Senate Banking Committee Releases Draft Legislation: Restoring American Financial Stability Act of 2009

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Introduction

The Senate Banking Committee has released draft legislation that, if enacted, would provide a sweeping overhaul of the regulation of U.S. financial services and markets. The Restoring American Financial Stability Act of 2009 would regulate systemic risk, enhance transparency and disclosure, delink executive compensation from excessive risk, expand consumer and investor protection, and prevent regulatory arbitrage. The draft provides for the regulation of hedge funds and over-the-counter derivatives and would establish a new resolution authority to unwind failing financial firms. The legislation also provides for major corporate-governance reforms, such as shareholder advisory votes on compensation and enhanced compensation committees. The draft further envisions a completely reformed securitization process playing an important role in the financial markets. A new independent regulator would be created with authority to make sure that consumer protection regulations are written and enforced.

In addition, the draft would provide for joint regulation of derivatives by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), make the SEC self-funding, strengthen the SEC's powers, better protect investors, and impose more effective regulation of the securities markets.

The draft would also reform the credit-rating process by establishing a new Office of Credit Rating Agencies at the SEC, as well as mandating new rules for internal controls, independence, transparency and penalties for poor performance in order to restore investor confidence in credit ratings. The draft also establishes a systemic risk regulator based on the council of systemic risk regulators model employed in the European Union legislation and in the House draft.

Finally, the draft would create a new agency to act as a single federal banking regulator. This agency would combine the functions of the Office of the Comptroller of the Currency and the Office of Thrift Supervision, the state bank supervisory functions of the Federal Deposit Insurance Corp. and the Federal Reserve Board, and the bank holding company supervision authority from the Fed. It would leave in place the state banking system. Under this structure, the FDIC would focus on its job as deposit insurer and resolver of failed institutions, and the Fed would focus on monetary policy.

Systemic Risk Regulator

The financial crisis demonstrated that large, interconnected financial firms that pose a systemic risk to the entire financial system need to be under a consistent and conservative regulatory regime. These standards cannot simply address the soundness of individual institutions, but must also ensure the stability of the system itself.

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Any financial institution that is big enough, interconnected enough, or risky enough that its distress necessitates government intervention is an institution that requires oversight by a federal agency responsible for managing the overall risk to the financial system. With new financial products always appearing and market conditions constantly changing, regulators must have authority to take a holistic view of the playing field, identifying gaps, pointing to unsustainable trends, and raising questions about new kinds of interactions.

Thus, Title I of the Senate legislation would create a regulator to police all systemically important firms and markets. This regulator would be authorized to take proactive steps to prevent or minimize systemic risk. The legislation seeks to ensure holistic regulation of the financial system as a whole, not just its individual components.

The Senate draft would create an independent agency with a board of regulators to identify and address systemic risks posed by large, complex companies, products, and activities before they threaten the stability of the financial system. The new Agency for Financial Stability could require companies that threaten the economy to divest some of their holdings. The agency would also be authorized to break up companies deemed to pose a threat to the nation's financial stability, even if those companies are not insolvent.

Moreover, the financial stability regulator would be charged with adopting capital, leverage, liquidity and risk-management standards that would become increasingly strict as companies grow in size or complexity. The draft would identify unregulated financial companies that pose systemic risk and assign them to a federal regulator for supervision.

The Agency would be composed of, among others, the chairs of the Fed, SEC and CFTC, with an independent chair appointed by the president and confirmed by the Senate for a six-year term. The Agency may appoint whatever special advisory, technical or professional committees may be useful in carrying out its functions.

The Agency has authority to request the production of information under a confidential regime from the SEC and other federal agencies, as necessary to monitor the financial services marketplace to identify potential threats to the stability of the financial system or otherwise to carry out its assigned duties.

The Agency may also 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 financial market in which the company participates, or the financial company itself, poses a threat to financial stability. In order to mitigate this reporting burden, before requiring the submission of reports from regulated financial companies, the Agency must coordinate with the SEC and other regulators whenever possible and rely on information already being collected by the SEC.

