, the legislation would clarify that the knowledge requirement to bring an aiding-and-abetting claim can be satisfied by recklessness. The Act also clarifies that the Investment Advisers Act expressly permits imposition of penalties on aiders and abettors.

Grand Jury Information

Under existing law, the SEC may access grand jury information only in the rare case in which it can demonstrate that it has a particularized need for the information and that the information is sought preliminarily to or in connection with a judicial proceeding. As a practical matter, the particularized-need standard and the required nexus with an ongoing or imminent judicial proceeding severely limit the situations in which the Department of Justice can share with the SEC even the most critical information relevant to parallel investigations.

In most cases, the SEC must therefore conduct a separate, duplicative investigation to obtain the needed information. This entails an inefficient use of government resources and frequently burdens private parties and financial institutions with the need to

provide essentially the same documents and testimony in multiple investigations. The need for the SEC to conduct a separate investigation also can result in substantial delays. Section 7214 works a narrow modification of the grand jury secrecy rule to aid the Commission in its investigations and greatly enhances the efficient use of the law enforcement resources devoted to those investigations.

This modification is modeled on Section 964 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which provides banking and thrift regulators with access to grand jury information. The legislation authorizes government attorneys to seek court authorization to release certain limited grand jury information to SEC personnel for use in matters within the SEC's jurisdiction.

The legislation permits the sharing of information only with regard to conduct that may constitute violations of the federal securities laws. With regard to that information, however, the measure lessens the burden in obtaining court approval. The court could approve the sharing of the information upon a showing of a substantial need in the public interest, rather than the higher particularized-need standard. In addition, the judicial proceeding requirement would not apply to the SEC, permitting information to be shared at an earlier stage in an investigation and in connection with an SEC administrative proceeding.

Information Sharing

The legislation would allow the SEC to share information with domestic regulators, foreign securities regulators, the PCAOB, and state securities agencies engaged in the investigation and prosecution of violations of applicable securities laws without waiving any privileges the SEC may have with respect to this information. The language is modeled on a provision in the Federal Deposit Insurance Act that enables the federal bank regulatory agencies to share information with other regulators without waiving their privileges. Also, the SEC cannot be compelled to disclose information obtained from any foreign securities regulator or law enforcement authority if that authority has in good faith determined that the information is privileged.

SEC Enforcement Actions

To expedite cases against violators of securities laws, the SEC will generally need to complete enforcement investigations, compliance inspections and exams within

180 days. The legislation would allow subpoenas to be served nationwide in SEC enforcement actions in federal court. Currently, the Commission can issue a subpoena only within the federal district where a trial takes place or within 100 miles of the courthouse. Witnesses in civil cases brought by the Commission are, however, often located outside of a trial court's subpoena range. The SEC has nationwide service of process of subpoenas in administrative proceedings.

The SEC would also be authorized to impose collateral bars against regulated persons. The Commission would have authority to bar a regulated person who violates the securities laws in one part of the industry, such as a broker-dealer who misappropriates customer funds, from access to customer funds in another part of the industry, for example, an investment adviser. By expressly empowering the SEC to impose broad prophylactic relief in one action, this provision would enable the Commission to protect investors and the markets more effectively.

The legislation expressly authorizes the SEC to bring actions against persons formerly associated with a regulated or supervised entity, such as an investment company or an SRO, for misconduct that occurred during that association. This provision closes a loophole in the securities laws that had allowed those who engage in misconduct while working for an entity regulated by the SEC, such as a stock exchange, to resign and avoid accountability for their wrongdoing.

The legislation streamlines the SEC's existing enforcement authorities by permitting the Commission to seek civil money penalties in cease-and-desist proceedings under federal securities laws. The measure would ensure appropriate due process protections by making the SEC's authority in administrative penalty proceedings coextensive with its authority to seek penalties in federal court. As is the case when a federal district court imposes a civil penalty in a SEC action, administrative civil money penalties would be subject to review by a federal appeals court.

For many years the SEC has relied on Exchange Act Section 20(a), which imposes joint and several liability on control persons unless they can establish an affirmative defense. Recent court decisions, however, have concluded that the provision is available only to private parties. Section 7220 clarifies that the SEC may once again impose joint and several liability on control persons unless they can establish an affirmative defense.