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OTC Derivatives

The financial crisis revealed that massive risks in derivatives markets went undetected by both regulators and market participants. In 2000, the Commodity Futures Modernization Act (CFMA) explicitly exempted over-the-counter derivatives, to a large extent, from regulation by the CFTC. Similarly, the CFMA limited the SEC's authority to regulate certain types of OTC derivatives. As a result, the market for OTC derivatives has largely gone unregulated.

This lack of regulation led to disastrous consequences. Many institutions and investors had substantial positions in credit default swaps, swaps tied to asset-backed securities—complex instruments whose risk characteristics proved to be poorly understood even by the most sophisticated of market participants. At the same time, excessive risk taking and poor counterparty credit risk management by many banks saddled the financial system with an enormous unrecognized level of risk.

Although OTC derivatives are supposed to protect businesses from risks, they became a way for companies to make enormous bets with no regulatory oversight and therefore exacerbated risks. Because the derivatives market was considered too big and too interconnected to fail, taxpayers had to foot the bill for bad bets that linked thousands of traders and created a web in which one default threatened to produce a chain of corporate and economic failures worldwide. These interconnected trades, coupled with the lack of transparency about who held what, made unwinding the "too big to fail" institutions more costly to taxpayers.

During last year's financial crisis, concerns about the ability of companies to make good on these derivatives contracts, and the lack of transparency about what risks existed, caused credit markets to freeze. Investors were afraid to trade as Bear Stearns, AIG, and Lehman Brothers failed because any new transaction could expose them to more risk.

In an effort to address the systemic risk to the financial markets posed by derivatives, Title VII of the Senate draft would mandate, for the first time, the federal regulation of derivatives under a dual SEC-CFTC regime. OTC derivatives would be cleared through centralized clearing houses and traded on exchanges, uncleared swaps would be subject to margin and capital requirements, and all trades would be reported so that regulators can monitor risks in this large, complex market.

The draft legislation would authorize the SEC and CFTC to regulate over-the-counter derivatives so that irresponsible practices and excessive risk taking can no longer escape regulatory oversight. The draft uses the Administration's outline for a joint rulemaking process with the new systemic risk regulator, allowing the Agency for Financial Stability to step in if the SEC and the CFTC cannot agree.

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The draft mandates central clearing and exchange trading for derivatives that can be cleared and provides a role for both regulators and clearing houses to determine which contracts should be cleared. It requires the SEC and the CFTC to pre-approve contracts before clearing houses can clear them. Traders would have to post margin and capital on uncleared trades in order to offset the greater risk they pose to the financial system and encourage more trading to take place in transparent, regulated markets. The draft requires data collection and publication through clearing houses or swap repositories to improve market transparency and provide regulators important tools for monitoring and responding to risks.

Hedge Fund Advisers

Similar to the House draft (HR 3818), Title IV of the Senate legislation would require the SEC registration of advisers to hedge fund and other private funds and disclosure of information to the Commission under a confidentiality regime. As in the House draft, the Senate bill would exempt advisers to venture capital funds from SEC registration. The SEC must require hedge fund advisers to disclose the amount of assets under management, their use of leverage and counterparty credit risk exposure, as well as their trading and investment positions, their valuation methodologies, and any side arrangements or side letters that treat fund investors more favorably than other investors.

The Senate draft orders the Comptroller General to conduct a study and submit a report to Congress on the feasibility of forming a self-regulatory organization to oversee hedge funds, private equity funds, and venture capital funds.

Consumer Financial Protection Agency

Title X of the draft consolidates consumer protection responsibilities in a new federal agency with broad authority to investigate and react to abuses as they develop. With this agency on the lookout for bad deals and schemes, consumers won’t have to wait for Congress to pass a law to be protected from bad business practices.

The management of the Consumer Financial Protection Agency would be vested in a board of directors composed of five members, four of whom would be appointed for five-year terns by the president, subject to Senate confirmation, and the last one being the director of the new Financial Institutions Regulatory Administration. From among the appointed board members, the president will designate a director of the new agency.

The new agency would level the playing field for insured banks by regulating the shadow banking industry, such as mortgage brokers and payday lenders, for the first time. This would ensure that companies offering customers the same products receive the same regulatory treatment. The draft makes one agency accountable for consumer protections.

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With many agencies currently sharing responsibility, it is hard to know who is responsible for what, and easy for emerging problems that have not historically fallen under anyone's purview to fall through the cracks.

The draft allows states to pass tougher consumer protections that apply to all lenders, preventing federal regulations from preempting stronger state laws. The new regime focuses resources on companies that pose the biggest risk to consumers, such as mortgage bankers, brokers, finance companies and the largest institutions.

SEC Self-Funding

The draft would also realize a goal of SEC self-funding. Section 991 would allow the SEC to fund its own operations by using the transaction and registration fees it collects in place of a congressionally-mandated budget. Self-funding will give the SEC access to millions more than is allocated through the congressional appropriations process.

The SEC is one of only two federal financial regulators that must go through the annual congressional appropriations process. Federal banking regulators such as the Federal Reserve and the FDIC, on the other hand, can use what they collect in fees, deposit insurance and interest income to fund their operations.

Under the current system, the SEC staff is struggling to keep up with the more sophisticated actors in the market, and the federal government cannot keep starving the SEC's budget or the agency will "remain a shadow of its former self," said Senator Charles Schumer, a key member of the Banking Committee, who noted that the Commission's ability to retain experienced personnel is an ongoing problem since Wall Street firms are increasingly able to lure the agency's experts with higher salaries. Mr. Schumer emphasized that the SEC's chronic under-funding must be addressed in a comprehensive way.

Currently, the SEC raises millions more dollars every year in registration and transaction fees (not including enforcement penalties or settlements) than it is allocated through the appropriations process, he noted, but its budget is limited to the amount approved by Congress. In 2007, though the SEC brought in $1.54 billion in fees, it secured just $881.6 million in funding.

PCAOB

The Madoff fraud revealed that the Public Company Accounting Oversight Board lacked the powers it needed to examine the auditors of broker-dealers. The $65 billion Ponzi scheme also exposed faults in the Securities Investor Protection Act, the law that returns money to the customers of insolvent fraudulent broker-dealers. Section 982 of the Senate draft would close these loopholes and fix these shortcomings.

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Broker-dealers would come under the PCAOB oversight regime. The Board would inspect the audit reports on broker-dealer financial statements 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 draft 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 would have authority to share with the SRO all information received in connection with an investigation or inspection without breaching that information's confidential status.

Brokers and Investment Advisers

Acting on a recommendation of the Obama Administration, the House draft (HR 3817) mandates a federal fiduciary standard for brokers and investment advisers in their dealings with retail customers. Under this harmonized standard, broker-dealers and investment advisers will have to put customers' interests first. The Senate draft mandates uniform standards for anyone providing customers investment advice, thereby eliminating different standards for brokers and investment advisers.

Similarly to the House draft, the Senate legislation would reorder federal-state regulation of investment advisers by raising the SEC registration trigger of assets under management from $25 million to $100 million. This would effectively move the regulation of thousands of investment advisers from the SEC to the states. The $25 million trigger for state regulation was set in the National Securities Markets Improvement Act of 1996.

Broker-dealers generally require their customers to contract at account opening to arbitrate all disputes. Although arbitration may be a reasonable option for many consumers to accept after a dispute arises, the Obama Administration believes that mandating a particular venue and up-front method of adjudicating disputes, thereby eliminating access to courts, may unjustifiably undermine investor interests.

Because mandatory arbitration of brokerage disputes has limited the ability of defrauded investors to seek redress, the House and Senate drafts would authorize the SEC to bar these clauses in brokerage firm customer contracts.

Investor Protection

As with the House draft, Section 989A of the Senate legislation contains specific provisions dealing with senior investor protection. The North American Securities Administrators Association (NASAA) has long raised concerns over the use of misleading professional designations that convey an expertise in advising seniors on

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financial matters. Many of these designations in reality reflect no such expertise but rather are conveyed to individuals who pay to attend weekend seminars and take open book, multiple-choice tests. NASAA has adopted a model rule designed to curb abuses in this area.

The drafts recognize the harm to seniors posed by misleading designations and establishes a mechanism for providing grants to states as an incentive to adopting the NASAA model rule. The grants seek to give states 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.