Several of the Exchange Act's antifraud provisions apply only to those transactions that involve securities

registered on an exchange. Congress believes that, in today's trading environment, the same standards should apply to transactions whether they involve securities registered on an exchange or not registered on an exchange. Thus, the legislation broadens the SEC's authority under several sections of the Exchange Act to also apply the antifraud provision to securities transactions not conducted on exchanges. The SEC's existing antifraud rulemaking powers would expand to cover short sales in the over-the-counter markets and of non-equity securities, as well as all options on securities. Government securities are excluded so as to avoid any possible impact of SEC rules on that market. The general antifraud provisions for these transactions would continue to apply.

Since 1975, the SEC has had the authority to examine all the records of broker-dealers and other persons registered under the Exchange Act, as well as all records of advisers registered under the Investment Advisers Act. The SEC's authority to examine registered investment companies, however, has remained limited to required records. The legislation would change the authority under the Investment Company Act to apply to all records and, by fixing this anomaly, allow the SEC to gain a better understanding of investment company operations.

The legislation also amends the Exchange Act, the Investment Company Act, and the Advisers Act to subject registered individuals and firms at any time, or from time to time, to such reasonable periodic, special or other information and document requests as the SEC deems necessary or appropriate to conduct surveillance or risk assessments of the securities markets.

The legislation authorizes the SEC to require that registered management investment companies provide and maintain a bond against losses caused by any officer or employee of the company or any officer or employee of the company's investment adviser.

International Reach of Securities Laws

The rapid globalization of financial markets in recent years has cast into stark relief issues surrounding the international reach of U.S. securities laws. Because these laws are silent on their international reach, federal courts have developed tests, including the conduct test, which focuses on the nature of the conduct within the United States as it relates to carrying out the alleged fraudulent scheme.

The legislation authorizes the SEC and the United States to bring civil and criminal law enforcement proceedings involving transnational securities frauds, which are securities frauds in which not all of the fraudulent conduct occurs within the United States and not all of the wrongdoers are located domestically. Specifically, the legislation would amend the Securities Act and the Exchange Act to provide that U.S. district courts have jurisdiction over violations of the antifraud provisions that involve a transnational fraud if there is conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors.

SEC Funding and Other Reforms

Title V, Subtitle C, Parts 3 and 4 would increase the SEC's funding and mandate other Commission reforms. Under Section 7301, SEC funding will double over the next five years, from \$1.115 billion in fiscal year 2010 to \$2.25 billion in fiscal year 2015. This will provide the SEC with the ability to hire additional staff with industry expertise. In total, nearly \$10 billion over the next six years will help the SEC better oversee the multi-trillion-dollar securities markets.

Senate contrast: *By way of comparison, the Senate legislation would make the SEC a self-funded agency through the transaction and registration fees it collects.*

In addition, the SEC will obtain additional funding via assessments on investment advisers. Section 7302 authorizes the SEC to create a new user fee to support the Commission's work related to the inspection and examination of investment advisers. Broker-dealers presently pay fees to FINRA to cover the costs of their primary regulator, but investment advisers do not pay such fees to the SEC, which serves as their front-line regulator.

In addition, the examination statistics of investment advisers and broker-dealers reveal disparities and further vulnerabilities in the present regulatory framework. Last year, the SEC examined only nine percent of investment advisers, while FINRA examined more than 50 percent of broker-dealers. The new fee would help to increase the resources available at the SEC to inspect investment advisers.

In assessing the fee, the Commission must consider a number of factors, including the size of the adviser and the number and types of its clients. The SEC may retain any excess fees imposed in one year for application in future years. Fee increases are not subject to judicial review.

The legislation also provides and clarifies several important rule-making authorities. The SEC would regulate and establish formal rules for municipal financial advisers.

There is currently no requirement that mutual funds hold liquid securities. The legislation allows the SEC to impose limits on illiquid investments by mutual funds.