Under Title IX, Subtitle F, investors in general will be better protected by improved competence of the SEC. Thus, the Senate draft mandates an annual assessment of the SEC's internal supervisory controls and a biannual GAO study of SEC management. The draft also creates the Investment Advisory Committee, a committee of investors to advise the SEC on its regulatory priorities and practices as well as the Office of Investor Advocate in the SEC, to identify areas where investors have significant problems dealing with the SEC and FINRA and provide them assistance.

The draft also sets up an SEC whistleblower award regime under which whistleblowers can provide information relating to a violation of the securities laws to the SEC. Section 922 authorizes the SEC to pay an award to one or more whistleblowers who voluntarily provided original information to the Commission that led to the successful enforcement of a judicial or administrative action in an amount not less than 10 percent of what has been collected of the monetary sanctions imposed in the case and not more than 30 percent of what has been collected of the monetary sanctions imposed in the case.

Corporate Governance

The Obama Administration and the G-20 have determined that corporate governance failures, including compensation that encouraged short-term risk taking, were significant causes of the financial crisis. Bonuses that rewarded short term profits over the long term health and security of the firm, and other incentive-based compensation for executives to take big risks with excess leverage, threatened the stability of their companies and the economy as a whole. Thus, under Title IX, Subtitles E and G, the draft legislation gives shareholders a say on pay and proxy access, ensures the independence of compensation committees, and requires companies to set clawback policies to take back executive compensation based on inaccurate financial statements as important steps in reining in excessive executive pay and helping shift management's focus from short-term profits to long-term growth and stability.

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The Senate draft provides that proxy materials must include provisions for a separate shareholder advisory vote to approve the compensation of company executives. Similarly, a separate shareholder advisory vote is required for golden parachute agreements in connection with a takeover. These non-binding shareholder votes cannot be construed to overrule a decision by the board, to create or imply any change to the directors' fiduciary duties or create any new duties, or to restrict or limit the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation.

The draft provides shareholders with this powerful opportunity to hold accountable executives of the companies they own, and a chance to disapprove where they see the kind of misguided incentive schemes that threatened individual companies and, in turn, the broader economy.

The draft also directs the SEC to clarify disclosures relating to executive compensation and to require disclosure of information showing the relationship between executive compensation and the company's financial performance. There must be disclosure of charts comparing executive compensation with stock performance over a five-year period or another period as the SEC determines.

The draft amends Section 16 of the Exchange Act to require companies to develop and implement clawback policies. Thus, companies must adopt polices to take back executive compensation if it was based on inaccurate financial statements that did not comply with accounting standards and that required an accounting restatement due to the material noncompliance with any financial reporting requirement under the securities laws. The company must recover from any current or former executive officer who received incentive-based compensation, including stock options, awarded during the three-year period preceding the date on which the issuer must prepare an accounting restatement based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.

The legislation also directs the SEC to require companies to disclose in their annual proxy statement whether their employees are permitted to engage in hedging by purchasing financial instruments, such as equity swaps, that are designed to hedge or offset any decrease in the market value of equity securities granted to employees by the company as part of employee compensation.

The draft gives shareholders access to management's proxy card to nominate directors. Providing shareholders a greater role in choosing directors can help shift management's focus from short-term profits to long-term growth and stability. Specifically, within 180 days of the bill's enactment, the SEC must issue rules permitting shareholders to use management proxy solicitation materials for the purpose of nominating individuals to the board of directors, under terms and conditions the Commission determines are in the interest of shareholders and the protection of investors.

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Corporate governance best practices often specify that the same individual should not serve as board chairman and CEO. In the spirit of the comply-or-explain concept found in European corporate governance codes, the Senate draft directs the SEC to adopt rules requiring a company to explain in its annual proxy sent to investors the reasons why it has chosen the same person to serve as board chair and chief executive officer or why it has chosen different individuals to serve as board chair and CEO.