The securities lending program of AIG greatly contributed to its downfall. Thus, Section 7401 authorizes the SEC to regulate stock loans and borrowing in order to enhance market transparency, reduce collateral risk exposures, and limit conflicts of interest in the securities lending process. The SEC would have broader authority to collect information from and coordinate with foreign regulatory bodies, as well as to pursue legal cases across national borders.

Section 7402 would expand the scope of securities that must be reported to the SEC or its designee under the Lost and Stolen Securities Program, to include cancelled, missing or counterfeit securities certificates.

SEC Staff Revolving Door

In an effort to address the revolving-door problem, the legislation directs the U.S. Comptroller General to conduct a study to review the number of SEC employees who leave the Commission to work for financial institutions regulated by the SEC and file a report with Congress within one year. The report must review the length of time these employees work for the SEC before they leave to work for regulated financial institutions.

Importantly, the Comptroller General must determine if greater post-employment restrictions are needed in order to prevent SEC employees from being employed by regulated firms when they leave the SEC, as well as whether the number of former SEC employees going to the industry has led to SEC enforcement inefficiencies. The report must also identify any information-sharing engaged in by the SEC employees while they worked for the Commission.

Reporting Timeframes

With regard to beneficial ownership reporting and short-swing profit reporting, the legislation authorizes the SEC to adopt rules shortening current reporting timeframes to help the markets receive more timely information concerning substantial ownership interests in issuers that may be important for purposes of obtaining the accurate pricing of listed securities.

The legislation would expand the scope of records to be maintained and subject to examination by the SEC under both the Investment Company Act and the Investment Advisers Act to the records of custodians or others who have custody or use of the investment company's or the investment adviser's clients' securities, deposits or credits.

State Regulation of Advisers

The legislation could move the regulation of thousands of investment advisers from the SEC to the states by raising the assets-under-management trigger for federal regulation from \$25 million to \$100 million and authorizing the SEC to move it even higher. The Act sets up state oversight of investment advisers with up to \$100 million in assets under management. The \$25 million trigger for state regulation was set in the National Securities Markets Improvement Act of 1996.

If no state in which an investment adviser is registered conducts an examination, the adviser must register with the SEC. If an adviser would have to register with five or more states, the adviser may maintain its registration with the SEC.

Equal Treatment of SRO Rules

Exchange Act Section 29(a) voids any contractual provision binding any person to waive compliance with any provision of the Exchange Act, any rule or regulation under it, or any rule of an exchange. The legislation would extend this safeguard to the rules of FINRA and registered clearing agencies. This change is consistent with provisions of the Exchange Act that encourage allocation of self-regulatory responsibilities among SROs to avoid overlapping and duplicative regulation. The change is particularly important now that FINRA has taken over the regulation of NYSE members' conduct in relation to customers.

The legislation also amends the Exchange Act to require fingerprinting of the personnel of registered securities information processors, national securities exchanges, and national securities associations. This change would bring these entities in line with the entities already listed in the statute, and would aid in ensuring that the entities are aware of whether their personnel have criminal backgrounds.

Testimony on Accounting

The legislation would require the SEC, FASB and the PCAOB to provide oral testimony to Congress by their

respective chairs beginning in 2010, and annually for five years, describing their efforts to reduce the complexity in financial reporting to provide more accurate and clearer financial information to investors. The testimony must discuss how the complexity of accounting and auditing standards has added to the costs of financial reporting, as well as the development of principles-based accounting standards.

Short Sales

The legislation would require every institutional investment manager effecting a short sale of an equity security to file a daily report with the SEC in such form as the Commission prescribes. The report must include the name of the institution, the name of the institutional investment manager and the title, class, CUSIP number, number of shares or principal amount, aggregate fair market value of each security, and any additional information requested by the Commission. Also, the SEC must adopt rules providing for the public disclosure of the name of the issuer and the title, class, CUSIP number, and the aggregate amount of the number of short sales of each security following the end of the reporting period. At a minimum, this public disclosure must occur every month.

Sarbanes-Oxley Amendments

Title V, Subtitle C, Part 6, would amend the Sarbanes-Oxley Act of 2002. As discussed below, the changes would, among other things, subject auditors of broker-dealer auditors to PCAOB oversight, exempt small businesses from internal controls reporting, strengthen the SEC's power to recover funds for investors, and improve existing whistleblower protections.

PCAOB

Closing a statutory loophole revealed by the Madoff scandal, the Public Company Accounting Oversight Board will gain the power needed to flexibly examine the auditors of broker-dealers. Thus, Section 7601 would bring auditors of broker-dealers under the PCAOB oversight regime. The Board can inspect the audit firms that audit the reports of broker-dealers and will have investigatory, examination and enforcement authority over the auditors of broker-dealers. In addition, brokers and dealers would be brought into the Board's funding scheme by paying a fee allocation in proportion to their net capital compared to the total

net capital of all brokers and dealers that are not issuers, in accordance with the rules of the Board. The Act also authorizes the Board to refer an investigation concerning a broker or dealer's audit report to the relevant self-regulatory organization. Moreover, the Board is authorized to share with the SRO all information and documents received in connection with an investigation or inspection without breaching confidentiality.

The House legislation would also change the Board's name to "Auditor Oversight Board." In addition, the Act would create an ombudsman within the Board to act as a liaison between the Board and registered accounting firms and issuers with regard to the issuance of audit reports.

Internal Controls

Section 7606 exempts small businesses from the internal control audit attestation reporting requirements contained in Section 404(b) of the Sarbanes-Oxley Act. The SEC has repeatedly extended the deadline for non-accelerated filers to begin providing audited assessments of their internal controls over financial reporting. The Act would make the exemption permanent for companies with less than \$75 million in market capitalization.

Fair Funds

The Fair Fund provisions of the Sarbanes-Oxley Act take the civil penalties levied by the SEC as a result of an enforcement action and direct them to a disgorgement fund for harmed investors. The legislation would increase the money available to compensate defrauded investors by revising the Fair Fund provisions to permit the SEC to use penalties obtained from a securities fraudster to recompense victims of the fraud even if the SEC does not obtain an order requiring the defendant to disgorge ill-gotten gains. Currently, in some cases, a defendant may engage in a securities law violation that harms investors, but the SEC cannot obtain disgorgement from the defendant because the defendant did not personally benefit from the violation.

Whistleblower Protections

The legislation authorizes the SEC to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards. Payment would be from funds collected in enforcement actions not otherwise distributed to investors. The SEC currently has this authority to compensate sources in

insider trading cases, and this provision would extend the Commission's power to compensate whistleblowers that bring substantial evidence of other securities law violations. SEC determinations on whistleblower awards are final and not subject to judicial review.

The legislation also closes a loophole in Sarbanes-Oxley Act whistleblower protection by including any subsidiary or affiliate of a company whose financial information is included in the consolidated financial statements of the company. Sarbanes-Oxley created federal whistleblower protections for employees when they disclose information about fraudulent activities within their companies. HR 4173 would eliminate a defense now raised in a substantial number of actions brought by whistleblowers and apply the Sarbanes-Oxley whistleblower protections to both companies and their subsidiaries and affiliates.

Comment: *A September 9, 2008, letter from Senator Patrick Leahy, author of the Sarbanes-Oxley whistleblower statute, to the Department of Labor emphasized that federal whistleblower protection extends to employees of subsidiaries of companies and urged that the DOL not interpret the statute to exclude employees working for company subsidiaries.*

Other Investor Protections

Title V contains various other investor protections. As discussed below, these include provisions amending the Securities Investor Protection Act, establishing an investment advisory committee, authorizing consumer testing and outreach measures, requiring a post-Madoff report and mandating certain protections for seniors.

SIPA Amendments

Title V, Subtitle C, Part 5, would amend the Securities Investor Protection Act of 1970 (SIPA). The \$65 billion Madoff fraud exposed faults in SIPA, the law that returns money to the customers of insolvent fraudulent broker-dealers. The legislation fixes these shortcomings. It increases the Securities Investor Protection Corporation (SIPC) cash advance limits to levels of coverage that are similar to those provided by the FDIC. Currently, under SIPA, any amount advanced in satisfaction of customer claims may not exceed \$500,000 per customer. If part of the claim is for cash, the total amount advanced for cash payment must not exceed \$100,000. The legislation increases the maximum cash advance

amount to \$250,000 and authorizes SIPC, subject to the approval of the SEC, to make inflationary adjustments every five years starting in 2010.