The draft also directs the SEC to adopt rules within one year prohibiting companies from having a board of directors with staggered terms of service unless the shareholders have approved that in advance. The percentage of shareholders required to approve a board of directors with staggered terms of service must be the percentage required by the company for an amendment to the certificate of incorporation or the bylaws. The draft defines a board with staggered terms of service as a board that conducts an annual election for membership in which fewer than all board members are elected.

Companies that already have boards with staggered terms of service not approved by shareholder vote would have to seek shareholder approval at the first annual meeting after the SEC rules are adopted.

In a major corporate governance improvement, the draft mandates independent board compensation committees, as well as mandating the independence of any compensation consultants and legal advisers hired by the committee. This will be a condition of listing on an exchange. In determining the independence of compensation committee members, SEC rules must require exchanges to consider the source of compensation and any affiliation with the company or any of its subsidiaries.

SEC rules must also allow an exchange to exempt a particular relationship from the independence requirements, taking into consideration the size of an issuer and any other relevant factors. Separately, the SEC is directed to adopt rules defining independence for compensation consultants and legal counsel hired by the compensation committee. Also, the SEC is directed to conduct a study and file a report on the effects of using compensation consultants on company performance.

The compensation committee has sole discretion to hire and obtain the advice of a compensation consultant and is directly responsible for the compensation and oversight of the work of the consultant. However, the compensation committee cannot be required to implement or even act consistently with the advice or recommendations of the compensation consultant. Ultimately, nothing can affect the ability or the obligation of a compensation committee to exercise its own judgment in the fulfillment of its duties.

Further, proxy or consent solicitation materials for an annual or special meeting of shareholders must disclose: whether the compensation committee retained or obtained the advice of a compensation consultant; whether the committee's work has raised any conflict of interest; and, if so, the nature of the conflict and how it is being addressed.

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The legislation directs companies to provide appropriate funding, as determined by the compensation committee, for the payment of reasonable compensation to a compensation consultant and to independent legal counsel or any other adviser to the committee.

SEC rules must allow exchanges to consider exempting a category of issuers from the compensation committee requirements. In determining appropriate exemptions, the exchange must take into account the potential impact of the requirements on smaller reporting companies.

Credit Rating Agencies

Credit rating agencies market themselves as providers of independent research and in-depth credit analysis. But in the financial crisis, instead of helping people better understand risk, they failed to warn people about risks hidden throughout layers of complex structures.

Flawed methodology, weak oversight by regulators, conflicts of interest, and a total lack of transparency contributed to a system in which AAA ratings were awarded to complex, unsafe asset-backed securities and other derivatives, adding to the housing bubble and magnifying the financial shock caused when the bubble burst. When investors no longer trusted these ratings during the credit crunch, they pulled back from lending money to municipalities and other borrowers.

Under Title IX, Subtitle C, the draft requires each nationally recognized statistical rating organization to establish, enforce, and document an effective internal control structure governing the implementation of policies and methodologies they use to determine credit ratings. Further, the SEC must adopt rules requiring credit rating agencies to submit to the Commission an annual internal controls report, containing a description of the responsibility of the management of the rating agency in establishing and maintaining effective internal controls. In addition, the rating agency must assess the effectiveness of the internal controls and the attestation of the CEO.

The legislation would authorize the SEC to temporarily suspend or permanently revoke the registration of a credit rating agency with respect to a particular class or subclass of securities if the Commission finds, after notice and an opportunity for a hearing, that the rating agency does not have adequate financial and managerial resources to consistently produce credit ratings with integrity. In making this determination, the SEC must consider whether the rating agency has failed over a sustained period of time to produce accurate ratings for that class or subclass of securities and whether the performance of the rating agency has been significantly worse than the performance of other rating agencies during the same time period.

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The SEC must also adopt rules separating the ratings from sales and marketing. Specifically, the rules must prevent the sales and marketing considerations of a rating agency from influencing the production of ratings. The SEC rules must provide for exceptions for small rating agencies when the Commission determines that the separation of the production of ratings and sales and marketing activities is not appropriate.

The Credit Rating Agency Reform Act of 2006 ordered rating agencies to name a compliance officer to ensure compliance with the securities laws and regulations. The Senate draft prohibits these compliance officers from working on ratings, methodologies, or sales and marketing, and from establishing compensation levels for employees other than those working for them. The SEC may exempt a small rating agency from these limitations if it finds that compliance with the limitations would impose an unreasonable burden on the agency.