The Act also updates SIPA to increase the minimum assessments paid by members of the Securities Investor Protection Corporation to the SIPC Fund. Currently, SIPA provides that the minimum assessment of a SIPC member must not exceed \$150 per year, regardless of the size of the SIPC member. The Act strikes this current minimum assessment level and sets a new minimum assessment at two basis points of a SIPC member's gross revenues.

The Act would extend SIPC insurance to futures positions held in a customer portfolio margining account under a program approved by the SEC. This provision tries to address the possibility that current law would treat a portfolio margining customer as a general creditor with respect to the proceeds from the customer's futures positions, while the same portfolio margining customer would have priority for its securities holdings in the case of insolvency of its broker-dealer.

Investment Advisory Committee

The legislation codifies the Investment Advisory Committee that the SEC recently established administratively to advise the Commission on regulatory priorities, including issues concerning new products, trading strategies, fee structures, and the effectiveness of disclosure; initiatives to protect investor interest; and initiatives to promote investor confidence in the integrity of the marketplace. Membership on the committee consists of individuals representing the interests of individual and institutional investors who use a wide range of investment approaches. The committee must meet at least twice a year, and its members will receive compensation for participation in meetings and travel expenses. Funding, as necessary, is authorized to support the committee's work.

Consumer Testing

In a congressional endorsement of the benefits that can accrue from field testing, consumer outreach, and testing of disclosures to individual investors, the legislation clarifies the SEC's authority to gather information, such as through focus groups, communicate with investors or other members of the public through telephonic or written surveys, and engage in temporary experimental programs, such as pilot programs to field test disclosures, in order to inform the Commission's rulemaking and other policy functions.

Post-Madoff Report

Within six months, the SEC must report to Congress describing the implementation of reforms in the wake of the Madoff fraud. The report must include an analysis of how many post-Madoff reforms have been implemented and how extensively. The SEC must publish the report on its website.

Senior Investors

Title V, Subtitle C, Part 7, would adopt certain investor protections designed specifically for seniors. Section 7703 would create a new grant program to provide states with the tools they need to prosecute securities fraud against seniors. The legislation recognizes the harm to seniors posed by the use of misleading professional designations by salespersons and advisers and establishes a mechanism for providing grants to states designed to give them the flexibility to use funds for a wide variety of senior investor protection efforts, such as hiring additional staff to investigate and prosecute cases; funding new technology, equipment and training for regulators, prosecutors, and law enforcement; and providing educational materials to increase awareness and understanding of designations.

Federal Insurance Office

To promote national coordination in the insurance sector, a Federal Insurance Office would be created within the Treasury Department with authority over all types of insurance other than health insurance, under Title VI. The Office would not be accompanied by the establishment of a national insurance charter. Its principal functions would be to:

- monitor the insurance industry, with the authority to gather information and issue reports;
- identify issues or gaps in the regulation of insurers that could contribute to a systemic crisis;
- recommend which insurance companies should be subject to stricter standards;
- assist in the administration of the Terrorism Insurance Program;
- coordinate international insurance issues; and
- conduct a study on ways to modernize insurance regulation and provide Congress with recommendations.

International agreements. The Treasury Secretary and the United States Trade Representative would share the authority to enter into and negotiate covered agreements with foreign entities, subject to consultation with

Congressional Committees. A “covered agreement” is a bilateral or multilateral recognition agreement entered into between the United States and foreign governments or regulatory entities that provides for recognition of prudential measures that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under state regulation.

Preemption. In carrying out its duties that relate to international insurance, the Office would have limited authority to declare that inconsistent state laws or regulations are preempted. A state insurance measure would be preempted if it results in less favorable treatment of a non-United States insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a United States insurer authorized in that state. Before making any determination of inconsistency, the Office must notify the state, provide interested parties an opportunity for comment and consider the effect of preemption. There would be a minimum 90-day period before a notice of determination of inconsistency becomes effective.

Reports. Issues to be considered as part of the required study will include: systemic risk regulation for insurance; capital standards and an appropriate match between capital allocation and liabilities for risk; consumer protection for insurance products and practices; increased national uniformity through either a federal charter or effective action by the states; improved and broadened regulation of insurance companies and affiliates on a consolidated basis, including affiliates outside of the traditional insurance business; and international coordination. Within one year of enactment, a report must be submitted to Congress containing any legislative, administrative, or regulatory recommendations to modernize and improve the system of insurance regulation. A separate report on the global reinsurance market is to be completed by Sept. 30, 2011.

Senate contrast: *The Senate draft contains additional provisions that are intended to streamline the regulation of surplus lines insurance and reinsurance through state-based reforms.*

Mortgage Reform and Anti-Predatory Lending

Title VII, the Mortgage Reform and Anti-Predatory Lending Act, would amend the Truth in Lending Act

(TILA) with the intention of reforming consumer mortgage practices and providing accountability for those practices. Title VII originally was a piece of legislation (H.R. 1728) introduced in the House on March 26, 2009, and passed by a vote of 300-114 on May 7, 2009. It was made part of H.R. 4173 by the House Rules Committee.

Mortgage Loan Originators

Title VII, Subtitle A, would amend TILA by adding a new Sec. 129B to Chapter 2 (15 USC 1631 et seq.). The purpose of the amendment is to assure that consumers are offered, and receive, residential mortgage loans on terms that “reasonably reflect” their ability to repay the loans. The added section would provide that a mortgage originator must:

- Be qualified and, when required, registered and licensed under applicable law, including the Secure and Fair Enforcement for Mortgage Licensing Act of 2008;
- “Diligently work” to provide a consumer seeking information on residential mortgage loans with a range of loan products for which the consumer would most likely qualify, based on information known, or obtained in good faith, by the originator; and
- Make full, complete and timely disclosure to each consumer in writing on: the comparative costs and benefits of the varying loan products; the nature of the originator’s relationship to the consumer; and any conflicts of interest between the originator and consumer;

Subtitle A also would amend TILA Sec. 129B to prohibit steering incentives by requiring that the amount of compensation permitted to an originator not vary based on the terms of the loan other than the amount of principal. An originator would be prohibited from arranging for a consumer to finance any origination fee or cost, except bona fide third-party settlement charges not retained by the creditor or originator, with some exceptions. Regulations adopted by the federal banking agencies to implement this title must be effective within 18 months.

The Secretary of Housing and Urban Development and the Federal Reserve Board must jointly issue proposed regulations providing for compatible disclosures to borrowers at the time of application and at closing, within six months. The disclosures would provide information on the terms and costs of residential mortgage transactions under TILA and the Real Estate Settlement Procedures Act of 1974 (RESPA).

Minimum Standards for Mortgages

Title VII, Subtitle B, would amend TILA Chapter 2 by adding Sec. 129C, which would establish a minimum federal standard for all home loans: institutions must ensure that borrowers can repay the loans they are sold.

Lenders would have to determine, through verified and documented information, that a borrower has a “reasonable ability to repay,” based on income, credit history, indebtedness and other factors. This standard also would apply to multiple residential mortgage loans secured by the same dwelling.

The legislation includes methods of determination for non-standard loans, such as variable rate loans that allow or require a consumer to defer repayment of principal or interest and interest-only loans.

Refinancing. The legislation would require that all loans provide a “net tangible benefit” to the consumer. Creditors would be prohibited from extending credit in connection with the refinancing of a prior existing residential mortgage loan without first “reasonably and in good faith” determining that the refinanced loan will provide such benefit to the consumer. Under this provision, a refinancing would not be considered to provide a “net tangible benefit” if the costs of the refinanced loan, including points, fees and other charges, exceed the amount of any new principal without any corresponding changes in the terms of the refinanced loan that are advantageous to the consumer.