The draft mandates that compliance officers must establish procedures for the receipt and treatment of complaints regarding ratings and the methodologies used to set the ratings, as well as a system to deal with confidential, anonymous complaints from employees or users of credit ratings.

Further, compliance officers must submit to the rating agency an annual report on the agency’s compliance with the securities laws and its own policies, including a description of any material changes to its code of ethics and conflict of interest policies, and a certification that the report is accurate and complete. Then, the rating agency must file the compliance officer’s report with the SEC, along with the financial report already required to be furnished to the SEC. The Commission may treat as confidential any information contained in a financial statement upon determining that its publication may harm the rating agency.

The legislation creates an Office of Credit Ratings at the SEC with its own compliance staff and the authority to fine agencies. The director of the Office of Credit Ratings would report directly to the SEC chair, and the Office must be adequately staffed with persons with expertise in structured debt.

The Office must conduct annual examinations of rating agencies and make key findings public. The draft also requires rating agencies to consider information in their ratings that comes to their attention from a source other than the organizations being rated if they find it credible. The SEC is authorized to deregister an agency for providing bad ratings over time. The Senate draft would allow investors to bring private rights of action against ratings agencies for a knowing or reckless failure to investigate or to obtain analysis from an independent source.

In an effort to improve transparency, the draft would require rating agencies to disclose their methodologies, their use of third parties for due diligence efforts, and their ratings track record.

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Securitization

In many ways, the financial crisis was at root a crisis of securitization. Although traditional securitization was a successful tool for bundling loans into asset-backed securities, in the last decade it morphed into the short-term financing of complex illiquid securities whose value had to be determined by theoretical models. The inherent fragility of this new securitization model was masked by the actions of market intermediaries, particularly credit rating agencies.

The collapse of structured securitization revealed the ugly reality that, far from managing and dispersing risk, it had increased leverage and concentrated risk in the hands of specific financial institutions. The Obama Administration proposed to reform securitization by changing the incentive structure of market participants, increasing transparency to allow for better due diligence, strengthening credit rating agency performance, and reducing the incentives for over-reliance on credit ratings. Provisions of the draft legislation would implement these goals.

One of the most significant problems in the securitization markets was the lack of sufficient incentives for lenders and securitizers to conduct due diligence regarding the quality of the underlying assets being securitized. This problem was exacerbated as the structure of those securities became more complex and opaque. Inadequate disclosure regimes also widened the gap in incentives among lenders, securitizers and investors.

There is a growing consensus that we have “crossed the Rubicon” into originate-and-distribute securitization and there is no turning back to originate and hold. Indeed, restarting private-label securitization markets, especially in the United States, is critical to limiting the fallout from the credit crisis and to the withdrawal of central bank and government interventions. However, no one wants policies that would take markets back to their high octane levels of 2005–07. Thus, the draft legislation aims to put securitization on a solid and sustainable footing. The IMF has recognized that the return to a more robust securitization market will not be instantaneous, since it will take time for the new policies to be put in place and become effective, in part because deleveraging will continue for some time.

Title IX, Subtitle D, reforms the process of securitization primarily by requiring companies that sell products like mortgage-backed securities to retain a portion of the risk. The Senate legislation would require companies that sell products like mortgage-backed securities to keep some “skin in the game” by retaining at least 10 percent of the credit risk so that, if the investment fails, the company that made, packaged and sold the investment would lose out right along with the people they sold it to. In addition, the draft would require issuers to disclose more information about the assets underlying asset-backed securities and to analyze the quality of those assets.

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Specifically, the draft directs the federal banking agencies and the SEC to jointly adopt regulations requiring any securitizer to retain an economic interest of not less than 10 percent in a material portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers or sells to a third party. In addition, the regulations must prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset. The regulations must also specify the permissible forms of risk retention and the minimum duration of the risk retention.