Safe harbor and rebuttable presumption. A creditor, assignee or securitizer of a residential mortgage loan would be permitted to presume that the loan has met the requirements of Subtitle B if the loan is a “qualified mortgage.” A “qualified mortgage” would be defined as a residential mortgage loan that, among other things:

- Does not allow a consumer to defer repayment or principal or interest or is not otherwise a non-traditional mortgage;
- Does not include a balloon payment;
- Has an annual percentage rate that does not exceed the average prime offer rate for a comparable transaction as of the date the interest rate is set; and
- Includes verified and documented information on the consumer’s income and financial resources.

The legislation would authorize the federal banking agencies to jointly revise the criteria defining a “qualified mortgage.”

Liability. A civil action would be permitted to be brought by a borrower against a creditor for violation of the title. A consumer could seek rescission of the loan and any costs incurred because of the violation.

However, a loan could not be rescinded if, within 90 days after receiving notification from the consumer that the loan violates the terms of the section, the creditor cures the violation.

The legislation would provide a consumer with the right to rescind with a defense or counterclaim to foreclosure by a creditor. Should a foreclosure proceeding begin after the period in which a consumer could bring an action for rescission, and the consumer would have a valid basis for the action had it been brought on time, the consumer would be able to seek actual damages incurred by the reason of the violation.

A creditor would be exempt from liability and rescission in the event of borrower fraud or deception.

Further provisions. Subtitle B also would prohibit prepayment penalties for loans that are not “qualified.” A “qualified mortgage” for this purpose would not include a residential mortgage loan with an adjustable rate. Single premium credit insurance, with some exceptions, would not be permitted. The requirement of arbitration or other nonjudicial methods for resolving controversies or settling claims would also be prohibited. In addition, Subtitle B would:

- Require notice to a borrower before the resetting of hybrid adjustable rate mortgages. During the one-month period that ends six months before the date of resetting, a creditor would have to provide written notice, separate from other correspondence, of the approach of the reset date and alternatives available to the borrower. Alternatives would include: refinancing; renegotiation of loan terms; payment forbearances; and pre-foreclosure sales.
- Provide legal assistance, via the Secretary of HUD, for foreclosure-related issues. This provision would become effective as of the date of enactment.
- Provide state attorneys general with enforcement authority.
- Provide tenant protection in the event of foreclosure of the dwelling by requiring that they receive proper notification and are given time to relocate—90 days if the unit will be used as a primary residence.
- Require the federal banking agencies to adopt regulations requiring any creditor that makes a residential mortgage loan that is not a qualified mortgage to retain an economic interest in a material portion of the credit risk—at least 5 percent—for any loan that the creditor transfers, sells or conveys to a third party. The banking agencies, however, would have the authority to provide exceptions or adjustments to this requirement. In addition, the agencies could apply the risk reten-

tion requirements to securitizers of residential mortgages that are not qualified mortgages.

- Require creditors to make certain disclosures to borrowers in the case of a variable rate residential mortgage loan for which an escrow or impound account will be established for payment of taxes, insurance and adjustments.
- Set forth disclosure requirements to be included in monthly residential mortgage loan statements.
- Require regulations be adopted in final form within 12 months and take effect within 18 months.

High-Cost Mortgages

TILA would be amended by Title VII, Subtitle C, to expand the protections available under federal rules on high-cost loans by lowering the interest rate and the points and fee triggers that define high-cost loans.

Provisions governing prepayment penalty provisions would be repealed. The legislation would prohibit:

- Balloon payments;
- Creditors from recommending or encouraging consumers to default on an existing loan or other debt prior to the closing of a high-cost mortgage that refinances all or part of the existing loan or debt;
- Late payment charges or fees in excess of 4 percent of the amount of the payment past due, with some exceptions;
- Acceleration of a debt, except in certain specified cases;
- The financing by a creditor of any prepayment fee or penalty payable by the consumer in a refinancing transaction if the creditor holds the note being refinanced, or of any points or fees;
- The structuring of a loan transaction as an open-end credit plan or another form of loan for the purpose of evading the provisions of Subtitle C;
- The dividing of any loan transaction into separate parts for the purpose of evading Subtitle C provisions;
- Modification or deferral fees, unless the modification results in a lower annual percentage rate for the consumer and the amount of the fee is comparable to fees imposed for similar consumer credit transactions;
- The charging of a fee for informing a person of the balance due to pay off a high-cost mortgage;
- Flipping; and
- The extension of credit without certification of pre-loan counseling from a counselor approved by HUD.

A creditor in a high-cost loan who, when acting in good faith, fails to comply with the requirements of this subsection would not be considered to have violated the requirement if remedial action is taken.

A violation may be avoided if within 30 days of the loan closing and prior to the institution of any action, the consumer is notified of or discovers the violation, restitution is made and adjustments made to the loan to either, at the choice of the consumer, make the loan satisfy the requirements or change the terms of the loan so that the loan is no longer high-cost. Similarly, the requirements are not violated if within 60 days of the creditor's discovery or receipt of notice of an unintentional violation or bona fide error, and prior to any action by the consumer, the consumer is notified of the problem, restitution is made and adjustments are made to the loan to either, at the choice of the consumer, make the loan satisfy the requirements of the subsection or change the terms of the loan so that it is no longer high-cost.

The Federal Reserve Board would have to publish final regulations implementing Subtitle C within six months of enactment of the legislation. Amendments made by Subtitle C would take effect six months from the date of enactment.

Office of Housing Counseling

Title VII, Subtitle D, would establish an Office of Housing Counseling (OHC) within HUD with the intention of boosting homeownership and rental housing counseling. Using only HUD-certified counselors and HUD programs, the OHC would be expected to lead and coordinate other efforts to expand homeownership counseling. The legislation also would require the launch of a national public service, multimedia campaign to promote financial counseling on homeownership and the establishment of a website and toll-free hotline.

Mortgage Servicing

Title VII, Subtitle E, would amend TILA Chapter 2 (15 USC 1631) to provide that a creditor in a consumer credit transaction that is secured by a first lien on the principal dwelling of the consumer must establish an escrow or impound account for the payment of taxes and hazard insurance and, if applicable, flood insurance, mortgage insurance, ground rents and any other required periodic payments or premiums. This provision would not apply to a consumer credit transaction under an open-end credit plan or a reverse mortgage.

A creditor would be prohibited from requiring an impound, trust or other type of account for payments as a condition of a real property sale contract or a loan secured by a first deed of trust or mortgage on the

principal dwelling of the consumer. This prohibition would not apply to a consumer credit transaction under an open-end credit plan or a reverse mortgage, except in certain limited cases.

The account would have to be open for a minimum period of five years, beginning with the date of the consummation of the loan and until the borrower has sufficient equity in the home securing the consumer credit transaction so as to no longer have to maintain private mortgage insurance, or for any period provided in regulations.

The legislation would provide for a limited exception to the requirement of an escrow account for loans secured by shares in a cooperative and for certain condominium units.

Disclosure requirements. The creditor would have to make required disclosures by written notice to the consumer three business days before consummation of the transaction (or as indicated in regulations).

Regulations. Title VII, Subtitle E, would require the federal banking agencies and Federal Trade Commission to adopt final regulations within 180 days. The amendments would only apply to covered mortgage loans consummated

after the end of the one-year period following publication of the regulations in the *Federal Register*.

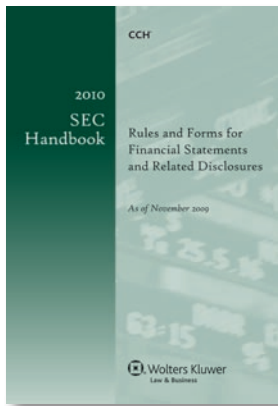
Appraisal Activities

Title VII, Subtitle F, would amend TILA Chapter 2 (15 USC 1631 et seq.) to prohibit a creditor from extending credit in the form of a subprime mortgage to a consumer without first obtaining a written property appraisal. As amended, TILA Chapter 2 would also provide that unfair or deceptive practices in extending credit or providing services for a consumer credit transaction secured by the consumer's principal dwelling is unlawful.

The legislation would prohibit a certified or licensed appraiser conducting an appraisal from having a direct or indirect interest in the property being appraised.

Under the subsection, the federal banking agencies and the Federal Trade Commission must prescribe regulations within 180 days, with an effective date no later than one year after enactment. The regulations would more specifically define acts or practices that are unfair or deceptive.

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