The regulations must exempt the securitization of an asset issued or guaranteed by the United States, a federal agency, or a government-sponsored enterprise, as the federal banking agencies and the Commission jointly determine appropriate. As a catch-all, the draft allows a total or partial exemption of any other securitizations, as may be appropriate in the public interest or for the protection of investors. Also, the regulations must allocate the risk-retention obligations between a securitizer and an originator in the case of a securitizer that purchases assets from an originator, as the federal banking agencies and the Commission jointly determine appropriate. The regulations will be enforced by the federal banking agency with respect to any securitizer that is an insured depository institution and by the SEC with respect to all other securitizers.

The SEC would have to adopt regulations under the Securities Act 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 this 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, including data having unique identifiers relating to 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 those assets.

The SEC must also adopt regulations on the use of representations and warranties in the market 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 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. Finally, the Commission must issue

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regulations relating to the registration statement required to be filed by any issuer of an asset-backed security requiring the issuer to perform a due diligence analysis of the assets backing the security and to disclose the nature of that analysis.

The draft adds a definition of "asset-backed security" to the Exchange Act to mean a fixed-income or other security collateralized by any type of self-liquidating financial asset, including a loan, a lease, a mortgage, or a secured or unsecured receivable, that allows the holder of the security to receive payments depending primarily on cash flow from the asset, including collateralized mortgage or debt obligations. The definition would exclude a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

Single Federal Bank Regulator

Title III of the Senate draft would do away with the Office of the Comptroller of the Currency and the Office of Thrift Supervision. It also would take away from the Federal Reserve Board and the Federal Deposit Insurance Corporation nearly all bank or bank holding company supervisory duties those agencies now have. A single regulatory agency—the Financial Institutions Regulatory Administration—would assume the responsibility for supervising all banks and thrifts.

The draft would, however, attempt to protect the dual banking system. State bank charters would remain, and the new agency would have a separate division charged with supervising community banks. According to Senator Dodd, this change would put an end to regulatory arbitrage, i.e., changing charters to secure a more accommodating regulator. It also would permit more efficient and consistent regulation.

The FDIC and Fed would survive the reorganization, but with reduced responsibilities. The FDIC would be expected to focus its attention on its task of insuring deposits and resolving failed institutions, although it would maintain some "back-up" examination authority. The Fed would lose all of its consumer protection and financial institution oversight functions. Instead, it would be concerned only with monetary policy and the stability of the financial system.

Senator Dodd asserted that the proposal was not designed to be punitive toward the Fed. "I really want the Federal Reserve to get back to its core enterprises," he said, adding that when the Fed took on consumer protection responsibilities and regulation of bank holding companies "it was an abysmal failure." The draft legislation, said the Banking Committee chair, would in fact boost the Fed's independence. "You start loading up the Fed with additional responsibilities and that independence can be threatened," he said.

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The American Bankers Association issued a statement saying it opposes the creation of a single prudential bank regulator, asserting the idea had "failed miserably" in the United Kingdom. The Dodd proposal would "tear apart the existing regulatory structure only to create a new one that would produce conflicts among regulators, undermine the state-chartered banking system, and impose extensive new regulatory burdens on those banks that had nothing to do with creating the financial crisis," the group said.

The Conference of State Bank Supervisors also opposes the single-regulator plan, asserting it "will inevitably produce further industry consolidation and eliminate necessary regulatory checks and balances that have helped to strengthen our nation's financial system." The proposal would have a disastrous impact on our nation's banking industry and economy as a whole, the agency said.

Resolution Authority

According to Treasury, the lack of a federal regulatory regime and resolution authority for large systemic financial institutions contributed to the financial crisis and, unless addressed with legislation, will constrain a federal response to future crises. As demonstrated by AIG, severe distress at large global non-depository financial institutions can pose systemic risks to the financial markets just as distress at banks can.

Title II of the discussion draft intends to end the belief that any firm can be too big to fail by establishing stricter regulatory standards and a method for managing failure. To begin with, capital, leverage and liquidity requirements would rise as companies grow, in order to ensure that the companies would be able to withstand financial stresses and discourage excessive growth. Institutions would have to provide their own support during difficult financial times by issuing long-term hybrid debt securities.

One part of the proposal would require each of these firms to create and submit for approval a "funeral plan" for how the company could be shut down in a quick and orderly way if it failed. A company that failed to submit an acceptable plan would be subject to higher capital requirements, limits on growth and activity, and even divestiture orders.

The FDIC would be the agency charged with resolving failed large institutions. However, the proposal would not establish a standing fund analogous to the Deposit Insurance Fund to pay resolution costs; instead, any costs would be covered by assessments on surviving firms with assets of more than $10 billion.

The Fed would lose any authority it has to prop up individual failing institutions. Instead, it would be limited to programs that provide system-wide support to healthy institutions or systemically important market utilities.

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Aiding and Abetting Liability

Section 984 of the draft legislation would enable investors to sue persons who help commit securities fraud. The draft amends Section 21D of the Exchange Act to provide that, in implied private civil securities fraud actions, any person that knowingly or recklessly provides substantial assistance to another person in violation of the securities antifraud rule or any other SEC rule or regulation must be deemed to be in violation to the same extent as the person to whom that assistance is provided. This provision appears to overrule legislatively the U.S. Supreme Court's 1994 opinion in *Central Bank of Denver v. First Interstate Bank* [1993-1994 Transfer Binder] Fed. Sec. L. Rep. ¶98,178 [Intelliconnect, IRN, IP access users] that there is no implied private right of action against secondary actors who aid and abet securities fraud.

Until the *Central Bank* ruling, every circuit of the Federal Court of Appeals had concluded that a private right of action for securities fraud allowed recovery not only against the person who directly undertook a fraudulent act, the primary violator, but also anyone who aided and abetted the actor. A five-justice majority in *Central Bank* narrowed the scope of the antifraud rule by holding that its private right of action extended only to primary violators.

Municipal Securities

Financial advisers to municipal securities issuers have been involved in "pay-to-play" scandals and have recommended unsuitable derivatives for small municipalities, among other inappropriate actions, and are not currently regulated. Under the draft, municipal securities will have better oversight through the registration of municipal advisers and increased investor representation on the Municipal Securities Rulemaking Board.

Under Title IX, Subtitle H, the legislation requires SEC registration for financial advisers, swap advisers, and investment brokers, unregulated intermediaries who play key roles in the municipal bond market. It also subjects financial advisers, swap advisers, and investment brokers to rules issued by the Municipal Securities Rulemaking Board and enforced by the SEC or a designee. The draft gives investor and public representatives a majority on the MSRB to better protect investors in the municipal securities market, where there has been less transparency than in corporate debt markets.

Accredited Investors

Section 412 of the Senate draft directs the SEC to adopt rules increasing the financial threshold for an accredited investor under the Securities Act by calculating an amount that is greater than the amount in effect on the date of enactment of the draft of $200,000 income for a natural person (or $300,000 for a couple) and $1,000,000 in assets, as the

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SEC determines is appropriate and in the public interest, in light of price inflation since those figures were determined. The rules must also adjust that threshold not less frequently than once every five years, to reflect the percentage increase in the cost of living. Section 413 directs the comptroller general to conduct a study and report to Congress on the appropriate criteria for determining the financial thresholds or other criteria needed to qualify for accredited investor status and eligibility to invest in hedge funds.

International Aspects

It is axiomatic that the financial crisis has international dimensions. The financial markets are globally integrated and financial stability must be cross-border in order to ameliorate systemic risk and prevent regulatory arbitrage. Thus, reform legislation must provide for the global monitoring of system stability and the regulation of cross-border systemically important institutions. For the proper regulation of cross-border institutions that can impact systemic risk, there must also be strong international cooperation and clear rules. At the same time, it is also clear that sovereignty will prevent an international mandatory regulatory regime by treaty. But there is still a need for some form of international financial regulatory harmonization, if for no other reason than to prevent regulatory arbitrage or a race to the bottom.

In this spirit, the draft seeks to promote the effective and consistent global regulation of swaps and security-based swaps by directing the SEC and CFTC to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation of these swaps. The SEC and CFTC may also engage in information-sharing arrangements with foreign regulators as deemed necessary or appropriate in the public interest or for the protection of investors and swap counterparties. ❐

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